LEGISLATIVE SOLUTIONS TO ABUSIVE MORTGAGE LENDING PRACTICES

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND
COMMUNITY OPPORTUNITY

AND THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MAY 24, 2005

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LEGISLATIVE SOLUTIONS TO ABUSIVE MORTGAGE LENDING PRACTICES

Tuesday, May 24, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY AND
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to notice, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Robert Ney [chairman of the Housing and Community Opportunity subcommittee] presiding.

Present: Representatives Bachus, Lucas, Ney, Kelly, Gillmor, Biggert, Shays, Miller of California, Feeney, Hensarling, Brown-Waite, Harris, Pearce, Neugebauer, Price, McHenry, Kanjorski, Waters, Sanders, Maloney, Velazquez, Watt, Carson, Sherman, Lee, Moore of Kansas, Ford, Crowley, Clay, Israel, McCarthy, Baca, Lynch, Miller of North Carolina, Scott, Davis of Alabama, Green, and Moore of Wisconsin.

Chairman NEY. The hearing will come to order.

Without objection, all members' opening statements will be made part of the record.

Today, we have two subcommittees which are meeting to continue to look into the important sub-prime mortgage market and its importance to consumers.

In the past few years, Chairman Bachus—whom we welcome today and thank for all his efforts—and I have taken a great deal of time to investigate and find solutions to the problems of abusive and predatory lending practices, especially in the sub-prime market.

We first began by holding roundtables to discuss these practices, sub-prime lending in general, and ways to ensure credit availability to those who need and want it. Those roundtables I think were very good, very successful. Many members on both sides of the aisle attended them. We also appreciated Mr. Kanjorski, among others, Ms. Waters and other members who are here today, both sides of the aisle that attended these roundtables.

In addition, last Congress we had a number of joint hearings to continue to investigate this issue that affects all participants in the mortgage market. Today, we will move this process forward by examining potential legislative solutions to these lending practices.

In March, I introduced, along with Congressman Paul Kanjorski of Pennsylvania—and I want to thank Mr. Kanjorski, who has just arrived on cue, for his support of this measure. I think he brings a tremendous amount of credibility to the bill and put in countless hours, he and his staff, Todd, who is here today, and our staff, in drafting this measure, which aims to stop abusive lending practices, while allowing the mortgage market to continue to offer affordable credit.

Congressman Kanjorski and I worked long and hard to craft a legislative solution that drew from the many hearings this committee held last Congress, as well as the thoughts and suggestions of all those who will be affected by the bill.

Congressman Kanjorski and I believe, I think it is safe in saying, that we have struck a lot of good compromises in this piece of legislation. I believe this bill provides the most comprehensive balance and effective set of legislative solutions that any Federal or State bill has ever offered for protecting mortgage borrowers from abusive, deceptive and unfair lending practices.

We have also come to understand, like all legislation many people have ideas about how it can be changed or improved further, according to people's points of view. As we stated from the beginning, we are willing to continue always to talk about the issues and always to look at the piece of legislation. That being said, I strongly believe the approach and the principles embodied in the Responsible Lending Act are the appropriate way to address the problem.

The United States mortgage market is the deepest and most affordable in the world due to the evolution of unique funding structures for mortgages. Americans pay less for mortgages than almost anyone else in the world. As a result, this country has the world's highest homeownership rate. However, many consumers have had to pay more for credit than they should because of abusive and deceptive lending practices. Many State laws, as well as the mortgage lending industry itself, have done a lot to stop these practices.

Unfortunately, the resulting patchwork of State and local laws threatens to undermine their intent, which is to provide affordable mortgage credit to consumers who need it the most. The time has come for a uniform national standard in this area. The Ney-Kanjorski Responsible Lending Act recognizes this fact and attempts to strike a balance between protecting consumers from unscrupulous practices and creating uniform regulations that will allow mortgage lenders to offer borrowers affordable credit options.

I look forward to hearing from our witnesses, and again I want to thank Chairman Bachus for his support on this issue, and again Mr. Kanjorski. For the record, I am going to just enter the cosponsors, but we have tremendous members from both sides of the aisle who I think bring an amazing amount of credibility to the process and also credibility to the issue.

With that, I want to recognize the gentleman from Pennsylvania.

Thank you.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, I want to say that it has been a pleasure in cooperating with you and coordinating with you on the Ney-Kanjorski bill. I think we have something here. I think we have a process in work and I look forward to that work today.

I can say I am pleased that you have convened this meeting at this stage of the process. I commend you for convening and working on this over the last several years with me.

In recent years, the sub-prime mortgage industry has grown dramatically. In 1994, sub-prime lenders underwrote just $34 billion in mortgages. By 2004, this figure had ballooned to more than $600 billion. As the sub-prime industry has matured, complaints about abusive lending practices and concerns about conflicting State laws have also grown.

As my colleagues already know, I have spent several years studying these matters. As a result, I have come to the conclusion that there is a genuine need for a strong, uniform national sub-prime lending standard with appropriate enforcement mechanisms to protect consumers.

Because the problem of abusive lending is complex, it also deserves a comprehensive solution. Beyond establishing uniform national standards, we need to improve housing counseling and better mortgage servicing. We also need to enhance appraiser independence and oversight, and strengthen mortgage broker licensing and supervision.

H.R. 1295, the bill that I have introduced along with Congressman Ney, achieves these five important objectives. Several of my colleagues have also introduced their own bills to address these issues. As a result, I am hopeful that in the coming months we can build on the growing bipartisan consensus in Congress about the need to address these matters.

Because the adoption of a uniform national standard is a key issue in these debates, I would like to focus briefly on why we need one. Establishing a uniform national standard will help us to ensure that consumers receive the same set of protections no matter where they live or from whom they borrow. A uniform national standard will also ease regulatory burdens, level the competitive playing field, and ensure the affordability of loans for all consumers.

We are fortunate to have with us today a diverse group of witnesses. I already know that they will speak forcefully and candidly about their views in these matters. I also hope that they will share with us their ideas for how we can improve H.R. 1295, the Responsible Lending Act.

In particular, there are a number of questions that I hope these experts will address. How should we refine the bill's preemption language? Should we ban mandatory arbitration and single-premium credit insurance on all loans? Should we also improve upon the bill's appraisal independence standard to incorporate a ban on collusion?

In closing, Mr. Chairman, we need to ensure that all homebuyers and homeowners are appropriately protected in today's complex mortgage marketplace. Today's hearing will further our debates in these matters and hopefully build a consensus for enacting a sub-prime lending bill into law later in this session.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Kanjorski can be found on page 118 of the appendix.]

Chairman NEY. I thank the gentleman for his comments.

Chairman Bachus?

Mr. BACHUS. Thank you, Chairman Ney. I thank you for convening this fourth joint hearing of our two subcommittees to review issues relating to sub-prime mortgage lending.

As Mr. Kanjorski and others have said, this market in 10 years has grown from $34 billion to $600 billion; from one out of every 20 mortgages to one out of every four mortgages. So it has been a dramatic shift in the number of sub-prime mortgages. It is time we do take a look at it and see if uniform standards would be an appropriate response.

In November 2003, we held a hearing which examined ways to eliminate abusive lending practices in the sub-prime lending market, while preserving and promoting affordable lending to millions of Americans.

Our second hearing last March focused on the characteristics of sub-prime borrowers and the advantages and disadvantages the market poses to the financial security of these consumers.

Our third hearing last June explored the role that the secondary market plays in providing liquidity to the sub-prime lending industry and creating homeownership opportunities for Americans with less than perfect credit records.

That is what we are dealing with today. We are dealing with people who do not have perfect credit scores and their attempts to get mortgage financing. Today's hearing will focus on legislative proposals to abate and eliminate abusive mortgage lending practices.

Earlier this year, Chairman Ney and Congressman Kanjorski introduced H.R. 1295, the Responsible Lending Act, which contained a number of new and comprehensive solutions to mortgage lending problems and abuses. As I say today, it also generated T-shirts, so it is evidently maturing.

The other major legislative proposal to address this issue is H.R. 1182, the Prohibit Predatory Lending Act, which was introduced by Congressman Brad Miller and Congressman Melvin Watt. I am not sure that you generated any T-shirts or slogans yet, Congressman Watt, but I have not seen any.

Congressman Ney, Congressman Kanjorski, Congressman Watt and Congressman Miller all deserve a lot of credit for their tireless efforts on this issue over the past year. I look forward to working with them and the entire committee to come up with some solution to the problem.

Unfortunately, the increase in sub-prime lending has, in some instances, increased abusive lending practices that have been targeted at more vulnerable populations. We have heard past testimony in this committee about practices toward the elderly and minorities.

An NPR story which ran last week talked about the fact that a sub-prime lending market has developed for offering illegal immigrants home loans. I do not know if any of you have seen those stories. At least according to NPR, these immigrants, some of them, do not have green cards. They do not have legal identification. They do not have a Social Security number or even a bank account.

One disturbing problem about this is not only I think first of all it tells us the fact that a market has developed for illegal immigrants for mortgages, it shows that the immigration crisis is obviously a large crisis, and an illegal immigrant homebuyers market has developed. The other thing that the story highlighted is that these illegal immigrants are being taken advantage of by predatory home lenders.

The mortgage companies, again according to NPR, see no problem with giving a home loan to illegals, some with no credit history or bank account. The approach apparently is even if the immigrants default on their loans or are deported, the mortgage company still gets the house back. It apparently is a win-win situation for the lenders and a no-win situation for the illegal immigrants. So this again just highlights the fact that in certain cases our illegal immigrant population is being abused and taken advantage of in so many ways.

Predatory loan features include excessive high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flippings, loan steerings and unnecessary credit life insurance. Predatory lending has destroyed the dream of homeownership for many families, while leaving behind devastated communities. Hopefully, today's hearing will help us come up with solutions to address this issue.

Let me close by saying this—predatory lending is not sub-prime lending. There is a difference and you should not use these terms interchangeably because there are, in fact today we are going to have testimony from some sub-prime lenders who do not practice these abuses and are not guilty of these abusive practices. What they do is they provide people with less than perfect credit the opportunity to own a home.

The testimony before this committee in the last year is we have increased homeownership among minorities, from legal immigrant families, among the elderly, by the use of sub-prime lending. So sub-prime lending market is not a dirty word. Predatory lending is a dirty word, and there is a distinction between the two. It is one that we should bear in mind and not use those terms interchangeably.

What we are attempting to do by this series of hearings is establish some uniformity in the sub-prime lending market and keep predatory lending practices out of that market. It is something that I think most of the large sub-prime lending companies very much want. It is something the consumers would welcome. It is a win-win situation for all of us.

I will close by saying that I am committed to putting an end to predatory lending, this committee is, while at the same time preserving and promoting access for all homebuyers to affordable credit. I again commend Chairman Ney for his leadership, both in presiding over these important hearings and in advancing creative solutions to the predatory lending problem. I think with Congressmen Miller's, Kanjorski's and Watt's help and that of others, we can fashion a good piece of legislation.

I look forward to hearing from our witnesses, and I yield back the balance of my time.

Chairman NEY. I thank the gentleman.

The gentleman, Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

I thank the Ranking Member for allowing me to go since I have to go to another appointment, and because I do kind of have a dog in this fight, as Mr. Bachus has indicated.

There are some things that I think we should focus on first that both the Ney-Kanjorski cosponsors and the Miller-Watt cosponsors agree on. We agree that there is a problem. There certainly is a problem in the predatory lending area. I know we agree because we had a discussion when we were doing our preliminary views in some document earlier in this term of Congress, that all sub-prime loans are not predatory loans. I think we agree that we need to find a way to separate the legitimate sub-prime and non-sub-prime loans from the predatory ones.

And then we start to ask ourselves some questions about which I am not sure whether we agree or disagree. I think I have detected in the opening statements perhaps a fairly substantial amount of disagreement.

The first question I would raise is, do we need to preempt all State law or do we need to preempt any State law? Are we going to be the big brother in this area, or is there going to be some semblance of respect for States' rights and federalism? Or is this yet another area where we are going to just take over the entire field?

And then, if we do agree that we are going to preempt all or some State law, should you adopt a standard that is the lowest common denominator, or should you adopt a standard that most of the testimony I have heard in all of our hearings suggests, that North Carolina has the right balance? Should you adopt that as the correct balance?

It should not go unnoticed that there are at least three people on this panel this morning who are from North Carolina and I think will have a perspective on that. Or should we be trying to adopt a standard, if we are preempting State law that is actually the highest common denominator that can be achieved?

I honestly have not spent a lot of time yet trying to figure out what the difference between Ney-Kanjorski and Miller-Watt, what those differences are. But most of you know that when we go out on breaks, I have a tendency to start reading this stuff, and I suspect that by the time I get back I will know what the differences are pretty substantially.

Some of the things I have read about Ney-Kanjorski, and these are not from my own independent verification, lead me to have a fairly substantial amount of heartburn. Despite that, if we have agreed that there is a problem and that there needs to be some fix of the problem, I hope that we are able to work our way to some common ground and try to reach a bill this term that will advance the rights of consumers.

I appreciate the gentleman and I yield back.

Chairman NEY. I thank the gentleman.

The gentleman from Texas, Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

As we enter this hearing, I am once again reminded of the physician's Hippocratic oath: First, do no harm. I fear that in our zeal to protect consumers from certain unfair lending practices, we may find that we have in fact protected them from any lending whatsoever.

In the past, we have heard testimony that this may have been the case in North Carolina, Georgia, New Mexico and New Jersey, all of which passed very restrictive laws aimed at so-called "unfair" lending practices. The practical effect was that most legitimate lenders ceased to make high-cost loans. Thus, many borrowers who failed to qualify for conventional loans ended up with no loans.

Mr. Chairman, those who fail to learn the lessons of history are certainly condemned to repeat them. I need not remind my colleagues on the committee that Americans currently enjoy the highest rate of homeownership in the history of America. The benefits of free enterprise and competition have been plentiful. With the advent of sub-prime lending, countless families have now had their first opportunity to buy a home or perhaps be given a second chance. The American dream should never be limited to the well-off or those consumers fortunate enough to have access to prime rate loans.

In addressing the issue of predatory lending, it is important that we do not act to tie the hands of mortgage lenders with the red tape of excessive regulation. Disclosure and transparency of business practices are important for consumers, but lenders must not be denied the flexibility to protect themselves from risk and to effectively price the credit risk of the consumers seeking loans from their businesses. A Financial Services Roundtable study has shown that origination costs for sub-prime loans are 30 percent higher. Servicing costs are more than double, and delinquency rates six times higher. Again, lenders must be able to price the credit risk if these loans are to be made.

If we truly want to be pro-consumer on this committee, I would suggest we find ways to work hard to make sure that we increase market competitiveness and not sow the seeds of the market's destruction. It is critical that we agree on what constitutes predatory lending and we isolate it from those reasonable players in the commercial market who are making homeownership opportunities available to low-income Americans.

Mr. Chairman, after careful consideration, I have chosen to cosponsor H.R. 1295, the Responsible Lending Act, which I believe represents obviously a compromise and a balanced approach. I certainly applaud your leadership and that of Mr. Kanjorski. Although I have great concerns over some of the provisions in the legislation that I fear may be overly burdensome or tantamount to price controls, I do believe the legislation does a good job in addressing many true predatory lending practices that often involve fraud and coercion, such as loan flipping, steering, and home improvement scams.

Importantly, the legislation would restrict assignee liability and create a uniform national standard that I believe will strengthen the ability of millions of Americans to access mortgage credit for the first time and achieve their American dream.

I thank the Chairman for his leadership and yield back the balance of my time.

Chairman NEY. Mr. Sanders?

Mr. SANDERS. Thank you very much, Mr. Chairman. Let me thank you and Chairman Bachus for holding this important hearing.

According to the Center for Responsible Lending, predatory lending is costing U.S. families $9.1 billion each and every year. Mr. Chairman, in the richest country on earth, the number of housing foreclosures in this country is a national disgrace. Between 1980 and 1999, both the number and the rate of home foreclosures in the United States have skyrocketed by almost 300 percent. According to a recent article in the New York Times, over 130,000 homes were foreclosed in the spring of 2002, with another 400,000 in the pipeline.

Many of these foreclosures are a direct result of predatory lending practices in the sub-prime mortgage market that must be put to an end immediately. According to the Mortgage Bankers Association, while sub-prime lenders account for 10 percent of the mortgage lending market, they account for 60 percent of foreclosures.

Mr. Chairman, according to figures compiled by National Mortgage News, new sub-prime loans totaled $290 billion in 2003, more than double the total loan volume for the year 2000. Homeownership is an American dream. It is the opportunity for all Americans to put down roots and start creating equity for themselves and their families. Homeownership has been the path to building wealth for generations of Americans. It has been the key to ensuring stable communities, good schools and safe streets.

Predatory lenders play on these hopes and dreams to rip people off and rob them of their homes. These lenders target lower-income, elderly and often unsophisticated homeowners for their abusive practices. Let us not forget that predatory lending is being perpetrated by the likes of Citigroup and Household International.

As a result of legal actions filed by the FTC, Citigroup agreed in September to reimburse consumers $215 million for predatory lending abuses, which represents the largest consumer settlement in FTC history. Household International has agreed to pay $484 million to reimburse victims of predatory lending, representing the largest direct payment ever in a State or Federal consumer case.

Mr. Chairman, let me be clear. We need to do more than simply help homeowners who are ripped off by predatory lenders. We need to stop predatory lenders from stealing people's homes in the first place. That is why Congress needs to pass anti-predatory lending legislation. We need strong standards that will not allow lenders to use loopholes to escape local and State laws. But we also must make sure that we do not prohibit State and local governments, the laboratories of democracy, from passing stronger consumer protection laws.

That is why I am a proud cosponsor of H.R. 1182, the Prohibit Predatory Lending Act of 2005, introduced by Representatives Brad Miller, Mel Watt and Barney Frank. This legislation is based on the State of North Carolina's predatory lending statute, which is widely considered the model State statute for preventing abusive lending, while preserving access to credit.

Mr. Chairman, since the North Carolina law was enacted, the State has seen a dramatic reduction in abusive or predatory subprime lending and refinancing. A recent study conducted at the University of North Carolina at Chapel Hill found that after the passage of the North Carolina legislation "there was a reduction of loans with predatory terms without a restriction on access to or increase in the cost of loans to borrowers" with imperfect credit.

Mr. Chairman, I know that this committee will also be considering H.R. 1295.

Chairman NEY. The gentleman's time has expired. Can the gentleman summarize?

Mr. SANDERS. Okay. I look forward to hearing what our witnesses will say about this legislation, but in my view it does not go far enough.

Thank you, Mr. Chairman.

Chairman NEY. I thank the gentleman.

Ms. Kelly of New York?

Mrs. KELLY. I have no opening statement. I am anxious to hear from the witnesses, Mr. Chairman.

Chairman NEY. Mr. Miller of North Carolina?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chair.

I agree with those who today have said that Congress's goal should be trying to provide a reasonable set of consumer protections, while at the same time assuring that credit remains available in the sub-prime market both for home purchases, purchase money mortgages, and for those consumers who need to borrow money against their home.

I also extend the invitation to all who are interested to discuss the provisions of Ney-Kanjorski and the bill that Mr. Watt and I have introduced, or any other proposals. I certainly welcome that opportunity to sit down, not just with consumer advocates, but with mortgage lenders, with mortgage brokers, with the bond market, with all God's children, to talk about this bill and these provisions.

I understand that there perhaps were discussions in the last Congress in the last several months over the Ney-Kanjorski bill and the provisions of that, but I do not believe that consumer advocates, those who are advocating from the consumer point of view, were involved in those discussions.

Although there may be some consensus or some compromise within the industry, to those who look at this from the consumer point of view, describing Ney-Kanjorski as a compromise bill is like the character in the Blues Brothers movie who said that he liked both kinds of music, country and western. Mr. Chairman, there are other points of view that need to be heard.

Thank you.

Chairman NEY. Ms. Harris of Florida?

Ms. HARRIS. Thank you, Mr. Chairman. I wish to thank you for holding this important hearing today, and I also wish to thank the distinguished members of the panel for joining us.

Consumer protection through disclosure is constituted as a staple of Chairman Oxley's leadership on the Committee on Financial Services, and certainly Chairman Ney's leadership in this subcommittee. Our discussions regarding this matter should remain consistent with this theme.

I believe that homeownership provides families and individuals with an unparalleled opportunity to generate wealth. Studies have shown that when a family of low-income persons, their net wealth is about $900 when they rent and it skyrockets to over $70,000 once they own their own home. So for most Americans, the ability to secure a mortgage is central to their ability to purchase that home.

Damaged credit that has resulted from past mistakes or financial reversals can serve as a major obstacle, thus the willingness of certain lending institutions to underwrite the increased risks associated with damaged credit constitutes an important service that provides a second chance for millions of people.

Regrettably, the abusive practices of bad actors which prey upon elderly and minority populations throughout my area have resulted in the demonization of an entire sub-prime industry. Nevertheless, we cannot ignore the effects of predatory lending when we truly seek to help the nonconventional borrowers overcome substandard credit.

While I applaud the industry and State-level initiatives to address unscrupulous lending practices, I contend that we must formulate a national policy that supplements and enhances these efforts. I look forward to the suggestions of today's panel which I hope will provide us with viable alternatives for reforming the sub-prime industry, without eliminating the critical borrowing opportunities that enable men, women and children to escape the grip of poverty.

Thank you, Mr. Chairman.

Chairman NEY. I thank the gentlelady.

Mr. Moore of Kansas?

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. I appreciate you and Chairman Bachus and Congressman Kanjorski for holding this hearing today.

Over the last few years, this country has experienced an exceptionally strong housing market that has created wealth for Americans of all income levels and sustained our generally healthy national economy. The new wealth created in our country by growth in home equity has accrued not just to wealthy homeowners, but also to brand new homeowners who have taken advantage of historically low interest rates and a competitive lending market to buy a home.

In fact, much of the growth in our housing market has come from individuals and families who have never been able to own a home in the past. Many new homeowners have benefited from the rapid growth in the sub-prime market. According to the FDIC, in 2004 approximately 20 percent of all new mortgages were sub-prime loans, an increase of over 11 percent from 2003, when sub-prime loans accounted for approximately 9 percent of all loans.

However, the growth of the sub-prime market has been accompanied by an increase in abusive lending practices as some lenders have exploited consumers' confusion with the complicated process of buying a home, to charge excessive rates and fees that far surpass comparable rates. Predatory lending is now a national problem, one that I believe requires a national solution.

While approximately half of the States and nearly two dozen localities have passed separate anti-predatory lending statutes and regulations, the State of Kansas, for example, does not have a statute defining "high-cost" mortgages and providing remedies to consumers who have been the victims of predatory lending.

Ney-Kanjorski would significantly strengthen the Homeownership and Equity Protection Act, which currently regulates abusive lending practices in Kansas. Ney-Kanjorski will strengthen the predatory lending laws that control in Kansas, and for that reason I am adding my name as a sponsor of H.R. 1295. At the same time, Ney-Kanjorski is not a perfect bill and has some room for improvement. While I recognize that not everyone will support this bill, I hope that members of the committee can work together as we did on the Fair Credit Reporting Act and came together with I think a great overall piece of legislation.

Here, we can do something that protects borrowers, and also continues to make credit available to potential homeowners and preserves lenders' access to the capital markets. While I support the uniform national standards in Ney-Kanjorski, I also believe that as currently drafted, Section 106 is overly broad and should be revised in such a way that Federal regulators, in this case the Federal Reserve Board, have the ability to identify, define and prohibit new abusive lending practices that may arise in the future.

Additionally, some provisions of the Miller-Watt bill could be used to improve Ney-Kanjorski as currently drafted. The right-to-cure provision in Miller-Watt, for example, is stronger than the similar provision in Ney-Kanjorski and could be an area in which H.R. 1295 might be improved. For that reason, I am also adding my name as a cosponsor of Miller-Watt and look forward to coming up with an overall bill that I think will accomplish what our objectives are in this area.

Thank you again, Mr. Chairman.

Chairman NEY. Thank you.

The gentleman from Georgia, Mr. Price?

Mr. PRICE. Thank you, Mr. Chairman.

I, too, want to add my thanks to the Chairman and Chairman Bachus for holding this hearing on this remarkably important issue. In a former life, I was a member of the Georgia State Senate, and we struggled and stumbled and struggled with this issue, and ultimately arrived, I believe, at a compromise that was really a delicate balance, but it is good for the citizens of our State.

So I look forward to the testimony and I would ask each panelist to specifically comment, if you would, on the appropriateness of a Federal role in this issue. I look forward to your comments.

Thank you so much.

Chairman NEY. Thank you.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I, too, want to commend you for having this hearing. I do not think we can grapple with a more important issue facing the American people than protecting their homes, which is the best first foundation of building wealth.

As my colleague from Georgia mentioned, Mr. Price, I, too, am from Georgia and for 10 years served as the Chairman of the Senate Rules Committee through which came much of our final legislation dealing with this issue. Before that, I was the author of the bill to respond to the Fleet financing debacle that happened in Georgia. So for many years, I have been grappling with this issue.

I concur with both the Ney-Kanjorski bill and the Watt-Miller bill, and I am a cosponsor on both of those pieces of legislation. But what I would like to do is to appeal to this committee, to all interested parties, that we have got to ratchet up the issue of financial education. For no matter what we do, no matter what laws we put on the books, if we do not provide those vulnerable people, those who are targeted, predatory lending a targeted, a targeted phenomena. Very few people in this room are going to be targeted for predatory lending. Predators know where to go. That is why they are called predators.

They go to the African-American community. They go to minority communities. They go to low-income communities. They go to seniors. They go to those communities that do not have the information and do not have access to that information. So while we grapple with balloon payments, while we grapple with preemption, while we grapple with excessive insurance costs, while we grapple with packing and all of these detestable things that we do not like, I ask this committee to deal with financial education as a part of whatever we come out with.

A part of what I have talked about, I introduced in a bill earlier in my career here, 2 years ago, called the Financial Literacy Act. Much of those components have been embraced by the Ney-Kanjorski bill. But I want us to ratchet it up so we understand that we are not just talking about a program or a piece of paper or a booklet. We have to engage. We have to send out a direct pipeline to these targeted communities, a toll-free number that is answerable by human beings at the other end, not get a recording, not tell them to go to a computer someplace, but somebody there to answer and respond to them. These are vulnerable people, not sophisticated, but even myself or you, when you pick up that phone and you call for help, you want a human being at the other end.

Also in this measure that we have, we will get grants down to the grassroots to groups like ACORN, NAACP; give these groups, AARP, with the credibility that is targeting and communicating with their constituency, grants to help market the toll-free number, to give these people help, so that in essence we are sending a message to America's most vulnerable about predatory lending, to say before you sign on the bottom line, call this number. This toll-free number will also help us to be able to catalog the experience, to be able to measure it.

This phenomenon is not going to end with a bill. It is an ongoing process. And very, very critical to the success of dealing with predatory lending is to make sure we arm our folks who are going to be the most vulnerable, with a help line, with that toll-free number.

Chairman NEY. The time has expired.

Mr. SCOTT. And finally, Mr. Chairman, I just want to say one thing. I know in the bill, I am mighty afraid that the infrastructure for the toll-free number and where we want to put this program, I think it has been designated to HUD. I have some strong reservations about that, as a result of seeing HUD being basically dismantled before our eyes. So I want us to look at this information and this financial literacy and the education, a toll-free number, lifted up and make sure that we put this in the right place in the Federal Government where it can do the most good.

Thank you, Mr. Chairman.

Chairman NEY. I thank the gentleman.

Mr. Miller of California?

Mr. MILLER OF CALIFORNIA. Thank you, Chairman Ney.

California is experiencing a very strong housing market, but nationally there is an affordability crisis we are having to deal with. It is significant. In California, our homeownership rates lag the rest of the nation by about 10 percent. We are about 56.9 percent. That is rather scary.

I praise Chairman Ney and Mr. Kanjorski for the bill they are putting out because we need a workable uniform national lending standard. We do not have that currently. There is no question that some non-prime borrowers are subject to abusive practices. We really have to effectively deal with that. There is no question that the number of asset borrowers out there are victims of practices that become victimized by poorly crafted protective languages by States or local municipalities.

When cities start drafting their own predatory language, you oftentimes force sub-prime lenders out of the marketplace because it is difficult to keep up with the requirements from city to city. So we do need a national standard. We need to understand clearly there is a huge difference between predatory and sub-prime, and too many people want to sweep both of them under the same carpet, saying if you are not prime, you are predatory.

We need to be very, very cautious because if we eliminate the sub-prime marketplace, we are going to hurt a lot of people whose credit is not necessarily stellar, but they should qualify for a sub-prime loan. If we become too dictatorial and we put too many requirements on that, you are going to wipe out a marketplace.

That is scary because there are people out there who are qualifying for sub-prime. If that market was not available to them, they would be paying outrageous rates today, or it just would not be available to them at all, and they would be stuck renting an apartment somewhere. That is not what we are trying to emphasize in this country and this committee. We are trying to emphasize homeownership. The legislation we are crafting, the bills we are putting out emphasize the need for homeownership in this country.

So yes, predatory lending is atrocious. It needs to be absolutely dealt with, but you just cannot necessarily couple that with the sub-prime market. There are bad people in every sector of society and there are some bad people in sub-prime. We are going to have to make sure they are eliminated. We need to do everything we can. I believe the Ney-Kanjorski bill goes a long way toward doing that.

I praise you for this hearing today, Mr. Chairman, and I look forward to the testimony. Thank you.

Chairman NEY. The gentlelady from New York, Ms. Velazquez?

Ms. VELAZQUEZ. I have no opening statement, Mr. Chairman.

Chairman NEY. Ms. Lee of California?

Ms. LEE. Thank you, Mr. Chairman.

I want to thank you and Chairman Bachus, our Ranking Members, Ms. Waters and Mr. Sanders, for holding this very important hearing today.

Unfortunately, too many of our constituents, mine included, know first-hand the devastating impact of predatory lending practices by what I call loan sharks. It is downright criminal in terms of the type of penalties and practices that are targeting hardworking homeowners and stripping them of their wealth. These practices, as you know, are particularly a threat to the African-American and Latino communities. That is why we must have strong anti-predatory lending laws.

So as we consider the two major bills that address the issue of predatory lending, I want to go on record early in opposition to the Ney-Kanjorski bill as it is currently written. At this point, Mr. Chairman, I would ask unanimous consent to include into the record two letters in opposition to H.R. 1295. They are from ACORN, AFSCME, the AFL–CIO, AARP, Center for Community Change, National Consumer Law Center, the NAACP, and the National Council of La Raza, among many, many others. So Mr. Chairman, I would like to ask for unanimous consent to insert these letters into the record.

Chairman NEY. Without objection.

Ms. LEE. And also The Washington Post article from March 25 entitled, "Civil Rights Leaders to Fight Lending Bill." So I think that the advocates have united in opposition to this bill and I would ask that my colleagues read these letters and consider the issues that they raise.

H.R. 1295 does not simply fail to protect borrowers from predatory lending. It does not simply wipe out strong State laws. It actually makes matters worse. So I would encourage my colleagues to look at H.R. 1182, the Prohibit Predatory Lending Act by Congressmen Miller and Watt, for a bill that would actually help to protect homeowners from abusive mortgage lending practices.

We owe it to our communities to empower them to build wealth, not to push them into foreclosure and bankruptcy. We owe them strong protections. We owe them a bill that will truly address abusive practices and not make matters worse.

Thank you, Mr. Chairman. I look forward to the hearing.

Chairman NEY. I thank the gentlelady.

Ms. Brown-Waite of Florida?

Ms. BROWN-WAITE. Thank you very much, Mr. Chairman.

I do not have an opening statement, but rather I look forward to hearing from the witnesses and commend you for putting together the hearing on legislative solutions to abusive mortgage lending practices.

Thank you.

Chairman NEY. The gentlelady, Ms. Biggert of Illinois?

Mr. BACHUS. Mr. Chairman, I would like to point out that Ms. Biggert, as Mr. Scott, talked about financial literacy, and she has been a leader in this field. I would just point out to the committee that I think she could be a great help in what you mentioned.

Chairman NEY. Mr. Green of Texas?

Mr. GREEN OF TEXAS. Thank you, Mr. Chairman.

I would like to thank our Ranking Member and also thank the members of the panels that will appear today for appearing with us.

Mr. Chairman, I understand that not all sub-prime lenders are predatory lenders, but I also understand that most predatory lending practices occur in the sub-prime lending market. I do believe that this does merit some of our considerable attention. We are talking about now the means by which most people start their wealth-building process, by acquiring a home. If they are stripped of the equity in the home, if they have an onerous balloon payment, if they have excessive interest rates, it makes it very difficult for that wealth-building process to become a reality for them.

I look forward to hearing from the persons who will testify. I do want to make it clear, however, that I am honored to support H.R. 1182, and trust that we will have an opportunity to strengthen the legislation that will protect wealth-building in this country.

Thank you.

Chairman NEY. The gentleman from Connecticut, Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman. Thank you for holding this hearing. I look forward to hearing from the witnesses.

Chairman NEY. Ms. McCarthy?

Mrs. MCCARTHY. Thank you, Mr. Chairman, for holding this hearing. I am looking forward to hearing from the panel. Thank you.

Chairman NEY. Mr. Neugebauer of Texas?

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I thank you also for holding this hearing.

I have been in the housing business for over 30 years, and actually did some mortgage lending. When we first, in the 1970s and 1980s, there was really no sub-prime market. In other words, a person either qualified under Fannie Mae or Freddie Mac guidelines, and if they fell within those guidelines, they got to buy a home. If they did not, they were given no other alternative. One of the reasons for that was there was no secondary market for "non-qualifying" loans.

So I think we are very fortunate in this country today that we have homeownership at the highest rate ever in the history of our country. Homeownership among minorities is up also. So I think ways that we can continue to encourage lenders to participate in this lending to hopefully open up homeownership for more Americans is a very positive thing.

I look forward to looking through and going through the process of this legislation and seeing if there are some areas where improvement is needed. But certainly, the goal would be not to discourage sub-prime lending, but to encourage it and to help facilitate that. I look forward to continued discussion.

Chairman NEY. Mr. Israel from New York?

Mr. ISRAEL. Thank you, Mr. Chairman. I will be very brief.

This has been a very good process, I believe, about 3 years of consideration on this issue. I think that we have all arrived at a general consensus that while we want to do everything we can to expand access to credit, we clearly cannot abide abusive practices, fraud, discrimination, steering, loan packing, unreasonably escalating payments, loan flipping, harsh balloon payments, and unreasonably harsh prepayment penalties.

I believe that Ney-Kanjorski is an imperfect bill, but it is a very good start at arriving at a common sense resolution that helps protect against these deceptive, misleading, coercive practices, while ensuring that access to credit to those who would not otherwise qualify is provided. I will continue to work closely with both sides of the aisle in the hopes that we can arrive at a common sense resolution to this issue.

I thank the Chairman for this hearing and yield back the balance of my time.

Chairman NEY. The gentleman from Massachusetts, Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman, and Chairman Bachus. I would like to thank you both, as well as Ranking Member Waters and Ranking Member Sanders for holding today's hearing.

Mr. Chairman, I think that this committee is taking an important step with today's hearing to open up the lines of communication on this issue surrounding predatory lending. I think this aspect of the debate was missing from our recent debate around bankruptcy reform, where we took away certain protections from folks who got into financial trouble and yet we did not address the issue of those who led them there to positions of financial infirmity.

I hope that at the end of this legislative process, a true bipartisan solution can be reached that will give consumers the protections they need, as well as to facilitate the ability of our local lenders to operate effectively in the sub-prime market.

I am sure we all agree that predatory lending is harmful to consumers and creates problems in the marketplace. I have received calls, as I am sure many of my colleagues have as well from constituents who have ended up with bad loans and who are now at the risk of losing their homes. I want to welcome a constituent of mine here today, Monica Saddler from Hyde Park in Massachusetts, who is here to help bring a personal face to the real consequences of predatory lending.

However, despite the mutual concern that we have about the issue, there are philosophical differences about how best to curb predatory lending practices without shutting down the sub-prime mortgage market. It is the job of this committee to navigate the differences between the legislative proposals to develop consensus on this legislation.

In my home State of Massachusetts, legislators worked together to come up with a comprehensive predatory lending statute that was passed last year. I am curious to learn from today's witnesses their opinion on how the legislative proposals reflect a departure from strong consumer State laws such as the one in my home State.

I understand that it can create a difficult marketplace if businesses have to play by 50 different sets of rules. That is why it is so important that we strike the balance that is proper within any Federal legislation. At the end of the day, I would like to walk away from this hearing with a better understanding of any rights that my constituents would gain or any current protections they would be forced to give up if we move forward with Federal legislation action on predatory lending as proposed.

I do want to thank the members of this panel and the next panel for their willingness to come before the committee and help us with our work.

Thank you. I yield back, Mr. Chairman.

Chairman NEY. Thank you.

We have one 15-minute vote. We have three members left. When we come back, we will begin, and I appreciate your patience with the panel.

Next is Ms. Carson.

Ms. CARSON. Thank you very much, Mr. Chairman.

And thank you very much for the panelists who have assembled here today. For the sake of my district, Indianapolis, Indiana, it is probably one of the most important hearings that this subcommittee could have for my district.

Indiana has the highest foreclosure rate in the nation, which I am sure all of you know. There are many factors, of course, that perpetuate the foreclosures and the predatory lending. I created a 1–800 number for consumers to call before they sign their name on the dotted line. It has worked extremely well. I have taken the lead in my district to get to the bottom of all this. We have had indictments. We have had it all in the district.

So I appreciate very much the time that you have taken to come and provide us with your thoughts on this very critical issue that affects my district in a very personal way.

I yield back, Mr. Chairman.

Chairman NEY. I thank the gentlelady.

Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

Sub-prime lending is critical to not only our economy, but to individual families. You know, there are a lot of developed countries in the world where you cannot buy a home unless you can put one-third or 40 percent of the money down. I do not know many working families in America that could even dream of doing that.

Whereas here in the United States, many times if you have less than 10 percent down, and even if you have a flawed credit history, you can get a mortgage loan and achieve the dream of homeownership. We have to make sure that this access to credit, credit of 90 percent or more of the purchase price of a home, credit for those with less than perfect credit ratings, is not thrown away.

We have an absurd patchwork of legal restrictions on lending, both geographical and as far as legal category. What is allowed in one State is not allowed in another. Now we have different counties getting involved, cities getting involved. And yet we want a situation where lenders compete so consumers win. Lenders cannot compete for business and give people the benefit of a market economy if we split this country up not only into 50 different markets, but into as many markets as we have cities.

We also have an absurd patchwork in that we have one set of rules for most lenders, and then national banks have, well, no rules at all. We need, of course, to prevent predatory lending. We need good national standards that will achieve that. For those of my friends who want to see the toughest conceivable restrictions, Berkeley, California for example, and somehow feel that the Federal Government will take that away through congressional action, I can only say it has already been taken away by the bank regulators who have exempted a huge class of lenders not just from what Berkeley does, not just from what California does, but from virtually all rules.

So we can do a lot more to protect consumers by having national standards that apply to everyone, than by bragging about how we have achieved some incredibly tight straitjacket on some lenders in some municipal jurisdictions.

I yield back.

Chairman NEY. Thank you.

The gentlelady?

Ms. WATERS. Mr. Chairman, I would like to thank you for your interest in this subject matter, both predatory lending and sub-prime lending. I would like to thank you for giving all of our members the opportunity to get involved in this issue with your legislation and, of course, the legislation by Mr. Watt and Mr. Miller.

We have been wrestling with the subject of predatory lending for so long. I have been involved in this issue since my days in the California State legislature, where we were basically dealing with redlining at the time. I am opposed, as you know, to preemption. I would not mind if we could get strong legislation that would take care of all of the jurisdictions in this country and not preempt those jurisdictions which have good laws on the books.

Whenever you get national legislation, it is very minimal. I do not mind having some minimum legislation that would deal with some of these issues. However, I do not want to preempt those entities that have stronger legislation to protect the citizens of their region.

This business of sub-prime lending is understood by many of us, and we are not opposed categorically to sub-prime lending. As a matter of fact, there are some lenders who have products that I like very much. For those people who have had some problems, who have demonstrated that not only have they taken care of those problems, but they have worked very hard to do it, I do not mind them getting into products that would cost a little bit more, but they have to be able to roll out of those products at some point in time.

If you demonstrate that you can make your mortgage payment, that you can make them on time, then I think if you enter with a sub-prime loan then you should be able to exit at some reasonable point in time and revert to the kind of interest rates that would have been given to you had you not had that problem.

It is absolutely unacceptable what many of our lending institutions are doing. I just really understood for the first time that you can have one of these banks who have offices that are for people who are not going to have to worry about being given sub-prime loans, and they have branches in mostly minority communities where that is all you can get. One bank, different treatment for people depending on where you live and what your ethnicity is, I suppose. That is absolutely unacceptable.

I think that the housing market has been good to lenders. Everybody is making a lot of money. It would seem to me that our lenders would be a little bit more charitable. They should be coming to us talking about getting rid of prepayment penalties. And they should absolutely wipe out this discriminatory practice of charging people who live in a certain area more for their mortgages, higher interest rates, even though the amount of money that those people earn, the way that they have paid their bills, match those who come from other communities. They are still being ushered into these sub-prime loans.

It is wrong. It must stop. I have not really weighed in 100 percent on all of this legislation, but I am not going to be charitable. I am not going to worry as much as some of my colleagues about the institutions and the ability for the institutions to have their way. I have discovered in this business that these banks can take care of themselves. Not only can they take care of themselves, they go way beyond what any reasonable person would expect in taking advantage of those who cannot negotiate these environments and fend off these practices because they just do not have the tools to work with to do it.

So I think if this committee wants to do something admirable, would like to do something to really help the people of this country, we will work very, very hard to see that our citizens are not taken advantage of. We continue to talk about the American dream, to talk about how wonderful it is in America to be able to own a home. Well, let's do something about it and help people to own a home, not help people to get into these loans that will cause them to have to pay a disproportionate amount of their income; loans that are really pretty risky and will cause them to default.

I think we can do better than we have done in the past, and I think the legislation that we are proposing now can take care of all of these issues now. Let's not delay it any longer.

Thank you very much. I yield back.

Chairman NEY. I thank the gentlelady.

Ms. WATERS. Excuse me one moment. I am sorry. If you do not mind, Mr. Chairman, I was asked to enter this opening statement of Congressman Meeks who could not be here today through no fault of his own.

Chairman NEY. Without objection.

Ms. WATERS. He cares an awful lot about this subject and I would like to ask unanimous consent to enter it into the record.

Chairman NEY. Without objection, it will be entered into the record.

Mr. BACHUS. I would just like to associate myself with the remarks of Mr. Sherman, who I think pretty much distilled my reasons for wanting some legislation. I am sorry that I cannot agree with my colleague.

Ms. WATERS. I am sorry, too.

Mr. BACHUS. I was very persuaded by his argument.

Chairman NEY. If you do not mind, we are going to miss a vote, and we will come back to the panel.

Thank you.

The committee will be in recess.

[Recess.]

Chairman NEY. The committee will come to order.

We have one brief, I am told, opening statement by Mr. Davis, and we will start with the panelists.

Mr. Davis?

Mr. DAVIS OF ALABAMA. Thank you, Mr. Chairman. Let me let everybody get assembled, if you do not mind.

Mr. Chairman, first of all, thank you for being gracious enough to give me an opening statement. Let me try to be brief because I know that we want to move to the testimony.

I simply want to make three points. Number one, this is an enormously important hearing because I think the context around this issue has frankly changed since I have been in the House of Representatives. I think there was a perception several years ago that there was a disparity in sub-prime lending in the country. We are seeing more and more evidence of that.

The concern that some of us have is that we may be entering a phase where the disparity in sub-prime lending does have a racial characteristic to it, at least descriptively it has a racial characteristic. I certainly compliment my friends from North Carolina, Mr. Miller and Mr. Watt, for their efforts in this area. I do compliment Mr. Ney and Mr. Kanjorski for their efforts as well. But the one determination that I have coming out of this process is that if we are going to have a new bill, if we are going to have a national standard, that, A, it be a strong one; and, B, that it be a standard that speaks to this emerging disparity.

Homeowners in this country ought to have an expectation of a market that is not racially tinged. They ought to have an expectation of a market that reflects the realities of the marketplace, and not one that reflects any other hidden biases in our society. So I would just simply say that I thank again both the Chairs of this committee for calling this hearing and I am hopeful that we will adopt an effective standard and one that does address this emerging problem in our economy.

Mr. Chairman, thank you for being indulgent with me today.

Chairman NEY. I thank the gentleman.

The gentleman from North Carolina is going to introduce the first witness.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

There are actually three witnesses from North Carolina on this panel, which is impressive. Two are fairly familiar, I think, to members of this committee, or at least to those who do follow the committee's work. Stella Adams and Martin Eakes are well known nationally as consumer advocates. The witness that the Chair graciously allowed me to invite was Joseph Smith, the Commissioner of Banks of North Carolina. Mr. Smith is a graduate of Davidson and the University of Virginia law school.

He practiced law at a variety of corporate law firms. He was the General Counsel of RBC Centura, a large North Carolina-based bank, before becoming Commissioner of Banks approximately 3 years ago, where he has both regulatory and rulemaking authority over the mortgage industry. He has licensed 1,500 mortgage firms and 15,000 individual mortgage brokers.

Ms. Adams and Mr. Eakes bring to this panel the perspective of a consumer advocate, which as I said before, is an important perspective to have added to this debate. But Mr. Smith's perspective is that of a corporate lawyer, and a banking lawyer, and his experience in applying and construing North Carolina's law from that perspective.

Thank you, Mr. Chairman.

Chairman NEY. I thank the gentleman.

Welcome to Mr. Smith.

Stella Adams is the executive director of the North Carolina Fair Housing Center, a nonprofit organization seeking to create equal housing opportunity and equal access to all citizens. Ms. Adams is testifying today on behalf of the National Community Reinvestment Coalition. The coalition seeks to increase the flow of private capital into traditionally underserved communities. Its members include community development corporations, civil rights groups, community reinvestment advocates, local and State government agencies and churches.

Martin Eakes is the chief executive officer of the nonprofit Center for Community Self Help in Durham, North Carolina. The center, with its two financing affiliate Self Help Credit Union and Self Help Ventures Fund, seeks to create ownership and economic opportunities for minorities, women, rural residents and low-wealth families.

Micah Green is president of the Bond Market Association. The association represents the largest securities markets in the world, the estimated $44 trillion debt markets. Its membership accounts for about 95 percent of the nation's municipal securities underwriting and trading activity, and includes all primary dealers in the United States Government securities, all major dealings in United States agency securities and mortgage-and asset-backed securities and corporate bonds.

Regina Lowrie is from Mr. Fitzpatrick's district, he wanted me to note, and is president of the Gateway Funding Diversified Mortgage Services in Horsham, Pennsylvania. She is also testifying on behalf of the Mortgage Bankers Association, a national association representing the real estate finance industry. Its members comprise more than 70 percent of the single-family mortgage market and more than 50 percent of the commercial multi-family market.

Steve Nadon is the chief operating officer of Option One Mortgage Corporation, a subsidiary of H&R Block Incorporated, located in Irvine, California. He oversees the company's Option One and H&R Block mortgage origination business, as well as the internal lending operations. Mr. Nadon is testifying on behalf of the Coalition for Fair and Affordable Lending, the coalition which represents over one-third of the non-prime mortgage lending industry, advocates for national and fair legislative standards for non-prime mortgage lending.

I want to welcome all the panelists.

We will begin with Mr. Smith. Thank you.

STATEMENT OF MR. JOSEPH A. SMITH, JR., NORTH CAROLINA COMMISSIONER OF BANKS

Mr. SMITH. Thank you, sir.

Representative Ney, Representative Bachus, Representative Kanjorski, my friend Representative Miller and Representative McHenry, all Tarheels, and I will say, Mr. Chairman, your counsel is also a Tarheel, so I feel very at home with this committee.

Thank you very much for inviting me to participate in this hearing.

Chairman NEY. Maybe he has been in Washington too long and he forgot that. Thank you for reminding me.

[Laughter.]

Mr. SMITH. He admitted it to me.

Thank you very much for inviting me to testify. I filed written testimony and in the interest of time I will try to pull out a few salient points that I hope you will find of interest.

First, I cannot resist beginning with a glaring generality, which is that home mortgage lending in the United States today is a local transaction that is funded globally. That is the issue that confronts policymakers at the State level and here at the national level.

There has been a revolution in mortgage finance, as I am sure you all aware, over the last 25 years. I can remember my first mortgage, barely, with a thrift institution in Connecticut, of all places, years ago and it is not the same world at all now. The mortgage business has been deconstructed. Funding, origination and servicing are done by different firms, many of whom never have contact with the consumer or the community in which the consumer resides.

The results have been what I call the good, the bad and the ugly. The good is increased access, as you have discussed, to mortgage capital. The bad has been increased foreclosures. And the ugly has been predatory lending and its ugly twin, fraud, and I think they are related.

The States have taken action. North Carolina was the first to adopt an anti-predatory lending law because, let it be remembered, Federal standards at the time were insufficient to stop predatory conduct. That is why this whole business got started.

So what has been the result? I am not a statistician, and I know there are various studies about the impact of North Carolina's law, but I understand you are interested in that. I will say I sit regularly at an office in Raleigh, North Carolina and travel around North Carolina and hear from people who have problems in North Carolina. My office gets about 1,500 formal consumer complaints a year. We get about five times that many informal ones. Two-thirds of those are about mortgages.

I have been in this office 3 years. I have never heard a single example of a single person who has ever come to me, to anyone I know in government, to anyone I know or have heard from in our General Assembly, claiming they were denied mortgage credit because of our laws, ever. I understand there are other studies that say different things, but I must tell you, so far I have yet to meet the flesh-and-blood example for this issue.

Further, it appears to me fundamentally that the law has not driven people from the market. Among our top 15 sub-prime lenders in 2003, 7 of the top 15 were among the top 15 nationally. Option One, by the way, was our leading lender in North Carolina in sub-prime during that year. And they have roughly the same market share in North Carolina that they have elsewhere.

So I think the case has yet to be made, to be frank, that North Carolina's law has driven people out of the mortgage market, driven lenders away who really wanted to be there, or driven people away, or had the effect—direct or indirect—of denying people mortgage credit.

What do I think are the lessons that may be drawn from our experience and the experience of other States around the country? By the way, if we are crazy, if this is some sort of insanity on our part, it is shared by a number of other States who seem to have the same problems in the real flesh and blood world. Let me suggest to you five or so items that I would appreciate it, and I think you might well consider in looking at Federal legislation.

This first one I am doing with trepidation because I know I am going to get stoned over it by some, but the first question is whether there is a Federal standard required at all. I understand the issue about separate State laws, but to be frank, the bond market and the secondary market in mortgage securities does not seem to be suffering greatly. They have made a boatload of money and it is hard for me to see that they are sort of at death's door, but I am sure they can defend themselves on that. They may be. They may just look better than they feel.

Secondly, if you must have Federal standards, look to the standards that worked in the States. I would say that North Carolina's standard is a standard that you ought to look at.

Thirdly, and this is very important, if you adopt Federal legislation, please give the States coordinated enforcement authority of Federal standards in your law. It is wrong to think that a law, however good it may be, adopted by you can be enforced centrally.

Finally, we should also be included in mortgage oversight. I will say I am pleased to see and I hope you will continue to incorporate the efforts that are going on with the Conference of State Bank Supervisors pulling together a unified national application system and database in the mortgage industry.

I appreciate very much the time allotted to me and would be happy to answer any questions. Thank you very much for inviting me, sir.

[The prepared statement of Mr. Smith can be found on page 355 of the appendix.]

Chairman NEY. Thank you for coming here.

Ms. Adams?

MS. STELLA J. ADAMS, BOARD OF DIRECTORS, NATIONAL COMMUNITY REINVESTMENT COALITION

Ms. ADAMS. Thank you, Chairmen Ney and Bachus, and Ranking Members, Representative Miller, Representative McHenry. It is an honor to be here today as the voice of over 600 community organizations from across the country that comprise the National Community Reinvestment Coalition.

NCRC is the Nation's economic justice trade association dedicated to increasing access to capital and credit for minority and working-class families. Our member organizations represent communities from your congressional districts, organizations such as the Coalition of Neighborhoods in Ohio; the Community Action Partnership of Northern Alabama; the Community Action Committee of Lehigh Valley in Pennsylvania; and finally, the North Carolina Fair Housing Center where I am the Executive Director.

We appreciate your convening today's hearing on an issue that all of our members have been addressing for the last 10 years. In North Carolina, my organization worked tirelessly in coalition with the Community Reinvestment Association of North Carolina, Self Help, and other grassroots community organizations and industry to craft, promote and help secure the passage of North Carolina's anti-predatory lending bill.

Although North Carolinians enjoy some protection from predatory lending, there are still many States where consumers have little or no protection at all, and we believe that should change. Congress must ensure that any national bill related to predatory lending has at its core the need to provide consumers relief from abusive lending practices that steal homeowner equity, which is the primary and often the only form of wealth-building for most Americans.

I am reminded today of the words of the prophet Jeremiah: "Thus said the Lord, do justice and righteousness and deliver from the hand of the oppressor him who has been robbed."

Not all sub-prime loans are predatory, but predatory lending is a subset of sub-prime loans that takes advantage of borrowers not familiar with the lending process. The new 2004 HMDA data allows us to identify which communities receive the most sub-prime loans and are therefore most prone to predatory lending. For the first time, it includes pricing data for sub-prime lending. We found that minorities and women receive a disproportionate amount of sub-prime loans.

Last month, NCRC released a report that was one of the first studies to examine the new HMDA data. The written testimony talks about this study and other NCRC studies. These studies reveal that pricing disparities remain consistent over the years. One of the studies controls for credit-worthiness and still finds large disparities.

In the written testimony, we discuss the NCRC fair lending test report. This nationwide testing project examined large sub-prime lenders and revealed substantial differences in pricing and treatment based on race and gender. The testing project looked at pre-application stage. In addition, NCRC's consumer rescue fund reveals alarming and distressing real-life stories of what happens to people throughout the application process and the long-term effects of unsafe and unaffordable loans.

Mr. Ney, in the State of Ohio, NCRC is working with over 100 consumers, most of them elderly minority people, who are being uprooted from the homes they have lived in for over 40 years. These unsuspecting consumers fell victim to a home improvement scam and are now facing foreclosure. In Staten Island and Long Island, NCRC is assisting over 100 New York City policemen and firefighters who purchased homes from an unscrupulous housing developer and mortgage broker. For these 9–11 heroes, the American dream of owning a home has now become their nightmare.

In my home State, we have seen numerous victims of predatory practice, none worse than what happened to the folks in Vance County. The center investigated over 165 complaints against Donald Gupton and his many businesses. We filed complaints with the North Carolina Attorney General. He sold mobile homes to consumers whom the company knew could not keep up with the payments. He lied to customers about the price of homes, about their ability to refinance at a lower rate; falsified loan applications; misrepresented the value of the property by encouraging inflated appraisals of the homes and land sold to consumers.

A consent decree was entered, but it has had little impact on the over 200 victimized families. Because there is no assignee liability, most of these victims of appraisal fraud and predatory lending abuses face foreclosure or are stuck making payments on homes that are not worth one-third of what they owe.

In High Point, North Carolina, 11 mortgage brokers were indicted for faking downpayments and submitting inflated appraisals for loans they brokered, practices that allowed them to pocket the difference when the inflated loan came in. Again, there was no recourse available for the victims of homeowners who are stuck in these loans. Property flipping and inflated appraisals resulted in $23 million worth of fraudulent laws and 50-plus home foreclosures in rural Johnson County.

We believe there is a need for a strong comprehensive national bill. We believe that State anti-predatory lending laws have not choked off access to credit. While we believe that lenders can operate in the current regime of Federal and State legislation, we would favor a national law if it is comprehensive and builds on the best State laws such as North Carolina's, New Mexico's, New Jersey's and New York's. It is remarkable that about half the States in this country have passed anti-predatory laws, but that still leaves citizens in half the other States unprotected from predators.

Thus, a strong comprehensive national law is needed that expands upon the best State laws and existing Federal law and builds upon the best practices established by industry.

I would like to highlight a couple of key provisions that must be included in any national bill. H.R. 1295 contains a provision that strives to outlaw steering or making a high-cost loan to a borrower who can qualify for a prime loan.

Chairman NEY. I am sorry to interrupt you, Ms. Adams. The time has run over, but if you would like to summarize and submit for the record?

Ms. ADAMS. Yes, sir, I would.

Chairman NEY. I am sorry.

Ms. ADAMS. If you would allow, I would like to also introduce into the record a letter from the membership of NCRC.

Chairman NEY. Without objection.

Ms. ADAMS. And also our studies that I talked about in my written text.

Chairman NEY. Without objection.

Ms. ADAMS. Thank you so much.

[The prepared statement of Ms. Adams can be found on page 124 of the appendix:]

Chairman NEY. Thank you.

Mr. Eakes?

STATEMENT OF MR. MARTIN D. EAKES, CHIEF EXECUTIVE OFFICER, CENTER FOR COMMUNITY SELF HELP

Mr. EAKES. Good morning. Chairman Bachus, Chairman Ney, Ranking Member Sanders, Ranking Member Waters, my fearless leaders from North Carolina, Representatives Miller, Watt and

McHenry, thank you for holding this hearing today and thank you for letting me come to testify.

I am the CEO of Self Help and the Center for Responsible Lending. Representative Miller introduced me as a consumer advocate, but that is not the way I think of myself. I think of myself as a lender first. Self Help is a community development lender, the largest nonprofit community development lender in the country. In the last 21 years, we have provided financing of almost $4 billion to 40,000 families who were underserved and unable to get homeownership financing.

I will also tell you that Self Help is one of the oldest sub-prime lenders. We were doing sub-prime before anyone called it that. We were doing loans to people who were credit-impaired, but really good people who deserved to be able to own a home. For 21 years I have been making these loans and I have had virtually no defaults. So any sub-prime lender that has a large number of foreclosures, it means they are doing something wrong. It does not have to be done that way.

Five years ago, 6 years ago, in response to borrowers who came to us and said, we are about to lose our homes; could you look at our financing papers? I started looking at individual borrowers and found that the first one that came to me a borrower who had a $29,000 loan that he had refinanced and was charged $15,000 in up-front fees. When he walked out of that office, he was doomed to lose that home one way or another. When I called the lender to contest, the person said to me, well, you are just a competitor trying to steal my loan and I will not even tell you what the payoff balance is for this borrower.

That really infuriated me. And we set up an affiliate called the Center for Responsible Lending, a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

I want to tell you a little bit about how the North Carolina bill came about. I was the person who helped put together the leadership group that ultimately passed the North Carolina bill. Here is what we did that was quite unique. We brought together a group that included all of the mid-size banks in North Carolina, all the large banks, all the credit unions, the mortgage brokers, the mortgage bankers, the realtors, the civil rights groups, the housing groups, the community groups, the elder groups, AARP, everyone at one table to negotiate a bill.

We ended up with a bill that no one particularly loved because it was a compromise. No one got exactly what they wanted, but those of you who have been in Congress for any time at all know that when you have the credit unions and the banks together saying pass a law that will regulate each of us, so that we can get rid of the bad lenders in our marketplace, you know something unique has happened and a problem that is very pervasive is being addressed.

What North Carolina did, and it was very bipartisan, passed legislation that out of 170 legislators had only three dissenters. It was totally bipartisan in every regard. North Carolina started with two principles. The first was that we would not impose any more disclosures on borrowers or lenders. With 30 forms at a homeownership closing now, there is so much paperwork that adding one more would do more harm than good.

The second piece that we did that was quite controversial is we said, but it was what brought all of us together in the industry and the wealth-advocate community, is we said we are not going to put a cap on the interest rate that can be charged to homeowners. Instead, what we are going to do is gradually get rid of the hidden fees that borrowers do not know they are getting and allow that to be translated into the interest rate on the mortgages.

The truth is, it did not happen. That was the theory, but when we passed the four restrictions in the North Carolina bill, all of which went away, interest rates did not go up at all. So what this tells us is that in a competitive marketplace, these fees were really unnecessary.

Here is what the North Carolina bill did in four ways. It did four things. The first thing is it prohibited the practice of flipping. "Flipping" is something that is done as an alternative to a high-cost loan. Someone finds the measure, whether it is 5 percent fees or 8 percent fees, and offers a loan that is just below that, but does it repeatedly so that they eventually strip the wealth out of a person's home.

The problem with the Ney-Kanjorski bill is in its details. It prohibits flipping only for high-cost loans, so either it does not understand that flipping is an alternative to high-cost loans, but it means that it will have absolutely no effect in this bill. That was one of the most significant pieces in the North Carolina law.

The second thing the North Carolina law did is it prohibited prepayment penalties. What it was basically saying, a large consensus of all the legislators in North Carolina, is that we do not want people who get into a bad loan to be trapped in it forever. Let's let people get out so that they do not have $5,000 or $10,000 fees preventing them from being able to get from a bad loan to a good loan.

The third thing we did was prohibit single-premium credit insurance altogether. Now, I think this is an unintended defect in the language of the Ney-Kanjorski bill now, but it actually would reauthorize single-premium credit insurance in this bill. It defines the prohibition against single-premium credit insurance only for high-cost loans, but it does not include single-premium in the definition of points and fees to trigger the high cost.

Chairman NEY. Sorry to interrupt you, but if you could wrap it up because the time has expired.

Mr. EAKES. Okay. The final thing that the North Carolina bill did was to put a limit on loans that had greater than 5 percent fees. In this regard, many of the bills are similar.

But those are the only four things that the North Carolina bill did. Unfortunately, in the Ney-Kanjorski bill currently before us, three of the four things are applied only to high-cost loans and the exceptions in the definition of a high-cost loan means that they will never apply.

So thank you for letting me come today. I am a real technician. I hope you will ask me questions and let me be the geek that I am.

[The prepared statement of Mr. Eakes can be found on page 150 of the appendix:]

Chairman NEY. Thank you.

Mr. Green?

STATEMENT OF MR. MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION

Mr. GREEN. Thank you, Mr. Chairman. I thank you for the opportunity to testify today at this important hearing on predatory lending.

I am Micah Green, as the Chairman said, president of the Bond Market Association. I am also representing the views of the American Securitization Forum, which is an adjunct forum of the Bond Market Association. It is a broadly based professional forum of participants in the U.S. securitization markets.

At the outset, I would like to acknowledge the tremendous efforts of you, Chairman Ney, and your coauthor Congressman Kanjorski, for introducing the Responsible Lending Act and the many cosponsors who are both on this committee and in the House generally.

This is a clear-headed piece of legislation that to your credit reflects years of discussion and consultation with many and varied stakeholder groups with an interest in the very difficult public policy question of how to best curb predatory lending and ensure subprime borrowers have access to mortgage credit. Members of the BMA and the American Securitization Forum commend you for your efforts. We support the Responsible Lending Act and the clarity it would bring to the secondary market for sub-prime mortgages.

The secondary market, more broadly securitization, plays an important role in our lives, not just for sub-prime mortgage borrowers, but all consumers. Besides mortgages, car loans, student loans, credit card loans and others, are repackaged by the secondary market as marketable securities. The process links the needs of borrowers to the broader capital markets, not just a single bank or credit card company. Credit for home mortgages and other credit needs as a result has become more broadly available and less costly.

Why do financial market participants engage in securitization? Because issuers of these securities have a need for more capital to make new loans, which ultimately benefits consumers. Investors in the United States and the world have come to realize that asset- and mortgage-backed securities provide attractive and reliable returns. Investors are buying the rights to loan payments. The secondary market knows that in order to please its customers, investors, the pool of loans backing these securities needs to be reliable. Loans with predatory characteristics add uncertainty and risk to securitizations for which investors must be compensated.

These loans are more likely to default or repay early, which strikes at the heart of predictability and reliability sought by investors. They are also more likely to carry the risk of liability under one of dozens of anti-predatory lending laws at the State and local levels. Loans with predatory characteristics are obviously not in the best interest of borrowers, but they are also not in the best interest of the members of the Bond Market Association and the American Securitization Forum, who structure mortgage-and asset-backed securities because they are not in the best interest of the investors who buy those securities.

For these reasons, secondary market participants employ rigorous due diligence, policies and procedures to screen for predatory loans. Mr. Chairman, let me state the obvious. No one testifying today favors predatory lending. It is a blight on an otherwise thriving home mortgage industry. It benefits no one except for the rare bad actors who typically take advantage of the most vulnerable borrowers.

We believe that the Responsible Lending Act is the best chance yet to combat in a comprehensive manner predatory lending. It achieves the twin goals of borrower protection and the preservation of the benefits of securitization for those same borrowers. In several critical areas, the bill brings clarity to what are currently areas of uncertainty for participants in the secondary market for sub-prime loans. The bill clarifies what is a broad assignee liability standard in the Home Equity Protection Act to specify where secondary market participants would face liability for bad loans and when they would not.

Under this legislation, borrowers facing foreclosure could bring claims against assignees under the appropriate circumstances. And regardless of their credit standing, borrowers could also bring affirmative claims against assignees that act with reckless indifference toward the terms of the Responsible Lending Act. Borrowers are protected and have avenues for relief. The secondary market is preserved.

The Responsible Lending Act limits the damages of an assignee it could face under the liability provision to the actual economic loss experienced by the borrower. This is fair compensation for borrowers and a fair cost to assignees. Providing borrowers with an opportunity to recover an amount in excess of what an abusive lending term has cost them would not be equitable for the assignee that did not participate in the lending process. As with assignee liability in general, the exception to this rule is the instance when assignees exhibit reckless indifference, and there they have affirmative claims of action.

The bill would also introduce the concept of a right to cure and preemption directly into the Federal mortgage lending regulation. The right to cure grants an assignee up to 60 days after the discovery to correct a lending violation and fully compensate the borrower for losses incurred. By establishing a uniform national standard for sub-prime lending, the Responsible Lending Act eliminates the confusion and inefficiency created by 47 varied and sometimes conflicting State statutes.

In conclusion, Mr. Chairman and members of the committee, any public policy solution to the problem of predatory lending is unlikely to leave all borrowers and all lenders satisfied that enough has been done or enough has been averted. I think we would all agree that there is a need to fight the scourge of predatory lending in a balanced way that protects borrowers before the loan is made, provides the same borrowers an avenue for fair relief, and does so in a way that preserves the secondary market as a legitimate source of capital for sub-prime mortgages.

We believe the Ney-Kanjorski bill does that.

And I thank you for the opportunity to testify.

[The prepared statement of Mr. Green can be found on page 186 of the appendix:]

Chairman NEY. Thank you.

Ms. Lowrie?

STATEMENT OF MS. REGINA LOWRIE, PRESIDENT-ELECT, MORTGAGE BANKERS ASSOCIATION

Ms. LOWRIE. Good afternoon, Mr. Chairman and members of the committee. My name is Regina Lowrie, and I am president of Gateway Funding Diversified Mortgage Services in Horsham, Pennsylvania. I am also chairman-elect of the Mortgage Bankers Association and appear before you today on behalf of MBA. Thank you for giving us the opportunity to express and share our views with you today.

Mr. Chairman, let me begin by stating that MBA detests predatory and abusive lending. Such practices, however rare, are a stain on our industry and undermine the trust that consumers put in us. I believe that everyone in this room today shares the same ultimate goal, to end abusive practices in the mortgage market. It is imperative that in doing so we exercise wisdom and foresight.

Over the last decade, the creation of a national non-prime mortgage market has made mortgage credit available to thousands of families for whom homeownership was previously out of reach. Non-prime borrowers commonly have low-to-moderate income, less cash for a downpayment, and credit histories that range from less than perfect to none at all, borrowers whose credit has been damaged by divorce or illness, single moms and dads, teachers and firefighters who have gone through difficult times, but still aspire to the dream of homeownership.

A number of States and localities have passed a wide range of intention laws to combat abusive lending. Unfortunately, these laws often include subjective standards and create an immense compliance burden and higher costs for consumers. In the worst case, these laws have chased legitimate lenders out of certain jurisdictions altogether, reducing credit options for consumers. These consequences are inconsistent with the goal of maintaining access to affordable credit, while ending abusive lending practices.

While H.R. 1295 creates a tough standard for the industry to operate under, MBA believes it is a big step toward creating a uniform national standard. In general, it strikes the proper balance by providing strong consumer protections and clear, objective compliance standards that will help facilitate market competition. Regulators, think about this, regulators would have one standard to enforce. Consumers would have one standard to understand and lenders would have one standard to obey.

MBA supports a number of specific provisions included in H.R. 1295. Under H.R. 1295, more loans would be subject to the Homeownership Equity Protection Act, bringing greater protection to high-cost borrowers. The bill would extend HOEPA coverage to home equity lines of credit, purchase loans, and also lower the points and fees triggers from 8 percent down to 5 percent.

The bill also includes an opportunity for industry to promptly cure errors for consumers, as well as reasonable assignee liability standards. It is also important to preserve borrowers' options by excluding yields per premiums and prepayment penalties from the points and fees calculation.

In summary, Mr. Chairman and members of the committee, MBA, like all of you, detests abusive lending and is committed to eliminating it. We believe strongly that the appropriate response to the problem of abusive lending is a clear, consistent, reasonable national standard for a national mortgage market.

Once again, Mr. Chairman, I thank you for allowing me the opportunity to appear before you today. I look forward to answering the committee's questions. Thank you.

[The prepared statement of Ms. Lowrie can be found on page 206 of the appendix:]

Chairman NEY. Thank you.

Mr. Nadon?

STATEMENT OF MR. STEVE L. NADON, CHIEF OPERATING OFFICER, OPTION ONE MORTGAGE, ON BEHALF OF THE COALITION FOR FAIR AND AFFORDABLE LENDING

Mr. NADON. The Coalition for Fair and Affordable Lending appreciates the opportunity for me to testify on its behalf today. I am Steve Nadon, CFAL's chairman and chief operating officer of Option One Mortgage, which is a subsidiary of H&R Block and which is one of the Nation's largest non-prime mortgage lenders.

CFAL commends the lead sponsors of H.R. 1295 and H.R. 1182 and their staffs for the thought and hard work that they have put into these bills. Both bills are well-intended and have a number of good concepts, but both have some problematic provisions. Having reviewed both bills, CFAL favors H.R. 1295, but believes that the committee should further refine it, including, where appropriate, incorporating certain of the Miller-Watt bill's concepts.

The Ney-Kanjorski bill significantly enhances current Federal law, covering more loans, improving the existing provisions and adding effective and workable new safeguards on other specific lending practices. Most of these provisions equal or exceed those of most State laws. Quite importantly, its provisions are designed to prevent abusive lending practices without limiting borrowers' access to affordable mortgage credit and their ability to choose flexible mortgage financing options.

Ney-Kanjorski provides for uniform national mortgage lending standards which CFAL strongly supports. Current State regulations provide very unequal levels of protection for borrowers. Uniform national standards can ensure that all borrowers in this country wherever they live and whatever lender they choose, enjoy a high level of protection, and that all communities have mortgage capital available on fair and affordable terms. CFAL believes that both Federal and State regulators should actively enforce these nationwide standards.

H.R. 1295 also has very important additional provisions to greatly enhance financial counseling and education programs that are based on legislation developed earlier under Representative David Scott's leadership. We share Representative Scott's confidence that provisions in the bill that mandate establishing and widely publicizing the existence of both a toll-free telephone number and an Internet site that the public can use for information about reputable credit counselors to assist them in making mortgage decisions will be practical important tools for helping consumers navigate the mortgage process intelligently.

We think the committee also should consider having lenders pay a modest fee, perhaps $2, when loans are recorded after closing to help support State-and community-based education and counseling programs. A portion of this fee also could be used as a funding mechanism for enhanced State enforcement efforts.

H.R. 1295, however, is not perfect and it needs a number of further technical and substantive refinements. For example, while we strongly support preemption, the provisions in Ney-Kanjorski need to be scaled back so that they do not sweep in almost all mortgage-related activities, for example, closure laws, and are instead targeted primarily at State and local laws aimed at regulating mortgage lending practices, whether based on a loan trigger rate or some other mechanism.

We believe that the Ney-Kanjorski bill for the most part strikes a good balance between adding protections against abuse of these financing options and allowing lenders to continue offering these choices to borrowers so they can make their loans more affordable. However, the Miller-Watt bill takes a fundamentally different approach on each of these issues, which have substantially negative impacts on loan affordability for all non-prime borrowers, not just high-cost borrowers. Let me explain this problem.

Both Ney-Kanjorski and Miller-Watt lower the 8 percent trigger to 5 percent, but they take very different approaches in dealing with prepayment penalties, yield-spread premiums, and discount points. As noted above, Miller-Watt includes both yield spread and the potential maximum prepayment penalty in the calculation of points and fees, and the exclusion of discount points essentially does not apply with most non-prime loans.

The result of this is that in real terms the 5 percent trigger is more like 2 percent or less. This forces the lender to put more costs into the rate, significantly raising the rate and therefore raising the borrower's monthly payment. Under Miller-Watt, the borrower also is generally no longer able to use discount points to buy down his or her rate, or to accept a prepayment penalty to lower the rate, and the de facto prohibition on the use of prepayment penalties would further cause all non-prime loans to go up by 1 percent.

The bottom line here is unmistakable and inescapable. Most non-prime borrowers would have no flexible loan financing options that are so essential to meeting their needs and circumstances, and would find that loans would be much less affordable. Moreover, many borrowers who want to purchase homes would find that with the much higher rates and monthly payments, they could no longer qualify for a large enough loan so they would have to shift to a less expensive home and a smaller loan.

Please look at the chart on page five of my oral statement or page 10 of my written statement which we handed out this morning. As you will readily see in the example provided, the Miller-Watt bill would result in monthly payments being increased by 25 percent or more because it effectively prohibits non-prime borrowers from using flexible financing options. Mr. Chairman, I suspect this is a classic case of unintended consequences and I do not believe that the Miller-Watt bill sponsors ever intended such adverse consequences for borrowers.

In any case, I sincerely hope that the committee will not adopt the overly restrictive approach on these flexible loan-financing options that are proposed in the Miller-Watt bill. CFAL believes that the Ney-Kanjorski provisions here generally provide reasonable protections that preserve borrowers' choices and their options for making their loans much more affordable than under the Miller-Watt bill. As I noted earlier, some of these Ney-Kanjorski provisions can be tweaked or tightened somewhat, but they are basically sound and should be retained.

CFAL is confident that the Financial Services Committee can work together on a bipartisan basis to fairly resolve the various issues addressed in these legislative proposals and can report out a balanced bill that provides effective national standards for fair lending and that protects all non-prime borrowers in every State without unduly limiting their financing options and access to affordable mortgage credit.

We appreciate your allowing us the time.

[The prepared statement of Mr. Nadon can be found on page 225 of the appendix:]

Chairman NEY. Thank you.

I am going to yield at this time to Chairman Bachus.

Mr. BACHUS. I thank the Chairman.

Ms. Adams, I think your testimony is you think we need a national standard. Is that correct?

Ms. ADAMS. Yes, sir. We need a strong national standard.

Mr. BACHUS. Okay. And I would say, I am from a State that has no law, no regulation and that is also the case with Kansas, Mr. Moore's State and others.

Let me ask all the panelists, and I would say, Mr. Smith, one thing that you said I sort of question. You said all lending is local. Is that right?

Mr. SMITH. I said that the mortgage itself is a local transaction, but it is funded globally. That has changed from the old days.

Mr. BACHUS. But securitization, there is the secondary market. It is a national market.

Mr. SMITH. Okay. But I mean ultimately, what I meant by "globalization" frankly was national and international markets.

Mr. BACHUS. But you understand now securitization is actually a national market. To finance loans locally, you go nationally.

Mr. SMITH. I understand.

Mr. BACHUS. Okay. I think we are all seeking the same thing, and that is a national law that will work, will allow people to get good loans, will basically weed out and prevent bad loans or punish those if they are made. We have talked about different States. One State that has not been mentioned, and I am curious to know why because the law has been on the books for some time, and I have not seen any criticism of it, and I am not seeing any. I know loans are still available and it does not seem to have driven up the cost of loans in California. Ms. Adams, the California law, is that a good law? You did not mention it in your list.

Ms. ADAMS. No, sir, I did not mention it in my list. To be quite honest, I personally am not familiar enough with the California law and how it works to be able to respond to that. But being from North Carolina, I know we have a really good law.

Mr. BACHUS. In some States like North Carolina, a lot of the loans, you cannot finance them on the national market, in the secondary market.

Ms. ADAMS. I have not found that to be true, sir. Almost all of the loans that we work with, there is national service involved with that.

Mr. BACHUS. What about, and I would just ask any of the panelists, what about the testimony about the studies that say it drives up the cost of loans and it affects loan availability? Anybody want to respond to that?

Mr. GREEN. I would.

Mr. BACHUS. Let's let Ms. Lowrie and then Mr. Green.

Ms. LOWRIE. Mr. Chairman, I would like to speak to that. I think sometimes true stories really speak volumes to it. We can run a lot of reports and gather a lot of statistics, and we do operate in a national mortgage market. Before I tell you my little story, I want us to just step back for a second and think about where the mortgage industry was in the early 1980's, when consumers went to banks and through deposits banks lent out money. There was no diversity on a national level, and if there was a credit crisis like when there was the oil patch crisis in Texas, liquidity in that market raced right up.

The sheer fact that we have been operating in a national mortgage market is evidenced by the fact that we have two government-sponsored enterprises that have standardized underwriting guidelines, borrowers' profiles, credit profiles, and all of you I applaud for having validated that by passing the Fair Credit Reporting Act, which creates a uniform credit standard.

Mr. BACHUS. My time is kind of low, but have you seen any lack of loan affordability or credit availability?

Ms. LOWRIE. Actually, there is a situation in the State of New Jersey that happened right after the New Jersey predatory lending law was passed. We had a customer who had come to Gateway Funding to apply for a cash-out refinance, debt consolidation, less than perfect credit. Most of it was due to medical bills and medical expenses that he had incurred. The gentleman was on disability and was blind. He wanted to do a debt consolidation to avoid losing his home. He came to us. We processed the loan, verified all of his information, and approved the loan with a commitment to sell it to an investor.

There were conditions to satisfy on that loan that unfortunately did not get satisfied prior to the effective date of the New Jersey predatory lending law.

Mr. BACHUS. So he was denied a loan?

Ms. LOWRIE. And subsequent to that law passing, his loan could not be closed.

Mr. BACHUS. Okay. I will come back.

Chairman NEY. I thank the gentleman.

The gentlelady from California?

Ms. WATERS. I have a few questions I want to try and get in. And even though this is a little bit off of the subject for today, for H&R Block, I believe you are the one that is involved in doing tax returns that help people get their earned income tax credit. You do a lot of that work. Is that right?

Mr. NADON. Option One Mortgage is not involved in that, but our parent company, H&R Block, does that.

Ms. WATERS. And H&R Block basically lends money to these people whose tax returns they prepare in advance of the money that they would be getting back from the government, and they charge an amount of money, interest, to do that. Is that correct?

Mr. NADON. I am not an expert on it. I think the way that the actual laws are written is H&R Block cannot be the lender on those, but I could certainly get you in touch with someone at H&R Block.

Ms. WATERS. So H&R Block does it and they have a partner who does the loans?

Mr. NADON. I do not work at H&R Block, ma'am, so I cannot really tell you. That is our parent company. I could get you a contact point within H&R Block to answer a question like that.

Ms. WATERS. I think I will find out about it. I guess the reason it is on my mind is poor people are disadvantaged in so many ways, and the earned income tax credit is one that I am looking at because I think what I am seeing is the tax preparers are helping them to get their money early and they are charging exorbitant rates on it.

So we are fighting not just on predatory lending. Payday loans, tax returns, tax preparation with advance amounts being given to people for exorbitant rates, it is just a mess in these poor communities, with all of these people descending on the poorest of the poor to exact from them every penny that they can get.

Having said that, I would like Mr. Eakes to explain to me what you referenced in your testimony about the bill and the definition of "high-cost loans" and why some of what is supposedly advocated in this bill would not apply because they will never meet that definition. What were you talking about?

Mr. EAKES. Thank you, Congresswoman Waters.

In the definition of "points and fees" under the current Ney-Kanjorski bill, there is an exclusion for any fees paid to an affiliate. Okay? So if you simply structure your origination, and this is something that has been raised by CountryWide a lot over the years. You structure it so you have an affiliate that does your settlement services or an affiliate that does mortgage insurance or an affiliate that does anything. And basically you split the fee off.

So the appearance of a 5 percent fee in the details of this bill, it is just an appearance. So really, you can do an unlimited amount of fees that you could not do even under existing HOEPA law at 8 percent.

Ms. WATERS. Thank you very much.

You heard a description from Mr. Eakes. I know that you said you are very much against predatory lending. Would you be willing to fix that in this bill? Do you agree with him? Would you be able to eliminate that from the bill that would allow these unlimited fees to be charged based on this definition?

Ms. LOWRIE. Congresswoman, MBA absolutely detests abusive lending and has been working—

Ms. WATERS. No, no. I just want to go to the specifics of what Mr. Eakes has just described. I know you are against predatory lending. It is a terrible thing. You would never do it. But I want to know about the specific language.

Ms. LOWRIE. The specific language in the bill takes the points from 8 percent to 5 percent. Sitting down and going through what is included in those points and fees triggers I think is part of the discussion over the next weeks and hopefully not months.

Ms. WATERS. Do you agree with his definition of what high-costs loans are and what he just described?

Ms. LOWRIE. No, I do not.

Ms. WATERS. Okay. So based on what you understand and know about it now, you would keep it just the way it is. Is that right?

Ms. LOWRIE. No. What I said was that MBA would like to sit down and work to modify those areas of the bill that may not provide strong protections to the consumer. At the end of the day, Congresswoman—

Ms. WATERS. You said you came to tell us that you supported this bill. You support this legislation. I am asking you about a specific aspect of it because while we work every day with our friends and our colleagues, we see things differently sometimes. And while you are adamantly opposed to predatory lending, we just got a description of what we consider is predatory lending. Now, maybe it is a mistake, but you support the bill and do not know about it. I did not know about it. So did you not know about it, or are you opposed to that language?

Ms. LOWRIE. We are not opposed to that language.

Ms. WATERS. Thank you very much.

Thank you, Mr. Chairman.

Chairman NEY. I thank the gentlelady.

Mr. EAKES. Could I add, there were two other pieces of the definition of points and fees in New Jersey, New York, Georgia. They include prepayment penalties and yield spread premiums, which are basically an incentive to up-sell to higher rates. If you do not include those in the definition, you will not be able to address those two problems. They are generally viewed as fees that substitute for origination fees, so they should be included in that definition.

Ms. WATERS. Thank you very much. I appreciate that.

Chairman NEY. Mr. Miller?

Mr. MILLER OF CALIFORNIA. Thank you, Chairman Ney.

I have been in the real estate and building business for over 30 years. I have worked with a lot of lenders and I understand that. I am looking at California, and there is a patchwork of local laws being passed, beginning with the non-prime mortgage market, and it is scary watching what is happening.

I am really concerned because I have met with several reputable lenders who operate in all 50 States, and these are lenders with huge loan originations and securitizations. I am concerned that their ability to continue doing business under the trigger of the Miller-Watt bill would be greatly impacted. To be fair regarding both bills, would any of you on the panel care to comment on the impact of the points and fees triggers in both bills?

Mr. NADON. The concern that we have with including financing options, these are just not non-prime financing options. These are used in the prime world every day. So the impact that it has on affordability is when you write legislation like they have in the Miller-Watt bill, part of the design I think is to try to drive more of the costs into an interest rate. The downside to that is that interest rate is what people's monthly payment is based on.

Mr. MILLER OF CALIFORNIA. They cannot make their payment if you drive it up.

Mr. NADON. It drives up the monthly payment, so we have fortunately right now rates seem to be stabilizing a little bit, but certainly in a rising rate environment—

Mr. MILLER OF CALIFORNIA. The 1 percentage point increase that you might experience, what percentage of the people does that put out of the marketplace by increasing interest rates by 1 percent? What would your guess be?

Mr. NADON. I would hesitate to take a guess on that, but I can certainly run the math on it, but 1 percent has a fairly dramatic impact on the average consumer. It could be $300-and-some a month on our average loan just for an average consumer. When you talk about taking $3,000 or $4,000 out of their paychecks during the course of the year, that gets to be a fairly significant amount of money.

Mr. MILLER OF CALIFORNIA. So in effect appearing to do what seems good in effect is going to have a major impact on people who do not have the earnings to basically pay the additional 1 percent.

Mr. NADON. It just reduces their purchasing power and so they either cannot buy at all or they have to scale down what kind of a home they are going to buy.

Ms. ADAMS. Mr. Miller, may I share with you what the downside of not including yield-spread premiums and prepayment penalties into the trigger is. I once saw a loan where there were 10 points on the loan that was the yield-spread premium. That would not be counted in the trigger. That is enormous. It was a loan where the principal balance on that loan was $10,000. With all the fees that were attached—

Mr. MILLER OF CALIFORNIA. Is that on a home loan, a $10,000 home loan?

Ms. ADAMS. It was a cash-out refinance. It was a $10,000 loan.

Mr. MILLER OF CALIFORNIA. With 10 points.

Ms. ADAMS. And they had a total of $11,000 fees on it. And this was one that was filed with the Banking Commission. When the Banking Commissioner challenged the lender about where was the benefit to the borrower in this, and this was an associate's loan, the lender said they got a 1 percent reduction in their interest rate. Under Ney-Kanjorski as it is currently written, that tangible benefit would be enough for that to be a legitimate loan. And I know that that is unconscionable to this Congress, that $11,000 worth of fees—

Mr. MILLER OF CALIFORNIA. Ten points is outrageous. I would agree with that, but the question as it applies in a broad base to everybody, do you believe that most people are so unsophisticated that they should not have an opportunity to decide what they want?

Ms. ADAMS. The yield spread does not even show up. POC, most borrowers do not know what POC means. They do not see it. They do not know it. They do not understand it. When I am sitting down and going over their loan to them when they come to me, they are going, what is a yield-spread premium? What is POC? They have no idea.

Mr. MILLER OF CALIFORNIA. In fairness, would anybody else like to respond?

Mr. NADON. If I can, I have within our written testimony for all of you. We have an example of what our disclosure is on a yield-spread premium. It makes it very, very clear to the borrower what is taking place.

Mr. MILLER OF CALIFORNIA. That is what we are trying to deal with. Disclosure, that is the key.

Yes, ma'am?

Ms. LOWRIE. And I agree with that, disclosure is key and consumer education, which is part of the Ney-Kanjorski bill is key. But let's think about for a second all of the studies that have shown that those who are underserved in the marketplace, one of the biggest challenges to achieving homeownership is the ability to make the downpayment and pay the closing costs.

If it were not for yield-spread premiums to give the borrower the choice of paying closing costs through the interest rate, and not putting those in points and fees, both the Fed and MBA agree that it would be double counting. Yield-spread premiums, I believe, can be a benefit to the consumer.

I think through all of this, we have to keep one thing in mind, not only that we have the best housing finance system in the world, the highest homeownership rate, but I would like to talk a little bit about the question on foreclosures. We talked about the fact that foreclosures are so high. And yet, from the third quarter of 2002 until the fourth quarter of 2004, we saw foreclosures decrease in sub-prime loans from 8.5 percent to 4 percent. That means 4 percent of the loans that may be going into foreclosure, out of 100, means 96 consumers received loans that may otherwise not have had the opportunity to do that. In a lot of cases, it is because of yield-spread premiums.

Chairman NEY. The time has expired.

Mr. MILLER OF CALIFORNIA. Thank you, Chairman Ney.

Chairman NEY. Would you like to wrap up?

Ms. LOWRIE. No, that is fine.

Mr. MILLER OF CALIFORNIA. Thank you, Chairman Ney.

Chairman NEY. Thank you.

The gentleman from Pennsylvania, Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

In listening to the testimony of the present panel, is it reasonable for me to assume that you do recognize that there would be a strong reason to have a national standard? Or are there members of the panel that really do not want to move to the national standard at all? I guess I am directing this to really Mr. Green and Mr. Eakes. I think everyone else has conceded the fact that a national standard is worthwhile.

Mr. SMITH. Do you want me to throw up the white flag?

Mr. KANJORSKI. No, no, no.

Mr. SMITH. I think what my testimony suggests, sir, is that whether there is an actual need for a national standard ought to be considered. But if there is to be a national standard, there needs to one, as Ms. Adams said, that is appropriate and that reflects the experience of the States.

Mr. KANJORSKI. Right.

Mr. Eakes?

Mr. EAKES. I would say that it depends on what the national standard is. If the national standard does more harm than good, we are better off without it. In the last 5 years, we have basically eliminated the Associates, United Companies, FAMCO, Greentree, IMC Mortgage, the worst players we have now eliminated without having a Federal standard. If you put a Federal standard in place that actually reauthorizes some of the practices like arbitration that the industry has now done away with, then it will do more harm than good.

Mr. KANJORSKI. All right. So it strikes me, then, that we almost have consensus on the panel that a national standard may be worthwhile, particularly considering 26 States in the Union have no standard, have no laws to protect consumers. Of course, the national legislature has to look at half the country being undressed.

I would concede that North Carolina has made excellent strides, but we also have to be practical. The likelihood that the North Carolina law would become the national law is highly unlikely, or Mr. Ney and I would not have had to try and find consensus on something that would meet the ability to pass. We can have the ideal, and we are never going to have legislation.

What I am hearing from both Mr. Green and Mr. Eakes, and I really welcome you, I am directing my attention to you, is the whole purpose for this hearing. I readily concede, and I think Mr. Ney would join me in this, that we do not have a perfect bill. Probably, we will never have a perfect bill. But you have brought up some suggestions that we can tweak things to make it more acceptable to you. I think, Mr. Eakes, I will talk to you, on this idea of the affiliate. It is a tough call.

We did not want to encourage activity by lenders to try and extract more monies from people. That is not our intent. What our intent is is that we want to encourage those institutions that outsource certain services that they can continue to do that. That means a large number of the community banks, a large number of the smaller mortgage makers. If we structure everything has to be done in-house, what we are doing is taking a large part of this market away that they cannot provide these services in-house. They just do not have the capital. They do not have the capacity to do it, so they are out of the mortgage business.

Now, on the other hand, we probably can find some language. What I am asking you do to is to work with us to avoid misuse and abuse of the affiliate charges, but yet still allow our ability to have the less than the largest in the mortgage business, so that we can keep this large segment of business activity, which I happen to think is much more competitive and will ultimately drive the rate down in sub-prime lending.

Now, I could be wrong, but I think that is where it goes. The indications to me are that this is now becoming a relatively mature market, and probably there will be a narrowing of people that are involved in the market just by virtue of the fact that it would be so price-competitive. What we want to make sure is it is consumer protective in that happening, and you could be of great assistance. Maybe you ought to make an offer to the Chairman that formed this advisory committee and have all the parties of interest, as you did in North Carolina, come together. And it is not necessarily the Ney-Kanjorski bill that we want you to look at, but look at Mr. Miller's bill and Mr. Watt's bill, and any other additions that we may have mentioned, to make a better bill.

Now, I will concede we cannot get a perfect bill. I think you agree with that, too. Regardless of what we do, we are probably going to lessen the protections of North Carolina, but we are certainly going to increase the protections of Kansas and Alabama and Pennsylvania.

Ms. ADAMS. Mr. Kanjorski, I am so sorry. I did not mean to give any indication that the provisions in our State law, our State law is a strong sub-floor, but if we weaken it, we will fall right through. I did not mean to give the impression that I thought a national bill that would be less than what we have in North Carolina is a bill. I think it is a strong sub-floor. I am willing to put up with parquet, rather than hard oak floor, on the covering of it. But the North Carolina law in our State is working. Foreclosures in North Carolina are half of what they are in other States that have no laws.

While I am willing to work to help cover the 26 States that do not have coverage, I think there is a place between what North Carolina has and what ideally Ney-Kanjorski can be.

Mr. KANJORSKI. Right. And that is what I am inviting all of you to do; make sure that we are aware of what changes can be made, and that we have to argue them out because there will have to be compromise in how it applies.

Let me end up, Mr. Chairman, I am taking a little more time than I really should. You know, when you really think of it in all these areas, I come to a conclusion, and I have always lived by sort of a principle, and I call it my "5 percent bastard" rule.

When you really think of all the laws and all the rules and regulations we have on the books, 95 percent of the people that are in these businesses are in it to do standard business operations, get people in houses, provide consumer protections, and are not out there to steal money from them or be predatory. But regardless of what we write, there will be the "5 percent bastards" out there. We should try and tighten it up, but fully recognize that we are not going to remove them to zero.

What we are trying to do is come a long way to take care of the Kansases, the Alabamas, the Pennsylvanias. Until last year, it is just now that Pennsylvania is coming forth with an effective piece of legislation toward predatory lending. I have had the personal experience in my district, in the Pocono Mountains. I have seen how disastrous it can be. I do not know what we could do.

As a matter of fact when I talk with the Secretary of Banking in Pennsylvania, it sounds like I am self-serving because I happen to be a lawyer by profession, but I cannot understand people that go into transactions to buy real estate that do not get a lawyer. And 50 percent or 75 percent of the abuses in Pennsylvania, if they had had any kind of a lawyer at all, would not have happened.

Ms. ADAMS. Well, Mr. Kanjorski, to address that, in North Carolina we had a law that said that all closings had to be done by attorneys so that there would be somebody there to help protect the consumer. The Federal Trade Commission said that that was a monopoly.

Mr. KANJORSKI. Anticompetitive.

Ms. ADAMS. Anticompetitive, and so now a person can go and close a loan with no safeguards.

Mr. KANJORSKI. It is a real problem. I think Mr. Scott's provisions were so compelling and that is why we took his provisions and put it in. I think it is going to go a long way for education, for counseling, but it is not going to solve all the problems. Sometimes these folks are so anxious to get a chance to get a home and want to believe everything that is attractive about the transaction, even though it is a fair transaction, but they may not be able to afford it; they may not in the long run be able to keep it.

But if you are living in an apartment in New York and you get a chance to move to the Poconos and get your kids out of a school system and into another, where your income will go a lot further in the Poconos than it will in New York, it is an awful driving force. We are not going to cure all of those problems, but I am hopeful that at least out of those of you that feel that we have not quite come the proper distance yet, you will help us close those holes, or at least elucidate the problems.

Chairman NEY. The time has expired.

The gentleman from Texas, Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

I will beg the pardon of many of the panelists. I was out of the hearing room for much of the testimony, so some of this may be redundant. We have just heard several comments from Ms. Adams regarding the North Carolina experience.

Dealing with assignee liability, Mr. Green, I guess I would like to get your opinion on it since I think you may have a slightly different opinion, but what do you see happening in States like North Carolina and Georgia that have passed strict assignee liability provisions that ostensibly are very pro-consumer? What is your observation of what happens in the marketplace?

Mr. GREEN. Well, it is fundamentally an arithmetic equation. Either they continue doing high-cost or other similarly situated subprime loans at a higher cost, or, because of the vagueness of the liability that they may have to take, they just do not participate in those loans. I do not want to say the sky is falling. I cannot sit here and say that because of the North Carolina law in the last 3 years X number of loans have exited the market.

Keep in mind, we have been in an incredibly attractive interest rate environment right now. What happens when credit as a matter of market gets tougher to come by for every participant in the marketplace, and the issues of vagueness in liability come front and center? So we believe as a matter of principle you need more clarity and frankly from the assignees' perspective, you need to make sure that it is very clear what the assignee's role is and what the assignee's liability is. We believe the Ney-Kanjorski bill provides a clearer standard and a more appropriate standard.

Mr. HENSARLING. So in your opinion, the bill gets it right.

Mr. GREEN. In our opinion, the Ney-Kanjorski bill does get it right.

Mr. SMITH. If I may respond to that also. I do think that the evidence in North Carolina is, and again in 2003, and this is the mortgage bankers' statistics, out of our top 15 sub-prime lenders, 7 were in the top 15 nationally. They accounted for 33 percent of the dollar volume of sub-prime loans originated in North Carolina.

So I will defer to my friend Mr. Eakes. He knows more about assignee liability than I, but, A, I think we do not have a very strong assignee liability provision in our law, and B, whatever provision we do have has not kept national lenders who are national market players from participating profitably in our market.

Mr. NADON. If I can just add a comment, because I am a national lender, that much of the lending that we have done in North Carolina, it has been in just the last few years. We did not have a presence there 10 years ago. So we have opened up a branch there, as I know some of our competitors have. We now have a lot more sales people working there than we did. There is a growth that is there, just the natural organic growth that comes from growing a business.

We were not living in a static environment in North Carolina. We had a very mature business in that State at Option One before the law passed, and then subsequent to that law you can look at it and say, well, we did not seem to get affected. We charge people a higher rate for the exact same loan in adjoining States and other States in the market than in North Carolina because of the law that they passed. So there is a higher cost.

I do believe that the Banking Commissioner has even commented, I am not sure how recently it was, but on the fact that credit is more expensive; non-prime credit is more expensive in that State.

Mr. HENSARLING. Mr. Nadon, since you spoke up, let me ask you another question. We need to go on please.

I believe, and I actually did catch part of your testimony. I think I heard you say that costs of a loan can increase 1 percent if you have a de facto prohibition on prepayment penalties. Did I hear you correctly there?

Mr. NADON. Yes, that was the outcome of a study done by an outside group, the Pentalpha Group consulting firm did that study. That was a conclusion they came to. It is fairly consistent. Right now, if you opt for one of our loans with a prepayment penalty, we take 100 basis points off your rate.

Mr. HENSARLING. Ms. Adams, unfortunately I missed some of your testimony, but I caught a little bit of it in the question and answer session. Assuming that there is actual full disclosure, is your organization against consumers having that option to actually sign up for a prepayment penalty and perhaps enjoy the benefits of a 1 percent reduction in their interest rates?

Ms. ADAMS. On sub-prime loans, yes, sir, and I will tell you why. The purpose of the sub-prime market is to give people a second chance to rehabilitate their credit so that they can go back into the prime market. So it is quite possible that without a prepayment penalty, that person would make on-time payments of that loan for

3 years, prove their credit-worthiness, improve their credit score, and then qualify for a prime loan—

Mr. HENSARLING. But if there is full disclosure, aren't you supplanting your decision with their decision?

Ms. ADAMS. —that benefits them. I am saying that if we are going to look at what is in the long-term best interest of the consumer, locking them into the sub-prime market is not helping them to build wealth. Whereas if they had the opportunity to move into the prime market with full knowledge that if they make their payments on time, full disclosure means telling them if you do not take it and you pay your payments on time for 3 years, you may be entitled to a 3-point reduction when you refinance into the prime market.

So with full disclosure, sure, if a consumer makes that choice, that would be their choice, but that is not what kind of disclosure consumers are getting.

Mr. HENSARLING. My time has expired, but I would offer the opinion that the consumer is probably the best judge of what is in the consumer's best interest.

I yield back, Mr. Chairman.

Chairman NEY. Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Nadon, I look forward to working with you as we continue to discuss the various bills. I did have a couple of questions from your testimony.

In the appendix, you have your best lending practices, or what is it called, fair lending practices set out. However, on your Web site, I printed it out this morning, it appears to be a different version or was perhaps an earlier version. It is on the PDF format as it appears on your Web site. Apparently, the HTML format does have it the way it appears in the appendix. But there are some changes, and I am curious.

On page 35 of your current best practices, on the appendix pages 35 and 36, it no longer says, to make certain there is no personal financial benefit for someone to charge you a higher rate, we do not pay yield-spread premiums to brokers, which means the broker does not receive a financial incentive to charge a higher interest rate than our published rate.

Mr. Nadon, when did you change, when did Option One change your position on yield-spread premium from the view that it created a conflict of interest between the broker and the borrower, and now view it as a wholesome practice that should be protected under law?

Mr. NADON. Our challenge on the yield spread all along was the clarity of the disclosure that was done within the industry, as I think someone on the panel commented. What was most frequently found was lenders were, particularly going back several years ago, would have a reference on a closing statement of POC or something like that. We did not think that was sufficient. We did not think that told a borrower what they really needed to know.

So we found a way to put a very, very clear disclosure out there that I would be happy to provide all the members a copy of.

Mr. MILLER OF NORTH CAROLINA. It is in your testimony.

Mr. NADON. It is on page 39 of the testimony.

Mr. MILLER OF NORTH CAROLINA. Okay. And that has changed your view that a yield-spread premium creates a personal financial benefit for someone to charge you a higher interest rate.

Mr. NADON. Yes, because what we are doing is we are actually lowering their rate for some things, and we are using these as a tool now to say that one of the challenges for a lot of non-prime borrowers, one of the reasons they actually wind up being in the non-prime category is a lack of financial reserves; their ability to have the cash needed to close on a transaction.

This actually, if done right, can allow people when they do not have cash or when they want to reserve some of their cash in savings for after the time the loan is closed, it still allows them to buy the home. So there is a clear benefit in there.

Mr. MILLER OF NORTH CAROLINA. Mr. Nadon, you heard Mr. Eakes earlier testify on why he thought additional, and the view in North Carolina was that additional disclosures were futile given how much was already being disclosed. It was just more paper. You disagree with that. You think the additional disclosure, one-page disclosure on this is not just one more form a consumer signs?

Mr. NADON. I think this one is a good disclosure.

Mr. MILLER OF NORTH CAROLINA. This one they read closely, word for word.

Mr. NADON. Yes.

Mr. MILLER OF NORTH CAROLINA. Okay. There are a couple of other points that are no longer in your fair lending practices, negative amortization loans and single-premium credit life or disability insurance, or any other types of credit or disability insurance when your loan is made. You no longer view those as unwholesome practices.

Mr. NADON. We have never offered any product like that.

Mr. MILLER OF NORTH CAROLINA. Okay. That is no longer in your fair lending practices.

Mr. NADON. That might just be an oversight when they did a revision of the document, because we have never offered, as Mr. Eakes knows, we have never offered any credit life insurance products.

Mr. MILLER OF NORTH CAROLINA. Okay. What was fairly striking in your testimony, and you have come back to it in the questions and answers as well, the assertion that you give a 1 percent discount when someone does not have, or you charge 1 percent more when someone does have a prepayment penalty.

Mr. NADON. We charge less when there is a prepayment option.

Mr. MILLER OF NORTH CAROLINA. I was struck by the lack of authority, the lack of citation of a study or an industry publication or anything, or even your own rates from State to State. An industry publication, Inside B&C Lending in 2001 said that the industry was setting out to study to try to document that North Carolina rates were in fact higher as a result of North Carolina's law. You have heard Mr. Eakes say that they were no higher.

Four years later, there still does not appear to be a study that documents that. In fact, B&C Lending said that they examined the rate cards for various sub-prime lenders for North Carolina versus other States and said they could not see any difference in the products that were available or in the rates.

Can you at least provide various rate cards? Can we see that for the different States?

Mr. NADON. Yes, our rate sheets are available on our Web site, and I certainly can have someone in our secondary marketing put it together for you in such a way to show the clear distinction on like loans. The importance is taking a like loan, the same loan amount, same LTV, same debt ratio, the same characteristics of a loan in that market versus another market, and just taking those two rate sheets in those two different markets, what do we charge. We can show that for you.

Mr. MILLER OF NORTH CAROLINA. Ms. Lowrie?

Actually, I am out of time and I had one more question for the folks, if I could, Mr. Chairman.

A couple of the members have noted that there now seems to be no disagreement about the need for a national standard. Mr. Eakes, Ms. Adams, do you think there should be a preemptive national standard? Do you think the standard should be both a floor and a ceiling? Or do you think it is sufficient? When you say that you want a national standard, do you mean that there should be a floor only?

Mr. EAKES. If I could take one step back on the pricing. If you look at page 22 of my testimony, I have the raw data looking at all the sub-prime loans in North Carolina and adjacent States, on page 22. It basically shows that the pricing across the industry in North Carolina for every year is no different than adjacent States, the interest rate. So regardless of what people theoretically think might happen, it has not happened, even though prepayment penalties have largely been eliminated in North Carolina. It is just a fact.

A preemptive standard I think will not work. Uniformity is overrated. When you have an entity that is a local finance company that has no national regulator, you have to have some sort of State standards that can enforce. You have to have the ability to adapt. My belief is what we need is a strong Federal floor standard. If it is a floor, you will not have any new State legislation being passed because it is too much work.

But if you put it as the maximum and say this is preempting any and all changes, then what you find is you cannot deal with the problems as they evolve. If North Carolina had been adopted by Congress in 2000, and said this is the end of the game, there is no more discussion, the elimination of single-premium credit insurance immediately morphed into something called debt cancellation contracts which were not insurance.

Chairman NEY. The time has expired.

Mr. EAKES. Okay. So the simple answer is you need a Federal floor. If it is high enough, there will not be any proliferation of State laws, but you should not preempt.

Mr. MILLER OF NORTH CAROLINA. Mr. Chairman, I would just ask to make part of the record today the fair lending practices that I printed off Option One's Web site this morning.

Chairman NEY. Without objection.

Mr. MILLER OF NORTH CAROLINA. As well as the March 5, 2001, copy of Inside B&C Lending.

Chairman NEY. Without objection. Thank you.

We now go to Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman.

Thank you to the gentleman from North Carolina as well.

Mr. Green, I was interested perhaps in your opinion of the tangible net benefit analysis under loan flipping. I was not able to be here for much of the hearing, but that looks like an awful subjective standard to me.

I am a cosponsor of the bill, but what regulatory guidelines do we have in place now to lenders and borrowers? And which ones would need to be developed so that what looks like a subjective standard can be turned into more of an objective and ascertainable standard before we enter loan criteria as opposed to afterwards?

Mr. GREEN. I think you raise an excellent point. The fact is that the goal here is to provide clear, objective standards by which lenders can be guided and that secondary market participants can flag readily and easily. Frankly, it goes to the issue of the need for a national standard. We believe very strongly that while there are many local elements to the mortgage market, it is now a national—and dare I say international—capital marketplace, and that a floor that does not provide preemptive strength will not provide a standard whatsoever.

There will be a cost to that uncertainty. The flipping and other standards that will be a part of the discussion that will ensue during the coming weeks and hopefully short months with this subcommittee and other market participants will hopefully provide better clarity for that and can provide that national standard that all can feel comfortable—be they borrower, lender, or secondary market participant. More importantly, you the Congress can have faith that predatory lending can be stopped with the implementation of these standards and that sub-prime lending can continue. But the point you raise is one of those exact points that we need to clarify.

Mr. FEENEY. Mr. Smith, I appreciate your defense of federalism. I came from the State legislature and appreciate the State prerogatives. But it does seem taken to its extreme that we have 5,000 to 10,000 jurisdictions if you include townships and cities and counties and the 50 States. Just the compliance costs for people who want to engage in not just national lending, but also the ultimate, I do not know of anything more liquid than capital other than perhaps water. Capital will chase places where there is certainty, where the risk is minimal and where the return is greatest.

One of the burdens is compliance costs. If I have a lot of capital, which I do not, but if I want to put it in the mortgage market as opposed to a myriad number of other investments, the last thing I want to do is to have 5,000, or for that matter 50 sets of regulations to worry about.

Mr. SMITH. Well, let me answer a bit of that, respond to it anyway. First, the fluidity of capital is the reason I said that mortgages are financed globally, because global capital markets allocate capital around the world and our national market is a piece of that. That was an attempt at sophistication. I will never try it again.

In the United States, there are multiple jurisdictions that have adopted these regulations. I will say I think the State level is an appropriate level to do it, not for the least of the reasons that State real estate law is still one of the last, I think, remaining I should say redoubts of State jurisdiction. Who knows? That may get preempted, too, but if you do loans in North Carolina, the deed of trust loans and the means of conveying are different.

So there are compliance or documentation issues in the real estate finance business that are inherent, setting aside for a moment predatory lending laws. It seems to me that a State jurisdiction is an appropriate jurisdiction in our Federal system to regulate loan content and lender conduct.

As to the issue of cost, it seems to me that by and large, and I know that some provisions of our laws deal with all loans, but by and large the protections we are talking about are for a subcategory of a subcategory. The sub-prime market is, I believe, its high point is—

Mr. FEENEY. I understand that, and I am about to run out of time. I will let you finish on that.

Mr. SMITH. I apologize.

Mr. FEENEY. That is okay. I will let you finish on that, Mr. Smith.

Mr. Nadon, whether your stats are right or his are right, we live in a very easy credit market. I was General Counsel to a real estate developer with a third-grade education, but boy he made millions in real estate. What he taught me was, not that he was a fool, any fool can make money in an up-market in real estate. At a time when we have 25 percent increases in values in residential homes in Florida, nobody who is lending is losing. But that is not always true, because we see the downsides also.

We have easy credit out there. Nobody is losing money by lending money in real estate today, but there will come a time when lenders will not be so easy. My view is you will be punishing borrowers, that are prepared to be flexible, if you are too rigid. It seems to me that at least theoretically, if not North Carolina, some of these local or State regulations are too rigid and you are going to ultimately punish the borrowers in tight money markets.

Mr. SMITH. Thank you.

Chairman NEY. The gentleman, Mr. Watt.

Mr. FEENEY. Mr. Chairman, if he could just have a moment to respond, I would be grateful.

Mr. SMITH. I agree very much with your concern about the future. I share it. In fact, it is one thing that keeps me up nights regularly. I do not think the restrictions on borrowing or lending are going to make a problem. I disagree respectfully that restrictions of the kind we are talking about on a small portion of the market are going to have a huge influence on the tide. I agree with you in part, and respectfully disagree on the second half, which is that the restrictions themselves would make a bad situation worse.

Chairman NEY. Thank you.

Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

Let me do two or three things here. First of all, I apologize to the first three witnesses, the ones from my own State whose testimony I missed completely, and extend a half-apology to Mr. Green, because I missed half of his testimony also. I had to go out and give a speech this morning, so I had to miss your testimony.

Second, let me say how valuable I think this discussion has been because at some level we are talking about potentially the difference between simplifying things by making it easier for borrowers to understand and compare loans, which is if you put everything into the interest rates, people understand interest rates and at least they can compare. If you allow other options that may lower the interest rate and people do not understand them, it can be really a confusing market situation for consumers.

More education favors people who can understand and who have time to understand and who have options. Simplicity favors people who, even though they may end up with a marginally higher interest rate, can understand how to compare and shop. I do not know that there is a right or wrong answer to a lot of these things, but this discussion I think has helped.

Mr. Nadon, I know that you speak for your organization and you also have an individual business hat, so it is not necessarily so that the organizational position would be consistent with your own business's position because you are talking for a more global group of people who may be doing different things. The one thing that Mr. Miller did not ask you about, I do not think, unless I missed it, apparently Option One does not offer mandatory arbitration. Is that right?

Mr. NADON. It is not part of our contracts.

Mr. WATT. Okay. Yet I guess what you are advocating, the Ney-Kanjorski bill would allow mandatory arbitration, you are saying that that is something that should be done in the industry even though your company itself does not do it.

Mr. NADON. I think the view there is that, I will give you my own personal view, as well as what I think where the industry is. My personal view is that there is actually a right place for arbitration. I think there is a way that it can—

Mr. WATT. That brings me to actually the final point I want to make, because your view is that if the yield-spread premium is appropriately disclosed, as you do in your disclosure, although you can argue about whether disclosure is effective or not.

I practiced law for 22 years and did a lot of real estate. I never went away from a real estate closing thinking that anybody in the real estate closing, including a lot of times the lawyers, knew what was going on by the end of the closing, despite all of the disclosures. So I am not a big disclosure fan, but people can disagree about that.

What you are saying is that if the yield-spread premium is appropriately disclosed, as you do in your company, then you think it is appropriate, but Ney-Kanjorski does not necessarily mandate what you do in your company in terms of disclosure. They just say we are not going to count yield-spread premiums in our calculation of fees.

So what about the companies that do not do that kind of disclosure? I mean, we are not mandating the kind of disclosure that your company uses in this legislation. And yet before you had the disclosure, your company's position was that yield-spread premiums, I mean, it was not a good thing.

Mr. NADON. We used borrower credit, which effectively got to the exact same place and disclosed it in a very clear and transparent manner.

Mr. WATT. All right. But what about the places where it is not disclosed clearly?

Mr. NADON. I think that there should be a lot of discussion on how do we make sure that everyone in this industry is disclosing in a very clear, simple language, transparent manner so that any consumer when they walk away from the table, there are some things they should know.

They are not going to know all of everything that is in a contract, and most of it frankly is written for attorneys, in my opinion. I am not an attorney so I do not understand it. But there are some critical components that should be just very, very plain and simple that says this is what is happening.

Mr. WATT. Okay. My time is up, but I would just say, I have looked at appendix D and after 22 years, I am not sure it would be all that helpful to somebody to have even your disclosure. I am not questioning the intent. I guess this just goes back to my belief that disclosures do not effectively do it. You are closing a transaction. You are doing a loan transaction and you usually just do not have time to be studying disclosures. I just do not think they are that effective, but I am not saying that the motives are not good.

Mr. NADON. And the benefits are clear, from our perspective, of having that tool there.

Chairman NEY. I thank the gentleman.

Mr. McHenry?

Mr. MCHENRY. Thank you, Mr. Chairman.

Thank you all on the panel for being here today. I certainly appreciate it. I appreciate half the panel, Mr. Chairman, being North Carolinians. It means a lot to me, being a Tarheel myself.

Mr. Eakes, you reference the fact that Self Help has given some $4 billion in loans over the last 20-some years; over 40,000 families. What percentage of those loans, how many have been subprime?

Mr. EAKES. I would say all of them have been to credit-impaired individuals. That is my definition of "sub-prime."

Mr. MCHENRY. How would you define "sub-prime" for someone else? Is that your normal definition? So all of these have been subprime.

Mr. EAKES. They have all had credit blemishes that did not make them qualify for the traditional conventional loan.

Mr. MCHENRY. But in terms of family homeownership, so all $4 billion has been for homeownership.

Mr. EAKES. That are unconventional, yes.

Mr. MCHENRY. Unconventional. Okay.

Well, you said in a press release and in your written testimony that sub-prime loans go to foreclosure 10 times more than prime mortgages, and one in five ends in foreclosure. What are your statistics for your organization?

Mr. EAKES. Were you here for my testimony?

Mr. MCHENRY. Actually, I was.

Mr. EAKES. You were.

Mr. MCHENRY. I was. I left right after it. So my apologies to the half of the panel that my colleague from North Carolina saw.

Mr. EAKES. We went our first 11 years and had not a single foreclosure. We have had a total now, it is less than one-tenth of 1 percent cumulative. It is a very, very small number of foreclosures.

Mr. MCHENRY. So on what do you base your 10 times more likely?

Mr. EAKES. We have a database that looks at all sub-prime loans and has the terms and disclosure of the interest rates, all those terms. We paid $250,000 for a database to be able to analyze that. So in my analysis, and the Mortgage Bankers Association produces data annually as well, that in States like Ohio, Ohio has the highest foreclosure rate in sub-prime loans of any State in the nation, and it is public data.

Mr. MCHENRY. So you have maybe less than 1 percent that have been foreclosed?

Mr. EAKES. My original point was that having been an experienced sub-prime lender before it was even called that, that if you have really high foreclosures, one of two things are happening: you are making loans to people who really should not have been approved for a loan; or number two, there are features in the loan that have stripped the wealth and made it unaffordable and unable for the borrower to succeed.

The most catastrophic thing we are facing right now is that the studies that have been done in Chicago and Pennsylvania and other places suggests that anywhere from 20 percent to 30 percent of sub-prime loans given in a certain year will eventually foreclose. So the 10 percent number that I mentioned, that is how many were in foreclosure at one point in time.

But if we had 20 percent of sub-prime loans in total that were foreclosed, and that is a very conservative estimate for right now, based on these databases. What is happening in the industry, the reason Joe Smith was so worried, is increasingly we are now seeing interest-only loans and hybrid ARM loans, your exotic products. We are going to have 40 percent to 50 percent of those loans eventually foreclosing.

Mr. MCHENRY. Let me also go to another person who is in this marketplace. Mr. Nadon, could you address those questions?

Mr. NADON. Yes, our volume members are a lot different from Self Help's. I am not familiar with their statistics at all. I can just tell you that yesterday I went back to the people in our organization in Irvine, California and asked them the question: What percentage of our loans life to date have ever ended in foreclosure? And the number is 3.72 percent on close to $100 billion worth of volume.

Mr. MCHENRY. So less than 4 percent.

Mr. NADON. It is not 20 percent.

Mr. MCHENRY. It is not 20 percent.

Mr. NADON. That has not been our experience.

Mr. EAKES. Let me explain the difference there. If you take a year's loans in 1998, that cohort, and say let's take it throughout time, and say how many of those eventually will default, the number will be 20-plus percent.

Mr. McHENRY. Well, 100 percent of us in this room are going to die, so therefore by your statistics we are all dead. Was that surprising to anyone?

Okay.

Mr. SMITH. You are going to reduce that to present value, aren't you?

Mr. McHENRY. Banking jokes.

All right. But in 2004, Self Help had some $45 million in loans you made, and $8 million of those have been delinquent real estate, or delinquent.

Mr. EAKES. I am sorry. Say your number again.

Mr. McHENRY. In 2004, Self Help made about $45 million in loans. Is that correct?

Mr. EAKES. Are you talking about Self Help Credit Union or all of Self Help?

Mr. McHENRY. Self Help Credit Union.

Mr. EAKES. That sounds like it might be right.

Mr. McHENRY. Sounds like it might be right. Well, you had over $8 million in delinquencies in real estate. So that is pretty close to your stats.

Mr. EAKES. Yes, and that is exactly my point. With low-wealth families, which is what we focus on, people who do not have a large downpayment, the thing I will tell you right up front is those families will have more delinquency, but they do not default. They cure it. So yes, people who do not have cash reserves, they get behind, but they catch the loan back up. And that is a good thing. That is what I think the sub-prime market has helped do.

But those loans do not default and ultimately produce losses for the lender. That is what I am telling you. A low-wealth family will have a crisis, just like other families. They will have death, illness. They will all have death, illness, divorce, job loss. If you have a cash cushion, a middle-class family that has $10,000 of cash, you will deplete that cash and then you will catch it back up when you get on your feet.

Chairman NEY. Speaking of death, the time of the gentleman has expired.

Mr. McHENRY. If I may say one final thing. That is close to your 20 percent statistics you are giving for other people, that you have 20 percent delinquency yourself. So it is an interesting finger you are pointing at other segments of the industry, but you are not realizing what you are doing yourself.

Mr. EAKES. Do you understand my distinction between delinquency, which means that you are 30 days behind in your payment at a various point, versus default, where you have been foreclosed on at 90 to 120 days past due. And the number you are citing is the 30-day figure, not the ultimate default and foreclosure.

Mr. McHENRY. Mr. Chairman, I have two follow-up questions if I may submit them for the record.

Chairman NEY. Without objection for the record.

Mr. McHENRY. And if Self Help will be so kind as to answer them.

Chairman NEY. The gentleman, Mr. Scott?

It will be submitted for the record, then you can respond. Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

Let me ask the panelists to examine very carefully in this legislation the financial education component, the toll-free number component, specifically because you all are the ones out there that can help us to make sure that we got it constructed right; to make sure we got the level of funding in it that needs to be. At this point, it is $58 million.

Is that adequate—and I know, Mr. Nadon, that you had mentioned that an interesting proposal, within your own industry and others, that could contribute in.

It is one thing to say in a bill, "We are going to get a financial education program, we are going to set up a toll-free number, we are going to get money down to the grassroots, we are going to get them into the communities, we are going to set all of this up." But do we have the right amount in there to do the job?

Mr. Nadon, in your opinion, do you think $58 million is enough to do all that we are doing in addition to staffing around the clock a 1–800 number?

Mr. NADON. I am not sure that it is.

The thing to go into my mind, just as a business guy, is that we do not know how many phone calls will come in. We do not know how long our customer service reps, if you will, will have to be on each one of those phone calls. We do not know how long it will take to get all those people up to speed so they can do their job right. We do not know what kind of telecom system we need, what kind of I.T. infrastructure we need.

So it is very hard to come up with a business plan—or a number for that, rather, without a business plan that, kind of, shows you what kind of dollars you have to invest.

Mr. SCOTT. Well, Mr. Nadon—because I have a couple of other questions for the others—because you are out on the street, you are there, and others as well could do this as well, this is a hearing, and the purpose of this hearing is to obtain information and assistance from you all that is very valuable in helping us.

I would like to ask each of you, and especially Mr. Nadon, if you could submit to us, in preparation for the markup of this bill, to make sure we have it worded right, to make sure we have the amount of money in, to make sure we have an effective business plan with who, what, where and how, as we go forward.

And as you look at the education component in this bill, help us and advise us as to what we need to add to it—in an amendment form or as we mark it up in this committee—because everybody on this committee concurs. Education is a critical part of helping and getting the help to the people in the first place. It is not all that needs to be done.

We need to put most of what is in the Ney-Kanjorski bill and the Watt bill as well. But certainly, we all concur that education is a vital component and certainly have to do that.

So if you could, I would appreciate that. Yes, I think you want to respond to that. And please be brief, because he is going to bug me and I have three more questions I want to ask.

Ms. ADAMS. I just want to say no, that is not enough money, for those of us who are on the street, doing the education and the counseling. In North Carolina, our law provided for pre-counseling education for people in high-cost loans.

Our legislature forgot to fund that. Those of us who are trained—and North Carolina provides training through the Housing Finance Agency for counselors to provide that education. Those of us who do it, it costs about $250 to really educate and help a consumer understand the complicated process and their options and choices.

And $58,000—

Mr. SCOTT. Million.

Ms. ADAMS. $58 million is a million for each State. We have 100 counties in our State. And it is $8 million to pass out to major metropolitan areas. You need to double that, just to start with.

Mr. SCOTT. Very good, thank you.

Yes, sir?

Mr. GREEN. Congressman, I just want to point out that we, the Bond Market Association, spent a lot of our own money on investor education and financial literacy Web sites. But as part of the major settlements that occurred a couple of years ago, the State securities regulators—the NASD and the SEC—have significant funds set up to allocate and award grants for financial education and investor education.

This committee has clear, broad jurisdiction over that end of the marketplace. You might let those regulators know that financial literacy should be part of that equation.

Mr. SCOTT. Excellent. Thank you very much.

Ms. LOWRIE. Congressman, I agree with what all the panelists have said. I think the industry, the various industry associations, in addition to whatever comes out in a uniform national standard or legislation, should step up to the plate.

I mean, in addition to what the Bond Association has done, the Mortgage Bankers Association has put out on its Web site a home loan learning center for consumers to go and ask questions, go through the education process. We have also supported the uniform real estate settlement procedures, simplifying the mortgage process.

Mr. SCOTT. Thank you all very much.

I have to get to my final question, and that is to the two issues, it seems to me, that we really have to resolve is the question of a national standard for assignee liability and the issue of preemption because we have to have some agreement on that.

Coming out of Georgia, of course, as you know—and I point to the gentleman from North Carolina because we called upon one of yours, Michael Calhoun, whom you may know, with the Center for Responsible Lending. There he is, back there.

Well, Michael knows we called upon him in Georgia. That was before I got to Congress. That was my last bill we worked on back 3 years ago.

The assignee liability issue, we need to have a national standard by that. Now we have what is called limited liability, assignee liability. We have strict assignee liability. We have liability in which you have some shelters in there from lawsuits.

I mean, where do we get the standard for assignee liability? And is it North Carolina's motto? And could you wrap that in, for me, with a clearer understanding of your requirements for preemption?

I think you mentioned a floor, as opposed to a ceiling. But I think you went through that pretty fast.

But please give us your feelings on what should be in the national standard for assignee liability.

Mr. EAKES. You are asking me, right?

Mr. SCOTT. Yes, if you would, Mr. Eakes.

And then you, Mr. Green.

Mr. EAKES. The issue around assignee liability is the following. If you have an innocent borrower and an innocent investor—assignee—with a loan that had a problem made by the lender or the broker, and it comes to foreclosure—so it was an abusive loan, made by someone who is no longer there; that is the primary issue—who bears the loss because the broker or the lender is no longer there?

Who bears the loss? Should it be the individual homeowner who is now in foreclosure, who was abused? Or should it be the investor pool?

And that is the challenge of assignee liability. I have now personally negotiated with Standard & Poor's, Moody's, Fitch's, Fannie Mae, Freddie Mac—virtually all the major companies in America who do sub-prime loans.

And at least for those first groups, we came to a standard that basically said: only for high-cost loans would there be assignee liability. So it is very limited to begin with.

There is a standard that was passed in New Jersey and New Mexico that all those other—not the major industry groups, but the ratings groups and Fannie and Freddie, the guardians of the secondary market, have all signed off on it. So we have a standard.

The standard that is in this bill will simply not work. It is worse than what we currently have.

Mr. SCOTT. That was my other question on that. This assignee liability in the Ney bill—

Mr. BACHUS. [Presiding.] I hate to bug you, but I think your time has expired.

Mr. SCOTT. All right. I will yield back, Mr. Chairman. Thank you.

Mr. BACHUS. I have great respect for you.

Mr. Pearce, do you have a question?

Mr. PEARCE. Sure, Mr. Chairman. Thank you. I was fascinated by my colleague from Georgia's questions.

Mr. Smith, if you were going to guess at the number of problem loans in the sub-prime market in North Carolina right now, what would you guess? And I am talking about the ones that Ms. Adams described. And those are just horrendous examples.

Mr. SMITH. The best proxy I have to answer your question is that the rate of foreclosures in the State have gone up—doubled—in the last 5 years. Now we have had a little bit of a remission in the last year, which is a blessing, so let's hope that continues.

I think if it were looked through, I believe a fair bit of those would be in the sub-prime market. What is ironic is that it is even higher in metro areas, which have not had the industrial problems we have had and the loss of jobs and the like, so it has less to do with economic conditions than it has to do with something else.

But that is my best proxy.

Mr. PEARCE. So your guess is that a high percent?

Mr. SMITH. Yes.

Mr. PEARCE. Would you guess about 50 percent of the sub-prime loans?

Mr. SMITH. Well, no. I would say that the rate of foreclosure has gone up. And I do not know whether my friend Mr. Eakes's 20 percent idea is correct or not.

Mr. PEARCE. Okay.

Mr. SMITH. But the events in our State suggest that it is a high rate. And it is probably in sub-prime.

Mr. PEARCE. The other 80 percent then, it is people trying to live within the letter of the law. They provide a product at a little bit higher price or something?

Mr. Eakes, you said that you all have been working in that market for 20 years. How much escalation do you give the sub-prime loans that you all work? In other words, if you were taking a look at a mortgage in a prime lender status and then you looked at sub-prime, how much do you all escalate it? Or do you at all?

Mr. EAKES. Escalate the interest rate?

Mr. PEARCE. Or whatever, points or whatever. In other words, what do you all do? What is the range of options that you have?

Mr. EAKES. On the loans that Self Help makes, we charge no points at all. We charge a 1 percent origination fee.

Mr. PEARCE. No points, but 1 percent, so if a loan for a house is at 7 percent nationwide, you would charge 8 percent.

Mr. EAKES. No, no, we charge a 1 percent origination fee, the fee for making the loan. Our interest is probably one-half of 1 percent higher than a Fannie Mae loan.

Mr. PEARCE. So you charge a 1 percent origination fee and then another half above.

Mr. EAKES. Interest rate.

Mr. PEARCE. Mr. Nadon, what would your industry, for instance, do in the same situation?

Mr. NADON. It depends on the risk category that the borrower was in.

Mr. PEARCE. Just give us the range.

Mr. NADON. Like a double A to a double C. But they really would be someplace between 50 to 75 basis points over a conventional rate on most of our business. But we do have products that can go as high as maybe 300 basis points above.

Mr. PEARCE. Okay, so anywhere from a one-half of 1 percent to 3.

Mr. NADON. Probably. I mean, right now, our current score, our waived coupons are around 7.3, 7.35 percent.

Mr. PEARCE. Mr. Eakes, these are somewhat different measuring sticks, so you have basis points versus loans. Would you feel like that, at your level at lending, that you leave any of the market on the table? In other words, are there people who come to you that could pay that do not have such good credit rating and they would be willing to, for a fee, have access? And that is simply what we are talking about here.

Do you leave any of the market on the table? That is, I think, my question.

At your rate of interest and your performance, do you leave market on the table, unserved people who would come in and would pay a little bit more?

Mr. EAKES. There are parts of the sub-prime market, probably the bottom 10 to 15 percent, that we would not make a loan to.

Mr. PEARCE. But those loans might function?

Mr. EAKES. We would not make those loans at any rate.

Mr. PEARCE. Those loans might function and they might be valid and good and not fall into the category—I think we universally would decry the problem loans that Ms. Adams talked about, but that lower 10 percent that you all will not touch, would they be performing loans?

Mr. EAKES. To me?

Mr. PEARCE. Yes, yes.

Mr. EAKES. I think, of the question you asked Commissioner Smith, there is 10 to 15 percent of the loans that should not be made at all.

Mr. PEARCE. Okay, I understand that. But I am asking about, you all are charging a little bit less for some of the sub-prime loans. And I am saying: do you leave anything on the table when you reach your—

Mr. EAKES. No, we have no limit on credit—

Mr. PEARCE. Mr. Nadon, would you want to comment on that? What does the sub-prime market, what is the value nationwide?

Mr. NADON. It is a little over $600 billion last year.

Mr. PEARCE. So you have $600 million. And those are people that you—

Mr. NADON. Billion.

Mr. PEARCE. Billion. Those are people that you are saying probably might not fall into the categories that the prime lenders or even Mr. Eakes might be willing to lend to. But these are performing loans.

Do you find 20 percent non-performance in your loans?

Mr. NADON. No, as I mentioned earlier, when we look at life to date, our loans that ended up in foreclosure, on close to $100 billion worth of originations, it is 3.72 percent.

Mr. PEARCE. Okay.

Mr. Chairman, I know my time is up.

Mr. BACHUS. Thank you.

Mr. PEARCE. I would just like to wrap it up by saying this is probably as difficult an unraveling circumstance because I do not believe we can just go in and say that these loans should not exist. When we first talked about non-prime lending into Mexico, I had people come to me that knew me personally, that fell into the category that Ms. Adams was talking about, who were saying, "I live paycheck to paycheck. And if you close these down, you are going to close the door to me. And so, yes, regulate them. Do what you have to do. But please do not close the door to me being able to hang on to my house because I occasionally go in and I cash my paycheck early and I get the funds to go and pay my bills."

And so this is a very difficult balancing situation for me. And I would just appreciate the input from each of the panelists on my questions.

Thank you.

Ms. ADAMS. If I could just respond really shortly to that?

Mr. BACHUS. Thank you, Mr. Pearce.

Actually, Ms. Velazquez was next and she has been waiting. Maybe she will ask you a question.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Chairman, before I proceed with my questions, I would like to ask unanimous consent to submit for the record testimony submitted by the National Council of—

Mr. BACHUS. Without objection.

Ms. VELAZQUEZ. Thank you.

Mr. Green, the reach and negative effect of abusive predatory lending practices have increased along with the dramatic growth of the sub-prime industry. Freddie Mac and Fannie Mae today buy a relatively small, but increasing share of sub-prime loans. And some analysts expect their share of the sub-prime market to jump to approximately 50 percent within the next few years.

Do you think the GSEs could play a role in helping to curb predatory lending through their own decisions on which loans they choose to buy?

Mr. GREEN. I know that is a big issue for this committee this week, so not to enter that debate.

Ms. VELAZQUEZ. And I also would like to hear from Mr. Nadon and Ms. Lowrie, if you have any opinion on that.

Mr. GREEN. As I understand it, Freddie and Fannie's charter is not crystal clear, to answer your question directly. But I would say that what we are talking about here comes back to the creation of a clear and objective national standard that all market participants—wherever they are in the continuum of borrower, lender, secondary market, assignee or investor—can understand what their responsibilities are.

And each one has a different responsibility and a different role. And just to get back to Mr. Scott's question of assignee liability, we believe that assignees have a role and a responsibility that is clearly defined in the Ney-Kanjorski bill. And it is not the same as the lender's responsibility.

And that is clearly defined. So I think there is a role for every market participant, whether or not—

Ms. VELAZQUEZ. Including Freddie Mac and Fannie Mae?

Mr. GREEN. Whether or not their charter allows it, I do not know that to be the case. But clearly, every market participant wants clear and objective standards that they can count on.

Ms. LOWRIE. Congresswoman, MBA believes that, along with the Bond Association, that the real key here is a strong, uniform national standard. I think we have seen both the GSEs enter into what we would call the alternate A, A-minus, in their mission to expand homeownership.

And I think as we see more and more, in an industry, risk-based pricing, we move more away from looking at just the conforming market, the A-minus market and the non-prime market. The risk-based pricing environment is really kind of creating synergies between all three of those markets.

So there will be opportunities where both the GSEs and even the Federal Home Loan Bank can enter into that in an effort to expand homeownership. But the real key to the success in any of that, whether it is the lenders, the broker community or the investor community, is going to be a strong, uniform national standard.

Ms. VELAZQUEZ. Mr. Nadon?

Mr. NADON. I cannot really comment too much about what their charter is and what they are or are not allowed to do. But I do think that they can have a pretty important role in the process.

We have had very good relationships with both for them for years. Freddie was one of the largest buyers of our bonds, actually, for a number of years.

So anything that they can do that would just add another place, another outlet for loans, for more capital being available in the marketplace, I just have to believe is a positive for consumers.

Ms. VELAZQUEZ. But would you support uniform standards for predatory lending for the GSEs, if they help define the standard?

Mr. NADON. Oh, I think there should be uniform standards for everyone then.

Ms. VELAZQUEZ. Okay.

Mr. Green, can you briefly describe the process that a securitizer will go through to weed out predatory loans from its pool, addressing whether or not the process includes such actions as providing the loan originator name and address to local and State authorities or notifying the lender that it no longer will do business with it?

Mr. GREEN. On the specific question about giving names and addresses, I will have to get back to you on that. But the process—the policy and procedures that are set up, the sample, the pool of mortgages, which can include hundreds if not thousands of mortgages—is pretty sophisticated, but it is only as good as the standard you are looking for. And that gets to the clear and objective standard issue because if an objective lacks clarity and lacks objectivity and a judgment has to be made, you can see how that can slow up the entire process.

So trying to get behind someone's intent or the style in which they gave the loan, as opposed to clear, objective standards, really makes those policies and procedures make sense. And frankly, the standard laid out in the Ney-Kanjorski bill, which requires such policy and procedures, requires such due diligence and also requires representation by the lenders themselves to the secondary market, the assignee, of this diligence that they undertook, is what the crux of those procedures are.

Ms. VELAZQUEZ. Do you feel that there is adequate support for assignees to share information with one another about unscrupulous lenders? Or do you have suggestions for things that would help them to better ensure that they do not purchase a predatory loan?

Mr. GREEN. We would have to look further into that, particularly as it relates to antitrust issues and those sorts of things. As to market chatter branding someone "bad," I am not sure that is a particular market participant's role.

It is one reason why government enforcement and government laws here are appropriate and necessary and, again, why we support a national standard. But I think it could run into some real problems on the antitrust side if there were to be that kind of chatter between market participants.

Mr. BACHUS. Thank you.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. BACHUS. First of all, I am going to go from side to side. I will try to be brief.

Ms. Adams, you had something you wanted to tell Mr. Pearce last time, I know—Congressman Pearce? I will give you part of my 5 minutes.

Ms. ADAMS. Thank you, Mr. Bachus. I promise not to abuse it.

The purpose of the stories was to, one, put a human face on it, but also to tie it to the provisions of the act. And the story of Vance County is a story of the failure of having assignee liability.

We were able to prosecute the bad guy. We were able to get funds from him. They were not enough funds to help the families.

The court ruled that there was no assignee liability and all of the people who held the mortgages are out. And so now they are foreclosing on these families.

These families are in homes that they have $90,000 mortgages on, but they are only worth $45,000. We want to work with the lenders to try to get them into a loan that they can afford, but there is nothing that makes the lenders want to work with us. There is no reason they have to work with us.

And so these people are in foreclosure. We need something to hold the assignee liable.

And that is why we have prepayment penalties, because they factor in the bad loans in the pool. They factor in the abuse of yield spread premium by the brokers. And that is the rationale behind the prepayment penalty, to protect the investor.

But no one is there to protect the victim.

Mr. BACHUS. Mr. Green?

Ms. ADAMS. Thank you, Mr. Chairman.

Mr. GREEN. I would just say very quickly, Mr. Chairman, that the Ney-Kanjorski bill does have a right to cure provision, so that if an assignee learns of a problem loan, they can make it right. And it does provide courses of action for the borrowers to take, particularly if there is reckless indifference.

So I do believe the Ney-Kanjorski bill provides such relief.

Mr. BACHUS. And actually, the North Carolina bill kind of cuts that off, as I understand it. Is that correct?

Mr. EAKES. Cuts off what?

Mr. BACHUS. It kind of cuts off the right to cure?

Mr. EAKES. The right to cure in most all consumer legislations says that you have 60 days; you have a period after the loan is made.

Mr. BACHUS. Which is a pretty short period of time.

Mr. EAKES. A short period that lets the lender use their own due diligence.

Mr. BACHUS. I am a former attorney, but when you get lawyers involved—

Mr. EAKES. But if you allow—

Mr. BACHUS. If you could have a little longer time, I think it benefits the consumer.

Mr. EAKES. If you allow—

Mr. BACHUS. Let me go on. Do you want part of my 5 minutes?

Mr. PEARCE. Let me say to Ms. Adams that I do not disagree with you at all. I agree that the people who are unscrupulous, we ought to be tearing them up.

But beyond that point, we have to figure out where to draw the line so that we do not close the door to people who would fit there.

Mr. BACHUS. All right.

Let me ask, real quick, Ms. Adams, you mentioned—it is Commissioner Smith, right?

Mr. SMITH. That is fine, yes.

Mr. BACHUS. You had mentioned coordinated enforcement authority?

Mr. SMITH. Right.

Mr. BACHUS. Do these bills, do they both provide for that?

Mr. SMITH. I am embarrassed to say I do not know. I think it is crucial though.

Mr. BACHUS. Okay.

Mr. SMITH. Particularly—and I am sorry he is not here, but to address the 5 percent problem because there are—well, as a lawyer, you will know, but in dealing with any kind of law enforcement, there is a materiality standard every law enforcer has to go through.

And having more people on the beat, rather than less, would be—

Mr. BACHUS. Now for the federally insured institutions, is that coordinated?

Mr. SMITH. Oh, yes. We coordinate all the time, yes.

Mr. BACHUS. Okay. Let me just close by saying this.

Mr. Green and Mr. Nadon—and I commend Option One for your best practices—but both of you all have testified previously—in November 2003 in Mr. Nadon's case and I think last March in your case, Mr. Green—that the North Carolina statute actually gave the clearest guidance for assignee liability of any of the State laws.

Is that not true? I mean, you did say you were not totally satisfied with it. But I have your testimony here. You actually referred me to the North Carolina law as a good law, I thought.

Mr. GREEN. I would have to review exactly what I said last March. Having said that though, that was at a time where there were many States that were coming up with far more extreme measures. And North Carolina was, in fact, attempting to try to make positive moves in the right direction.

Having said that, upon reflection of the entire development of a national standard, we believe that the assignee liability direction that the North Carolina bill takes does not provide the clarity because it just continues to—

Mr. BACHUS. You did say that, but I guess last year, we have been looking for that clarity. And we cannot seem to find it. And we have to find it if we are going to—

Mr. GREEN. Well, we do believe very strongly that the many months of drafting that I know Mr. Ney and Mr. Kanjorski and many members of this subcommittee and the House have in putting the Ney-Kanjorski bill together, have found that balance.

Mr. BACHUS. And Mr. Nadon, in November of 2003, you actually on assignee liability said—and I do not want to put words in your mouth, but I thought you said it is workable and you could do it.

And actually, I think, Mr. Green, you said it does not inhibit market capital.

Mr. GREEN. I think what I said precisely then, I think that was part of the oral testimony and in question and answer, was to properly define assignee liability because one of the panelists at the time said without assignee liability, there is no teeth in the enforcement of the law. And frankly, we do not disagree with that.

And I think the Ney-Kanjorski bill provides such clarity to acceptable and appropriate levels of assignee liability, keeps the entire marketplace on notice, whether you are a lender or a secondary market provider.

Mr. BACHUS. Mr. Nadon, let me just ask you to go ahead.

Mr. NADON. Yeah, I am not an attorney so the assignee liability is a little bit outside of my realm. I am just a mortgage guy.

Mr. BACHUS. Okay.

Mr. NADON. But I will say this, that we have seen differing opinions on North Carolina about the extent of the assignee liability. And from my vantage point as a lender, our position has always been that we follow what the Bond Market Association says is acceptable and what the rating agencies tell us that they can quantify.

And when they get very comfortable, as a lender then we become very comfortable.

Mr. BACHUS. Standard & Poor's testified at that same hearing you did. And they said they were comfortable with it, I thought.

And this is actually legislation that has been on the books for several years. So we have a history with it. I mean, I just want to point that out. I am going to introduce that just into the record. And this is not a "gotcha."

In my mind, you all are pretty comfortable with North Carolina on assignee liability. You said it was actually better than most other States. And maybe you were talking about New Mexico and New Jersey, comparing it.

Mr. GREEN. I mean, keep in mind, again, back at the time, there were several State laws that had standards different than HOEPA that were far worse than HOEPA. We believe Ney-Kanjorski is—

Mr. BACHUS. What about the existing assignee liability provisions under HOEPA? Are they good? Could we go with those?

Mr. GREEN. We do not believe they provide the clarity, the distinguishing nature.

Mr. BACHUS. So the Federal statute does not and none of the State statutes do?

Mr. GREEN. Again, one reason why Federal legislation is needed is that there is not a Federal statute that gets to where we need to get to stop predatory lending and preserve the secondary market. And the State statutes are all over the lot.

Mr. BACHUS. Okay. Could you take North Carolina, since maybe it was one of the closest to what you wanted, and tell me what is wrong with it? I am not talking about here. I am talking about just send it in.

Mr. GREEN. Be happy to.

Mr. BACHUS. Okay.

Mr. Green?

Mr. GREEN OF TEXAS. Thank you, Mr. Chairman.

Mr. BACHUS. Without objection, I would like to introduce this.

Mr. GREEN OF TEXAS. Mr. Chairman, I would like to thank you for your evenhanded approach to this. You get high marks in my book.

And thank you, the members of the panel, for the information that you have imparted today.

With reference to the prepayment penalty, we seem to base the notion that consumers can make mistakes that are to their detriment by having an invidious prepayment penalty, in the sense that it is invidious in its effect, upon the premise that if a consumer wants to do it and makes a mistake, then the consumer has a right to make that mistake. I am not sure that we do that in all cases in society, that we allow consumers to make mistakes.

I will use an extreme example first. With reference to drug abuse, we do not let people consume crack cocaine. We have just decided that that is not good for them and it is not good for society to allow that to occur. So we have a law that prohibits it.

And by the way, the person who engages in the consumption is indeed a consumer, in a literal sense. But to make this point transpicuously clear, let's talk about securities and securities transactions.

There is something called a sophisticated investor. If you are not a sophisticated investor, when you want to engage in certain securities transactions, we will not allow it.

Having money is not enough because you are not a sophisticated investor. When I purchased my first home, right out of law school, I would have signed anything they put before me because I wanted the home. And quite candidly, I was not a sophisticated investor as it related to prepayment penalties and some other things.

So I say to you respectfully that I do not agree with the notion that we can just allow people who can buy down a half point or so the opportunity to make a mistake that will haunt them the rest of their lives. I am not sure that I have the solution, but I do know that in other areas of business transactions, we have considered the sophistication of the person who is engaging in the transaction.

Now with that said, I want to go back to Mr. Eakes, sir. You talked a bit about these prepayment penalties. Can you explain to me why it is necessary to have the penalties, given the circumstances that have developed in your State?

Mr. EAKES. In my State, the prepayment penalties have been prohibited, so only 1 percent of sub-prime loans have an override where they have prepayment penalties. I do not believe they are necessary at all for sub-prime loans.

Mr. GREEN OF TEXAS. Have you found that people who buy down these loans to get the better interest rate, that they truly have the sophistication to understand the long-term implications of the prepayment penalty?

Mr. EAKES. No, they do not. There was a study that Freddie Mac did with focus groups and they concluded somewhere more than 50 percent of the borrowers who had prepayment penalties did not even know they had them.

Mr. GREEN OF TEXAS. Are you familiar with the term "sophisticated investor?"

Mr. EAKES. Yes, I am, in the securities context.

Mr. GREEN OF TEXAS. Yes, sir.

Do you believe that that is a good thing to have in the securities market, the sophisticated investor requirement?

Mr. EAKES. I think it is, yes.

Mr. GREEN OF TEXAS. Let me ask my namesake.

Mr. Green, you and I share the same last name. Wonderful last name. The color green symbolizes life.

Mr. Green, do you think that we are dealing with, in many circumstances, persons who are sophisticated enough to understand the implications of their actions?

Mr. GREEN. Well, as you correctly state, in the securities industry, there are suitability requirements. And frankly, even with suitability requirements, there is still a big gap between what investors ought to know and what they do know, which is why investor education has become so crucially important.

Financial literacy is an extension of that. And I think the provisions of the Ney-Kanjorski bill which will expand that education is very important.

But I would actually defer to the originators of mortgages, the lenders who deal directly with the borrowers, in terms of the education levels that exist between them.

Mr. GREEN OF TEXAS. Yes, sir? I will yield to you for a quick response.

Mr. SMITH. I would just like to respond to that briefly, if I could, because it seems to me that the issue really is: what does it take to make someone—to make the market work properly; in other words, to have parties involved who have relatively equal knowledge, relatively equal bargaining power and the ability to negotiate based on the knowledge of what is going on in the universe?

I think the problem that there is in the sub-prime market and the tragedy, in some ways in my mind, about the preemption actions frankly that the OCC has taken with regard to Georgia's law is, for example, the OCC explicitly preempted a requirement in that law that people have direct personal counseling to ensure that they were at least getting closer to parity with lenders, so they would in fact understand the terms of the transactions and the like.

I do think a policy problem that relates to the sub-prime market is the cost—and it is costly—of providing an appropriate level of consumer education so that people do approach that ability to bargain. I will say Freddie Mac has done a study that shows—Freddie Mac is being mentioned a lot today—but there is a Freddie Mac study on, I think it is housing, gold housing or housing gold or something that shows a direct and very helpful positive correlation between homeownership purchase counseling and success in loans.

But that, again, is a fairly extensive program. And there is an incentive for people to pay attention.

Mr. BACHUS. All right, thank you.

Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

Mr. BACHUS. And after Mr. Sherman, the order is Mr. Davis, Mr. Cleaver, Mr. Clay, Mr. Ford.

Mr. SHERMAN. This panel brings to us consumer protection expertise, business expertise. We up here have a little political expertise.

And let me tell you that if a bill is written that does not have preemption, in effect is not both the ceiling and the floor, it does not have a chance of passing. So we can attack the concept of having national preemption and not pass any bill at all. The effect will be, in many States, no consumer protection at all and, for many lenders, those that are national banks, no restrictions at all.

So I hope that we get some consumer protection. I can understand how those of you from North Carolina prefer the North Carolina bill.

I am from California. And the bill that I have cosponsored is modeled after California law.

Mr. Nadon, you say you charge more in North Carolina than for identically situated loans in adjoining States or perhaps in California where the law is different. Can you quantify how much more a sub-prime borrower is going to pay?

Mr. NADON. Yes.

Mr. SHERMAN. Is it 50 basis points? 100 basis points?

Mr. NADON. Yes, when I asked our secondary marketing department, which does our pricing for us, that question and I gave them the loan parameters—$150,000 loan, single-family, owner-occupied, 80 percent LTV, 45 percent debt ratio—and gave them some basic credit risk parameters and said, "Take that loan in California, put it in Pennsylvania, put it in North Carolina. Tell me what the differences are."

And North Carolina was the highest priced loan.

Mr. SHERMAN. By how many basis points?

Mr. NADON. It is 55 basis points higher.

Mr. SHERMAN. Fifty-five basis points higher than what?

Mr. NADON. Than California. And I believe it was 50 higher than Pennsylvania.

Mr. SHERMAN. Gotcha.

Regina, is that your experience as well?

Ms. LOWRIE. Yes, Congressman, that has been our experience. And an interesting point to note, when you talk about prepayment penalties and the value that they bring to the consumer in lowering rate and giving them the choice.

And I have heard a couple times here today that we have not seen that hurt consumers or raise interest rates in North Carolina. But the one thing we have to remember is that when you single out one State out of a national mortgage market, that State is being subsidized by all of the other States' loans that are in the securities.

So if we are looking at billions of dollars of securities on Wall Street—and you can speak to this, Congressman.

Mr. SHERMAN. I have limited time. I mean, there are two different approaches. One could say, hey, it does not really raise costs. The other could say it raises costs for North Carolina borrowers. And the third approach is it raises costs for all borrowers.

But the next issue is: what are the default rates in sub-prime loans? We have heard everything from 20 percent to 3 percent.

And when I say default, I do not mean somebody is 30 days late. I mean the loan goes to foreclosure.

Mr. Green, would the bond market be interested in buying a portfolio of loans if they thought one in five of those loans would go to foreclosure and they as lenders were going to end up owning the property as a result? Using the definition of you having to take the property back, what kind of foreclosure rate would be acceptable to the bond market?

Mr. GREEN. And I sit between 1 in 5 here and 4 in 100, which are the Mortgage Bankers Association statistics. But the bond markets, if they can reasonably predict with reliability a foreclosure rate, can price it. The question is at what price?

Remember, the only portfolio that has zero foreclosure risk is the portfolio of Treasury securities.

Mr. SHERMAN. But what I am asking is, I mean, certain borrowing is just such junk that the bond market does not want to deal with it. I mean, there are junk bonds and there is really junk.

At what point does an expected foreclosure rate of even 5 percent or 10 percent cause that portfolio to be such junk that your members do not want to deal with it?

Mr. GREEN. The question is, are there investors that want to take those risks? And can it be reasonably priced? And is there adequate information to price it reasonably?

And if there is, which comes to clarity and reliability of the information, it can be priced.

Mr. SHERMAN. I was hoping that you could resolve the conflict between those sitting on your right and left. And you really cannot.

Mr. GREEN. I think it is impossible to. But I think we feel comfortable with the statistics that we seem to come out of.

Mr. SHERMAN. Yes, and it is also tough to predict because we are talking about sub-prime loans being made, say, in the 1990's, predicting what portion of them will default and go into foreclosure in 2012. Who knows?

It has been said that we are all dead in the long run. These loans only have to live 30 years. And so the question is how many of them die of unnatural causes, namely foreclosure?

Mr. BACHUS. Thank you.

Mr. SHERMAN. Have I used up all my time? I guess I have.

Mr. BACHUS. But you have established we all die, I think. No, I am just joking.

Mr. SHERMAN. If I can just go to this prepayment penalty issue, some would paint the picture that a prepayment penalty is something that only a poor or uneducated borrower would tolerate.

I would ask Mr. Green, aren't there a lot of very sophisticated corporations that sell bonds with call premiums, that in effect go to the market and say we want to get a good, low interest rate on our bonds and we will agree to a prepayment penalty?

Mr. GREEN. Well, yes. In fact, most municipalities, when they issue bonds, they are typically 10-year call bonds. And by virtue of that, they lock in a very favorable rate.

Mr. SHERMAN. So if we were to go to municipalities, corporations and say, "You are not allowed to issue a bond with a call premium," then all those very sophisticated borrowers would be upset because they would have to offer higher interest rates.

Mr. GREEN. Well, that would be a factor that the investment community would price into it. And I think that would be a limitation.

Mr. BACHUS. Thank you. I think you have established that, in sophisticated situations, sophisticated investors do agree to prepayment penalties.

Mr. Davis?

Mr. DAVIS OF ALABAMA. Mr. Chairman, we have established—

Mr. BACHUS. You can pursue this line of questioning.

Mr. DAVIS OF ALABAMA. Mr. Chairman, we have established that everything dies except for 5 minutes in committee hearings. That goes on and on.

Let me direct this first question, Mr. Smith, to you because I suspect you might be the most knowledgeable person in the committee to answer it. Some of us on this side of the aisle were critical of the OCC preemption, not because we opposed the idea of a national standard, but because we think that we are the ones who ought to be doing it.

We think the Congress ought to be doing it, as opposed to the OCC doing it, without Congress's consent or even knowledge in this instance. One of the things that is unclear to me about the Ney-Kanjorski legislation is the degree to which it widens the scope, narrows the scope or matches the scope of OCC preemption.

I do not want to spend my whole 5 minutes on this, but can you quickly give an answer as to the degree to which Ney-Kanjorski matches OCC preemption?

Mr. SMITH. Well, what I have suggested is that Ney-Kanjorski should not preempt the ability of States to enforce national standards.

Mr. DAVIS OF ALABAMA. I understand that and I agree with you. But I am asking in terms of—

Mr. SMITH. I think what Ney-Kanjorski would do, to the regard that it deals with normative provisions and loan terms, the kind of stuff that has been debated already, it would virtually totally preempt or come close to totally preempting State laws.

Mr. DAVIS OF ALABAMA. So your opinion is—

Mr. SMITH. And I think that is what the proponents expect. It is what they want to do.

Mr. DAVIS OF ALABAMA. All right.

Does anyone on the panel disagree with that proposition, that Ney-Kanjorski would be just as preemptive as the OCC regulations that were announced a year ago? You are all nodding your head in agreement.

Does anybody think, per chance, that Ney-Kanjorski would go even further than the OCC has gone with respect to preemption?

And she needs to take it down, so let me just go person by person.

Ms. Adams, you are nodding your head that you think Ney-Kanjorski is even more preemptive than OCC? Just a quick yes or no?

Ms. ADAMS. Yes.

Mr. DAVIS OF ALABAMA. All right.

Mr. Eakes?

Mr. EAKES. Yes.

Mr. DAVIS OF ALABAMA. All right.

Mr. Green?

Mr. GREEN. Technically, yes, but it creates a better national standard.

Mr. DAVIS OF ALABAMA. Okay.

Ms. Lowrie?

Ms. LOWRIE. Yes. And MBA wants to actually look at maybe some areas where it may go a little too far.

Mr. DAVIS OF ALABAMA. Okay.

Mr. Nadon?

Mr. NADON. Yes. I think yes, and it creates a better standard.

Mr. DAVIS OF ALABAMA. Okay, because this has been a subject of some confusion in meetings I have had. So it seems we have established that Ney-Kanjorski goes even further than OCC.

Let me ask another broad set of questions. I have been asking this for 1.5 years and I have yet to get an answer, so I am going to take one last crack with this panel.

We know that the HMDA data is coming out. We know that there is going to be, we have reason to believe, indications that sub-prime lending is far higher in the African-American and Latino community than the Caucasian community.

And the first line of defense to those statistics is that well, you may have higher levels of poverty, for example. You may have lower incomes in the black and Latino community, so that could make some higher credit risk and could account for a disparity.

But then we also see data that says the amount of sub-prime lending is twice as great in the affluent African-American community as in the low-income white community. So I want to ask the same question of each member on the panel.

Do any of you believe that the disparity in sub-prime lending between blacks and whites is purely a function of the market?

Mr. Smith, yes or no? And I rush simply to give everybody a chance to answer that?

Mr. SMITH. No.

Mr. DAVIS OF ALABAMA. All right.

Ms. Adams?

Ms. ADAMS. Absolutely no.

Mr. DAVIS OF ALABAMA. Mr. Eakes?

Mr. EAKES. No.

Mr. DAVIS OF ALABAMA. Mr. Green? Did not get an answer from you, just a head shake.

Mr. GREEN. I would say no.

Mr. DAVIS OF ALABAMA. Ms. Lowrie?

Ms. LOWRIE. No.

Mr. DAVIS OF ALABAMA. All right.

Mr. Nadon?

Mr. NADON. No.

Mr. DAVIS OF ALABAMA. Okay. Now that is striking to me. And I compliment you on your candor. So I want to turn to this question: given that you all believe that this disparity is not just based on the market, what is the industry doing right now, without waiting for Congress, without waiting for us to wave our magic wand, if we had one, what is the industry doing right now to address what you all just acknowledged is a problem that is not market-based?

Ms. Lowrie, do you want to take a crack at that?

Ms. LOWRIE. Thank you, Congressman.

Well, first of all, the Mortgage Bankers Association, as the trade association representing our members, has really made a concerted effort through our Web site to go out, through the Home Loan Learning Center, to try and educate consumers because I think it gets back to education. It also gets back to diversity in our industry.

We are serving a much more diverse market today than we were serving 10 years ago. And if we look at demographics across the entire country and the percentage of immigrants, minorities and low- and moderate-income borrowers that have come into the market and now there are innovative products and solutions, this is a whole new segment of the market that we need to be able to support, educate.

We need a more diverse workforce population that speaks the various languages of these different segments of the marketplace. So the industry has a big responsibility and has already started efforts in those areas in addition to working—

Mr. DAVIS OF ALABAMA. Last quick question.

Mr. NADON. If I could just expand on that? Just real quickly?

Mr. DAVIS OF ALABAMA. As long as it does not come out of my time. Go ahead, please.

Mr. NADON. One of the very practical things that we have done in our organization is for the last year, we have had the National Fair Housing Alliance working side by side with our associates to make sure that just even in the wording of a policy or procedure, that we do not have words or phrasing that might get in the way of our doing the right thing for our customers.

Mr. DAVIS OF ALABAMA. Last 30-second point because I am a little bit past my time limit.

Ms. ADAMS. But please let me address that.

Mr. DAVIS OF ALABAMA. As long as I get my last 30 seconds, sure.

Mr. BACHUS. You are already 40 seconds over, but I am going to give you that last 30 seconds.

Mr. DAVIS OF ALABAMA. Thank you. Thank you, Mr. Chairman. Go ahead, Ms. Adams.

Mr. BACHUS. Is this an Alabama thing?

Ms. ADAMS. NCRC conducted testing of 12 sub-prime lenders with retail outlets. And in our testing, which is in the written record, we uncovered a 45 percent rate of disparate treatment based on race. We also found that when we test, people are not given the same information. The white tester was given different rates than the black tester when they walked in the door.

When we did testing on upper-income African Americans—the North Carolina Fair Housing Center did testing on upper-income African Americans to kind of find out why that 2-to-1 disparity existed, we found that they were not getting the same information. They were given different loan products with different rates and different terms.

And there is still difference in treatment. So I refer you to our written response because we do have an answer to your question.

Mr. DAVIS OF ALABAMA. And let me sneak this in, as I think you would agree this is an important question.

Ms. Adams, you have explained what the industry is doing to address this problem.

Recognizing that my time is out, so if you would be extremely brief, Ms. Lowrie, could you or Mr. Nadon or Mr. Green take a crack at the following question: what tools does this institution, the House of Representatives, need to give you to combat what you have acknowledged is a problem of actual discrimination in some instances? What can Congress do legislatively and statutorily to better arm the industry to deal with this problem?

Thank you, Mr. Chairman.

Ms. LOWRIE. Very quickly, first of all, a strong, uniform national standard, strong consumer protections, objective compliance standards and I think the funding to support the consumer education and counseling, not just before application, before the borrower commits to the obligation of paying that loan back, but also to help those that do get in trouble on the back end with possible foreclosures, counseling to work them through so they can keep their home and not lose it through foreclosure.

Mr. BACHUS. Thank you. We appreciate that 9 minutes of questioning.

Mr. Cleaver?

Mr. CLEAVER. Thank you, Mr. Chairman. I will reduce my number to accommodate the 9 minutes from my colleague, Mr. Davis.

In part because my questions are along the same lines that he was raising, would any of you or all of you agree that sub-prime lending has been highly profitable?

Mr. NADON. I can tell you from personal experience that the margins in our business have been cut in half in the last 18 months. In an industry that was working historically for 200 to 225 basis point pre-tax margins for years, we are now operating at about a 100 to 110 basis point margin.

And we think that is going to be the way the future is, which I think is a positive because I see that as just one more sign of our industry truly maturing. This is the normal process that goes through any maturing business and we are seeing a lot of that.

And so now it becomes very important for us to emphasize a lot of our effort on cost control. One of the reasons why we are advocating getting a national standard for every lender in this country to follow and for regulators to have to pay attention to is because our IT costs, our training costs, our staffing costs, compliance costs, all of those are things that consumers have to pay.

Mr. CLEAVER. If we did away with prepayment penalties—Congress—is there any prediction on how the market would react?

Ms. LOWRIE. There have been studies done by some of our members within our organization that would show that rates would increase by about 100 basis points. And there are studies out there that we could share with the committee, to have you review.

Mr. CLEAVER. Anyone with a different?

Mr. EAKES. We believe, based on the data in North Carolina and other States that do not have prepayment penalties, that there is no premium in the interest rate now. So in fact, while people's rate sheets may show that they get a half a point lower, in reality, it does not work that way.

You do not pay a higher interest rate, in reality. And there is a Harvard study that has done that. We have done that study in North Carolina.

And I can explain why, but I have already gotten the hook a couple of times, so I will be quiet.

Mr. GREEN. Except that, in the secondary market, the risk of prepayment and the identification of that risk is part of the pricing. And a prepayment penalty is clear, identifiable. And if someone has agreed to it and it has been properly disclosed and educated and they have agreed to it and it makes sense from the total transaction, that does give a degree of certainty that gets priced into the deal, which also reduces the interest rate.

Mr. CLEAVER. Okay. I am working fast, Mr. Chairman.

Mr. BACHUS. You have all sorts of time. I mean, you really do.

Mr. CLEAVER. If a sight-challenged person was in need of a seeing-eye dog and they need this in order to make it, to get around, and someone provided the seeing-eye dog, who also had schizophrenia and would bite the person periodically, he would help the person but, you know, every four or five blocks, he would bite him.

And if the sight-challenged person were your cousin, what would you do for your cousin?

Ms. ADAMS. Sir, that is exactly what is going on in the marketplace right now.

Mr. CLEAVER. Absolutely.

Ms. ADAMS. But the cure exists within these two bills. The reason the prepayment penalty works is because—Mr. Green says it—they will market anything if you are willing to bear the risk.

Mr. CLEAVER. No, no, no.

Ms. ADAMS. So if the dog bites, okay, one, you do not get that dog; you get a dog that is properly trained.

Mr. CLEAVER. No, all the dogs bite.

Ms. ADAMS. But if you have that dog, you muzzle it. You train it and you restrict it so it does not have the ability to bite that person.

Mr. GREEN. But you do not kill the dog.

Ms. ADAMS. We have not killed the dog. You factor into your risk on the assignee liability. You factor in the prepayment penalty that lowers the rate. You factor in the fraud that increases the rate that you charge.

If we put those things in the fees, if we take out yield spread premium, if we take out the incentives for fraud that the mortgage brokers do, then you would have lower costs on the investment. And I will tell you that having the term—what is it?—reckless indifference is not a standard on assignee liability that makes any kind of sense because where is the recklessness when you have factored in all the fraud, all the predatory practices?

And the investor is protected. But the blind man is running around being chomped to death.

Mr. EAKES. We have a system right now that provides an incentive for people to take advantage of the unsophisticated. That is the problem is we have financial incentives for the originators of loans to put people into higher interest rate and into prepayment penalties that they may or may not require.

There are incentives built into the marketplace to take advantage of the unsophisticated.

Ms. LOWRIE. And that speaks volumes to why we need a strong, uniform national standard. If we think of the laws that are out there now on a State-by-State basis and just think of the thousands of municipalities that could pass laws over the next 12 to 24 months and we are sitting here saying we know the consumer needs to be better educated, we need to disclose better to them, they need to understand, we need to simplify the entire process with a strong, uniform national standard to make it easier for the consumer to understand, so that that consumer does not get abused.

And then, furthermore, laying it out with one standard that needs to be enforced across this country by the States and the departments of banking in each of the States to enforce a strong, uniform national standard.

Mr. EAKES. I mean, let's be honest here, when the North Carolina bill passed, I went to the Mortgage Bankers Association and to industry leaders and said to them, at this point in time, I could help deliver a uniform standard based on the North Carolina bill. The response I got was, ″No, we think we can stop it at the borders of North Carolina.″

It was not that folks wanted a strong, national standard. They wanted a weak national standard or no national standard. That is the truth. That is the truth.

Ms. ADAMS. I was there. I witnessed it.

Mr. BACHUS. All right.

Thank you.

Mr. CLEAVER. Thanks, Mr. Chairman.

Mr. BACHUS. I think for the record, for the panelists, would each of you all indicate whether it was the blind man or the seeing-eye dog that was schizophrenic?

Mr. CLEAVER. It is important.

Mr. BACHUS. Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman.

I thank the entire panel for your participation today.

Let me start with Mr. Eakes. Last week, Citigroup announced that it would not make home loans with mandatory arbitration clauses, joining a growing list of lenders that do not use them. What are your views on the legislation before this committee and how it deals with mandatory arbitration? Can you explain your concerns with mandatory arbitration clauses?

Mr. EAKES. I am glad you pointed out Citibank. I have been negotiating with Citibank for 6 years. And the announcement last Thursday was the culmination of 6 years of conversation and negotiation.

And what they did was prohibit arbitration clauses on any of their home loans. There are virtually no sub-prime or prime mortgage lenders left who offer arbitration clauses.

Wells Fargo is one and Household Finance. They are the only two I know of in the entire industry.

So arbitration clauses are basically a moot point now with Citibank's announcement. They also put a limit on all of their prepayment penalties of no more than 3 percent in the first year, 2 percent in the second year and 1 percent in the third year.

So what has happened in the last 5 years is the industry has adopted best practices and we really do have a better, cleaner industry now than we had 5 years ago. There is no question about that.

Mr. CLAY. Let me ask Mr. Nadon about that. I noticed that you offer brokers a signed commitment between brokers. And Option One to include a lot of issues, but one is that you will not knowingly submit an application for a non-prime loan for a borrower who is eligible for and whose needs are best met by a prime loan, along with Option One, reports all fraud to licensing and/or criminal authorities and may civilly sue brokers and agents.

If some version of this bill passes, do you anticipate the industry will experience a void or lose quite a few companies or just the bad ones?

Mr. NADON. I think it is just hopefully the few remaining bad players out there. I agree with Mr. Eakes.

I think there has been tremendous improvement over the last 5 to 10 years in the way that the industry behaves, all of which has been of benefit to the ultimate consumer. Is it where we all want it to be at this point? No. that is why we are all here today.

We think there is more that we could do, certainly within the confines of a national standard, to hold everyone accountable and try to set real best practices on fraud prevention, on points and fees, on all kinds of things, in the way that we are supposed to behave in this industry.

Mr. CLAY. And you are confident that, along with legislation, that the industry has already started by policing itself?

Mr. NADON. Oh, absolutely, because we really have to take a much more aggressive stance on that. And so we have been doing things in our own organization for the last 5 years, with quarterly educational notices on fair lending and antidiscrimination and things like that just for our brokers.

We do things for our associates every time we hire one and all the time that they are working for us. But we are extending that out now to the people that are touching the borrowers directly to try to educate them on things that they should be doing every day to make sure we treat people fairly.

Mr. CLAY. Thank you for that response.

Ms. Adams, let me ask you, Representative Davis posed a question and you did not get to answer it. Ms. Lowrie answered it. But he talked about racism and how disproportionately minorities are steered into sub-prime loans and worse and predatory loans.

How do we address that through legislation? Can you give me some examples of how maybe other States have tried to attack and fight racism through the lending industry?

Ms. ADAMS. I think one of the key things that we have to do is the Congress can—one, we have the Fair Housing Act and the Equal Credit Opportunity Act. We need more money for enforcement. In fact, there were major cuts to fair housing enforcement in the HUD bill this last time.

We need money for enforcement. But we also need the ability for State regulators and Federal regulators to monitor and look at the pools and portfolios of the lenders and to test them, to have the authority to go in and look at their practices more aggressively around these lending.

We also need Congress to, when these lenders come before you, to challenge them about their numbers and to ask them specifically what is the cause of the disparities within their ranks. If they say that it is credit score, then have them put the proof in front of you because I do not believe—all we are asking for is for people to be treated the same who have earned the same level of credit.

And I do not believe that that has panned out. The 2004 HMDA data has some really disturbing numbers in terms of the disparities that we found amongst the 15 lenders in the five million loans that were looked at.

They cannot be explained away simply by differences in credit. But I tell you that if you build upon discrimination by one, taking A-prime borrowers from African-American neighborhoods and putting them and locking them in the sub-prime market or worse, in a predatory loan, then they get behind and then you create a negative situation for that borrower that took a good A-credit customer and made them a C-credit borrower.

Mr. CLAY. I am bumping into Mr. Ford's time now, but who should enforce the antidiscrimination provisions of law? Should it be the State attorney generals or the Federal Government?

Ms. ADAMS. I believe that we need as much enforcement as possible. We do not have enough regulators at all. We need every regulator with the authority to bring these bad actors to justice swiftly.

The problem is that a law that does not have an enforcement mechanism is worthless to the victim. If they cannot find someone who will defend them and protect them, it is worthless. So we need as many cops on the beat as possible.

Mr. BACHUS. Mr. Ford?

Mr. FORD. Mr. Chairman, thank you.

I agree. There needs to be some kind of national umbrella. But I, like many on the panel, am concerned about what it looks like.

Ms. Adams or Ms. Lowrie, you were making the point when the question was asked about comparing the OCC preemption to Ney-Kanjorski and whether or not it went further, to my colleague, Mr. Davis's question. You were beginning to say that there were parts of it you thought that overstepped. And you talked a little bit about it in your testimony.

Do you want to clarify for 30 seconds?

Ms. LOWRIE. Not in relation to the OCC or the OTS exemptions, but just the exemptions within Ney-Kanjorski.

Mr. FORD. That is what I am talking about. I am sorry. I assumed that is the point you were making.

Ms. LOWRIE. What MBA supports and has supported for a long time is the strong protections and objective standards as it relates to loan origination. And there are some other broad exemptions within Ney-Kanjorski as it relates to foreclosures that would impact the States in some other areas.

We could submit that information to the committee. MBA staff could submit it. But we hope to work through some of those questions that have come in from our members, basically, that have said, you know, beyond the origination fee.

Mr. FORD. I would appreciate it if you would follow up on that.

Mr. Green, you have a good man sitting behind you. But let me ask you this question. And you make the point about not killing the dog, but in relation to Ms. Adams, I mean, I am struggling here. And Nadon there is my friend too.

I am struggling to figure out how do you reconcile the two? Because I think what was said by Ms. Adams is right. There has to be somewhere in between that we can land here that will help us.

How do we get close to training the dog, but not killing it? I mean, I read your testimony and I am glad you answered the question for Mr. Bachus because I had some questions about the testimony a little bit as well.

But how do we reach that kind of middle ground, if I can be so bold as to take Ms. Adams comment and use it as kind of a rubric?

Mr. GREEN. Well, we strongly believe that the sub-prime market is the way to ensure that all blind people have access to a dog. It may not be the very best dog.

And not to extend this analogy too far, but the point being that if the sub-prime market creates access to capital and people are educated and they have rights of action, that there are clear standards that every participant in the marketplace understands what is expected of them, including the lender, including the borrower, but particularly the lender and the assignee, and the roles of each are well-defined and the liabilities are defined and relevance to the role that they play in the transaction, I think you will create an environment where you will be able to root out even more predatory lending.

And I think I agree with everything that has been said here about the progress that has been made. You will root out more predatory lending and you will still preserve the ability of that subprime market to provide dogs of different varieties.

Mr. FORD. I hear you. And I do not know how we do that exactly.

I remember when I was in school and I was not very good at any sports, but they put me on most of the teams. And whenever one person in any drill that we were participating in did not meet the standard, we all were punished.

And although I had very little to do with why this guy behind me was too slow to actually finish the doggone thing in the right thing, if he did not finish, we all had to do it over. So we encouraged him to find a way to do it right.

I have to think there is a way to do that. And I understand there are real concerns about what North Carolina has done. I certainly do not want to do anything to squeeze people out of this business or hurt people who want to access capital.

But it just seems to me that there has to be a way. I mean, you all do not do this, but people who you—a lot of folks you know—we find kids in school who do not have jobs and we give them credit. We have to figure out a way to do this better than we are doing.

But the bad actors out there, I know you want them out of the business as much as I want them out of the business. And we have to be able to—I do not mean—I want to attribute that to everybody on the panel. But there has to be a way to find to do this.

I will close on this. I want to close with Steve.

This question of financial literacy—and I know your commitment. Ms. Adams laid out pretty clearly that $80 million is insufficient.

What could we do? What could this committee do to help?

Because I trust everybody on the panel. But I trust the way you kind of put these things together with the big South Carolinian you have behind you there, but figure out how we can get together and figure out how can we put a business model together for this, to figure out what it would cost nationally to do this?

Because we have a pretty sad state of affairs in my district in Memphis. And we have the highest bankruptcy rate in the country in my State and the second highest in the country in my city—something we are not proud of.

How can we help come to better understand that? And I would ask the chairman and even the ranking member of the committee, who I know are as committed to this as any on this committee, to figure out how—can we figure out some model that will give us a cost to do something at this level?

Mr. NADON. I think it is possible to put something together that we could submit. And I think Mr. Scott's recommendations are a great first step.

But I would take it to another level. If there is something that Members of Congress could be able to do somehow, if they could influence this, this is what I would ask.

Mr. FORD. Thank you, Mr. Chairman, for letting me go over time for a little bit. I apologize.

Mr. NADON. For most people in this country, the single largest financial transaction they will ever go through is either the purchase or the refinance of the mortgage of a house. It is complicated, a lot of things going on, a lot of information to know about, a lot of questions they should be able to ask. And they should be able to understand what kind of answers they are getting and whether they are good or bad answers.

Interestingly enough, there is nothing that I am aware of in our school systems today that teaches someone, going through grade school or high school or even into college that I am aware of, that teaches people the value of having a checking account, why that matters, to be banked, that teaches them what a credit score is and why it matters to pay their bills on time and how that will influence their ability to accumulate wealth in the future, that teaches them what a real estate transaction is all about so they would be able to get into the marketplace more educated than they start out, the way we are doing things today.

So somewhere between an educational financial literacy component within Ney-Kanjorski bill, but somehow the next generation and the generation after that, I think we all owe them something better than we have given them so far.

Ms. ADAMS. NCRC and its 600 members would love to work with Congress in developing a model that can be effective nationwide.

Mr. FORD. Yes, sir?

Mr. BACHUS. Quickly.

Mr. FORD. I am acting like I am the chairman.

Yes, sir, Mr. Green. Go right ahead.

Mr. GREEN. The Bond Market Association and its foundation, the Bond Market Foundation, would love to work with all of you. We have actually invested a great deal of time and money in this, doing quite a bit of case studies.

And targeted audiences like women, young people, the Hispanic community are the most underserved. And we have created a family of Web sites under tomorrowsmoney.org to help provide very basic fundamental building blocks of financial literacy that get people from knowing nothing to ultimately be planning for retirement and home purchases and things like that.

But it starts at targeting to the audiences you need to target because otherwise, you do not get through. Otherwise, it is too generic.

Mr. FORD. And I tell you, there is a hunger for it. Because we have been approached by the National Association of Hispanic Real Estate Professionals that are trying to find from us, is there some way you can help us serve our marketplace, our constituents better than we do today?

And it includes information. It includes literacy. It includes financial information.

But some of it is just getting good products out there and getting good services out there in a way that that clientele is going to be able to understand and feel good about.

Mr. BACHUS. Time has expired.

Mr. FORD. As the chairman knows, for every dollar an American earns today, he or she spends, on average, $1.22. All that financial literacy you are talking about, we could probably use a little of that help here in the Congress too with all the spending we do, so we look forward to whatever you all put together.

Mr. BACHUS. Thank the gentleman. Time has expired.

Mr. Baca, from California?

Mr. BACA. Thank you very much, Mr. Chairman. I know that most of the questions have been asked. But I want to ask the following question. And any one of you can respond to it.

I understand from reviewing your testimony that your organizations associated with credit unions offer lending services to underserved—and again talking about the underserved—and of course needing the education and the outreach.

Can you comment on how the two major proposals before Congress—the Ney-Kanjorski and the Miller-Watt-Frank bills—would affect your standing in the marketplace with respect to your competitors, as well as your ability to serve minorities—and this is the area that we are talking about—serve minorities and the underserved, which are two areas, which is question number one?

And do you feel that sometimes doing the right thing puts you at a competitive disadvantage and that putting additional restrictions on sub-prime lenders could level the playing field?

Mr. NADON. Well, I can take maybe the first shot at that. And I will tell you a compliment that we are paid by our sales force. This has been consistent for the last 13 years since we opened up Option One Mortgage.

They think that we are just awesome at responding to and complying with any law change. They think we are terrible at new products or competitive pricing, things like that. But they just know we are totally on it when it comes to compliance.

And it does put us at a competitive disadvantage. That is a position that our organization has been willing to accept because our view of it was—

Mr. BACA. Is that positive or negative?

Mr. NADON. We think it is positive in the long run. We think it is positive for our associates. We think it is positive for people to go home at the end of the day and actually feel good about what they have accomplished. That is the environment we are trying to create in our workplace.

And we think that if we can have our associates feel that way about their job, that will transfer over to the way that they deal with our customers. And we measure, through an outside source, customer engagement scores.

We have very high customer engagement scores, which means our customers are pretty happy doing business with us. And they refer people to us.

But that comes at a price. And the price is that we are not the biggest. We could be doing a lot more volume than we do today. But our wanting to do the right thing and make sure that we are complying with the rules the right way slows us down a little bit.

Mr. BACA. And the first portion, between the Ney-Kanjorski and Miller-Watt-Frank, anyone want to tackle that question?

Ms. LOWRIE. I will. The Mortgage Bankers Association feels very strongly that by creating a uniform national standard that has strong protections and has clear, objective standards for lenders to follow and for consumers to understand, that there will be less chance of discrimination. And you are going to have less chance of access to capital being removed from a marketplace, so all consumers will have equal access once there is a uniform national standard that exists throughout this country.

And I think we have a fiduciary responsibility to make sure that that standard is such that it not only protects the consumer, but it also gives them access to the capital within their marketplace and not be deprived.

Mr. BACA. How would you be able to determine, if you are looking at a uniform standard right now, less discrimination? How would you be able to detect that there is discrimination? And how is that discrimination applied?

Ms. LOWRIE. Well, I think it was mentioned earlier about the HMDA data. And all lenders are required to report under the Home Mortgage Disclosure Act. And I know that there have been some comments that initial reviews of the HMDA data is evidencing discrimination.

I would say though, I would submit to you and to the committee, that a big part of that is due to the fact that we have reached out to so many more borrowers through the alt-A and the non-prime market in a risk-based pricing environment. And when you look on the surface at the HMDA data, you do not see credit score; you do not see a lot of the information that causes that borrower to be a higher risk to the investor and ultimately to cause that consumer to pay a higher rate.

So in answer to your question, that is how we will have to look at it. And there will have to be in-depth studies, but not just initial reviews of the HMDA data, detailed studies looking at all of the data, including the credit score.

Mr. BACA. Mr. Eakes?

Mr. EAKES. I wanted to introduce to the record a table comparing the Miller-Watt-Frank bill and the Ney-Kanjorski bill and a summary that describes the weaknesses we see in the Ney-Kanjorski bill.

Mr. BACHUS. Without objection, part of the record.

Mr. EAKES. The problem really is in the details. The problem I have with the existing Ney-Kanjorski bill is that it does not work for the flipping standard; it does not work for the definition of fees. It reauthorizes single premium credit insurance and mandatory arbitration, where the industry has largely done away with it.

So it is not the intent of that bill that I am faulting at all; it is that the details of implementation in almost all of the sections in Title I, they do not work. And I think I will leave my written table to go into that in much more detail.

But that is my basic problem, is that the intent is good. But as of right now, the Ney-Kanjorski bill is an industry bill. It does not have a single civil rights group or wealth advocate group, community or consumer group that has sat at the table to help draft and fix the language.

I spent the last 6 years of my life working in 20 different State legislatures the details of these standards all across the country. And it is just that it is an industry bill at this point.

Eventually, we will all have to sit down and figure out how to make it, like we did in North Carolina.

Mr. NADON. If I could just add, as a spokesman for industry, we agree that there are pieces of the Ney-Kanjorski bill which I truly believe is the right long-term solution. But it is not perfect yet. There is tweaking that has to be done, tightening up, things that have to be modified to make it, I think, the kind of bill that we would be, at the end of the day, comfortable with.

Mr. BACA. So then it would be very harmful. I do not know if it would be, but would it be harmful in terms of passing legislation that does not really have the details of implementation or to fix the kind of language that would be inclusive of everything?

Mr. EAKES. If we could fix it and have, I think, particularly a non-preemptive bill, a bill that sets the floor, then I think it would do a lot of good. And the notion that having a non-preemptive bill would not do anything is just wrong.

HOEPA now is a non-preemptive bill. It was so weak that it did not do the job. But passing the Ney-Kanjorski bill in the form it is in now and preempting the right of States to enforce and to deal with the problems that arise newly in each State would be more harm than good.

It would create, I would predict, somewhere between 50,000 and 100,000 new foreclosures per year based on passing the bill in its current form.

Mr. BACA. I know that my time has run out, but you have indicated that apparently it would be very difficult on the States to enforce that law then?

Mr. EAKES. To enforce the Ney-Kanjorski? The provisions in the bill as it is currently written do not have any meaning. They do not constrain the bad practices that we have been working with the last 6 years.

So it is easy to enforce because there is nothing that it really is prohibiting.

Mr. BACA. Okay, thank you.

Chairman NEY. [Presiding.] I did not actually ask a question before. I yielded to everybody so they could get the questions in. And I do not want to hold up the next panel.

But just following the line for a second, I would be curious how it creates foreclosures, how the bill creates it.

Mr. EAKES. The two places I just mentioned. It reauthorizes mandatory arbitration, which has been pretty much abandoned by all of the players in the sub-prime marketplace. There are only one or two that are left.

So the bill, the Ney-Kanjorski bill now prohibits mandatory arbitration only on high-cost loans. So the rest of the sub-prime market, no one could prohibit it. And it would basically, with impunity, be able to come back.

On single premium credit insurance, I mentioned that earlier, essentially the bill as currently written allows single premium back into the marketplace. And no one could stop it.

Chairman NEY. How does it reauthorize it? It just does not ban it. But how does it reauthorize it?

Mr. EAKES. On which one?

Chairman NEY. How does it reauthorize mandatory arbitration?

Mr. EAKES. It says that no other State, no jurisdiction anywhere, can deal with it; that you have, by definition in this bill prohibited arbitration only on high-cost loans.

Mr. NADON. And Mr. Chairman, if it is worth maybe noting this for people's files, to my understanding, there is not one State law with an outright ban on mandatory arbitration.

Mr. EAKES. Well, the reason for that—

Chairman NEY. I think your terminology of reauthorization may not be technically accurate, reauthorizing.

Mr. NADON. And I do not think there has been the commensurate impact on foreclosures as a result of not one State law having an outright ban on mandatory arbitration.

Mr. EAKES. Well, States cannot ban arbitration. It is a Federal law. So the reason in North Carolina, we looked at it and we would have banned it.

But there is a Federal law dealing with arbitration.

Chairman NEY. I want to wrap up because I want to move on to the next panel. But looking at North Carolina, we have heard about obviously legislation, which goes beyond the minimum protection of HOEPA.

Other States are lagging behind, frankly, if you compare. If we do not do the national standard here, which would bring probably 25, 28, I am guessing, I think it is 30-some States almost up at the standards they do not have, how do you suggest those other States, if we do not do a national standard, come up to better standards, one? And in what period of time will it take to do that?

Mr. EAKES. Number one, I am all for a national standard, so long as it is the floor and that would cover all the States. Number two, the States that have not passed bills have still benefited from the battles that have taken place in the States that do.

The fact that Citigroup has just announced that they are reducing their prepayment penalties and having no mandatory arbitration benefits not just borrowers in North Carolina, which is where I was primarily focused for the last 6 years, but it would benefit borrowers in Ohio and Tennessee and everywhere else.

Chairman NEY. Oh, so one State does affect another State?

Mr. EAKES. It does.

Chairman NEY. So we are not in the areas where we used to be, where a State was isolated and what happened there did not affect the Nation?

Mr. EAKES. The lending that takes place in Ohio now is better because of the work that was brought to lenders in North Carolina 5 years ago. If you pass a weak standard, a standard that says for prepayment penalties, we are going to set it at 3 years.

Chairman NEY. But you are not against national standards, per se?

Mr. EAKES. National standard that sets a floor is a wonderful thing.

Chairman NEY. But I am just saying, you are not against national standards.

Mr. EAKES. I have spent the last 6 years of my life trying to get national standards, with no help from Congress, by working directly with lenders and industry groups. These guys are to be commended.

Option One is a great lender. They have, in fact, prospered in North Carolina and in the States that have put rules for the good guys to prosper.

Chairman NEY. I want to thank you for your time and patience. Thank you.

Move on to the second panel.

We will move on to panel two.

Our first witness is Lisa Bouldin-Carter, the national executive director of the BorrowSmart Public Education Foundation located in Cincinnati, Ohio. BorrowSmart educates homeowners about the home equity borrowing process and ways to avoid abusive lending practices and borrowers' rights and responsibilities. The foundation works with credit and housing counselors to get needed information and educational materials to the consumers.

And for the next witness, we turn to our gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

The next witness is Ms. Martina Guilfoil, from my district, Inglewood Neighborhood Counseling Services, where she is executive director.

She received her BA in community development from the Evergreen State College, her masters degree from the University of California, Los Angeles and has taken any number of courses in her own professional development that include: Achieving Excellence in Community Development from Harvard University; Leadership Development in Inter-Ethnic Relations, Asian-American

Legal Center; Community Scholars Program, University of California at Los Angeles.

Inglewood Neighborhood Housing Services are responsible for any number of programs, including the development and implementation of high-impact community development strategies, such as rehab loans, homeownership education, leadership training. And I know a little bit about Neighborhood Paint Out. I visited them on a Saturday in a paint out.

And I would like to welcome her to our committee and to Washington, D.C., Ms. Martina S. Guilfoil.

Chairman NEY. Thank you.

Next is Alan Hummel. He is the chief executive officer for the Iowa Residential Company in West Des Moines, Iowa. He is a licensed real estate broker and certified general real property appraiser in the State of Iowa.

Mr. Hummel is testifying today on behalf of the Appraisal Institut, Association of Professional Real Estate Appraisers, with 18,000 members throughout the world. The organization promotes professional credentialing, standards of professional practice and ethics.

Welcome.

And last is Jim Nabors from our State of Ohio, actually from Congressman Gillmor's district, although we like to claim, I think, Jim in Cleveland too and other parts of Ohio. He is president of Mister Money Mortgage of Sandusky, Ohio, is a founding member of the Ohio Association of Mortgage Brokers.

Jim has worked closely with many State legislators. And I was in the Senate and I saw firsthand how he helped pass Ohio's first State licensing bill and three other important regulatory bills.

Jim is the president-elect of the National Association of Mortgage Brokers. The association's members originate more than two-thirds of all residential loans in the United States.

Welcome, Jim.

And with that, we will start with Ms. Carter. Thanks.

STATEMENT OF MS. LISA BOULDIN-CARTER, NATIONAL EXECUTIVE DIRECTOR, BORROWSMART PUBLIC EDUCATION FOUNDATION

Ms. BOULDIN-CARTER. Good afternoon. My name is Lisa Bouldin-Carter and I am the national executive director of BorrowSmart Public Education Foundation, a non-profit based in Cincinnati, Ohio, which is a national organization.

Thank you, my fellow Ohioan, Chairman Ney and to the committee, for having me here today to share with you how BorrowSmart is educating homeowners to on how to wisely manage the investment in their most important asset—their home.

I hope to explain to you why financial education helps families to build personal wealth, but also serves as one deterrent to protect borrowers from abusive lending practices.

We also need a strong Federal law to provide consumer protections everywhere.

Consumers, especially those with less-than-perfect credit, often lack the knowledge to understand their mortgage options, whether they are buying a home or refinancing a mortgage. Many programs provide financial education of first-time homebuyers, but until the National Home Equity Mortgage Association, NHEMA, established BorrowSmart in 2002, none focused on educating the homeowner seeking to tap into their home equity.

BorrowSmart has created unique financial education programs that help both consumers and credit counselors understand the risks, rights and responsibilities involved in borrowing against equity in one home. To help as many consumers as possible, we distribute our program in two ways: one is to teach the consumer directly and the other is to train practitioners who work with consumers.

This is a national effort. And we have reached communities across the Nation.

This year, we plan to take it from Birmingham, Alabama, to Cleveland, Ohio, as well as many other communities. Our training focuses on money management development, making good budgeting decisions, how to work with lenders and spotting red flags for possible fraud or inappropriate loan practices or terms.

We also counsel on foreclosure prevention. All of our programs, services and materials are provided at no charge to help current and prospective home equity borrowers.

We partner with responsible mortgage lenders and community- or faith-based housing organizations to reach deep into the grass roots level. For example, BorrowSmart premiered its foreclosure training for housing counselors and homeowners in collaboration with SCANPH of Los Angeles, California and the First African Methodist Episcopal Church of Los Angeles, which is known as FAME Renaissance.

We are also working with the Urban League in the City of Orlando to offer foreclosure prevention, homeownership training to housing professionals and financial institutions in the greater Orlando-Tampa area. Part of the problem is that, too often, uneducated borrowers focus on the size of their monthly payment and fail to take into account the risks associated with borrowing against equity.

For an example, an adjustable rate new mortgage note might offer an initially low monthly payment, but will the homeowner be in the financial position to pay the mortgage when the rate adjusts? This is not to say that a borrower should not take an adjustable rate mortgage any more than one with early prepayment or discount points.

Such features can provide a borrower with a significantly more affordable monthly payment, but they must be considered in the context of the borrower's particular circumstances and goals. Each participant in a BorrowSmart program uses financial planning sheets and enables families to compare loans and to measure what they can afford.

We teach financial counselors to encourage consumers to consider at least three lenders and compare products to assure a loan fits into their budget and needs. Based on the goal a consumer is seeking, they learn to determine what type of loan is best for their financial situation and how to shop for it.

Based on my firsthand experience counseling consumers, I believe that borrowers, regardless of the reason they are seeking a loan, will make a wiser decision if they choose to participate in financial literacy classes, rather than if they are forced to attend. While BorrowSmart and other financial literacy programs are helping thousands of people, more needs to be done.

I commend Chairman Ney and Representative Kanjorski for incorporating Representative Scott's recommendations and including a housing counseling title in their bill, H.R. 1295, the Responsible Lending Act of 2005. A well-funded Office of Housing Counseling would strengthen the Federal Government's role in promoting financial literacy and make resources more available for housing counseling assistance.

In closing, let me emphasize that financial literacy is a tool that strengthens families. Children who connect to communities because they are in a home are more likely to stay in school.

Homeownership creates stronger tax bases to support hospitals, schools and other community services that are important in connecting and sustaining neighborhoods. They are the very basis of our society to achieve the American dream of homeownership and become involved citizens and community participants.

By housing counseling and financial literacy programs like those provided by BorrowSmart, we can reduce the amount of foreclosures, community decay and blighted neighborhoods. And, just as importantly, homeownership enables individuals to create, preserve and increase wealth for themselves and their families.

With financial literacy, we can change lives.

BorrowSmart commends the committee for focusing attention on the need for financial literacy education and creating solutions to eliminate abusive lending practices. We are passionate in our commitment to provide financial literacy education nationally and help consumers make better informed home purchasing and ownership decisions.

We hope to have the opportunity to work with you to further financial literacy for all Americans, regardless of social or economic status. I thank you for the opportunity this afternoon.

[The prepared statement of Ms. Bouldin-Carter can be found on page 138 of the appendix:]

Chairman NEY. Thank you for your testimony.

And we will move on to Ms. Guilfoil.

STATEMENT OF MS. MARTINA GUILFOIL, EXECUTIVE DIRECTOR, INGLEWOOD NEIGHBORHOOD HOUSING SERVICES

Ms. GUILFOIL. Thank you.

Good afternoon, Chairman Ney, Ranking Member Waters and committee members. It is my pleasure to appear before you today to present testimony regarding predatory and abusive lending practices and offer my perspective on necessary legislative remedies.

My name is Martina Guilfoil and I am the executive director of the Inglewood Neighborhood Housing Services, as well as the president of the National NeighborWorks Association. NNA is the national membership association of the 230 NeighborWorks Organizations working to revitalize nearly 3,000 communities throughout the country.

NeighborWorks organizations create and sustain economic wealth in low-and moderate-income communities by creating first-time homebuyers, providing pre-and post-purchasing counseling, financial literacy training and affordable home-improvement loans.

NeighborWorks organizations leverage funding they receive by the congressionally chartered Neighborhood Reinvestment Corporation now doing business as NeighborWorks America. Since 1993, NeighborWorks organizations have assisted over 88,000 households to become homeowners and have counseled nearly 524,000 people about the homebuying process.

Our members across the nation work tirelessly to educate potential homebuyers not only on how to purchase a home, but how to keep their home once they achieve ownership. Unfortunately, we are no match for the aggressive and relentless marketing efforts of the predatory lenders working in our communities.

Education is a tool that can prevent predatory abuse from taking place. But NeighborWorks organizations and other community counseling agencies do not have the resources to reach out to all of those who are being preyed upon.

For this reason, legislation that protects the consumer is needed.

In my written testimony, I outline several stories of families. And I do not want to belabor those today, especially since the hour is late.

But there are similar characteristics. Each loan is a bit different. But there is a common theme, and that is that the borrowers were unable to understand the complexity of the loans that they were being given; they were unsuspecting that they were being taken advantage of. And none of them could afford the loan payments, putting them in jeopardy of losing their homes without the intervention of the NeighborWorks organizations to prevent an inevitable foreclosure.

If we are to make any impact preventing unsuspecting Americans from falling prey to predatory lenders, any Federal legislation enacted must protect people of being stripped from their biggest asset, their home.

NNA and INHS vigorously support a national anti-predatory lending law that does not preempt existing State law. Any Federal law enacted must address these critical areas: education and disclosure, transparency, reasonableness and fairness.

NNA strongly encourages Federal legislation to err on the side of the consumer, as the consumer is the party left worse off by these loan transactions. Some of the following provisions we support in Federal legislation include, first and foremost, required counseling for high-cost loans. This is not unprecedented, as counseling is required in order to obtain a fully federally insured reverse mortgage loan.

Educational standards should be clearly spelled out, to ensure that the counseling being provided meets quality standards. Counselors should be HUD-certified, which would demonstrate a certain competency level; $58 is not enough money. A national hotline would act as a good clearinghouse, but would not substitute for having a counselor review the good faith estimate or closing statement.

Loan fees and terms should be fully disclosed. Assignee liability protections need to be in place.

We do not ask you to enact burdensome legislation that extinguishes firms' profitable niches; we simply advise you to construct thoughtful and articulate legislation that serves a practical purpose, helping individuals purchase or refinance a home using clear and fair lending products.

NeighborWorks organizations have been making home improvement loans to low-income and credit-challenged borrowers for over 27 years. The majority of people we assist fit the same profile that are targeted by predatory lenders.

However, our loan performance is far superior to that of predatory lenders. Nationally, the NeighborWorks loan portfolio has only a slightly higher 90-day delinquency rate than conventional loans and performed better than FHA and VA loans.

Few of these loans ever go into foreclosure. This experience indicates that, given the right product, one designed for success rather than loaded with excessive fees and interest rates, that borrowers can achieve and sustain ownership.

I would just like to address a couple of questions that came up previously that I do not think were adequately answered. One had to do with the foreclosure rates and the quote that foreclosure rates right now have gone down. However, if you look in high-cost markets, as in Congresswoman Waters's district and the one that I serve, where housing prices have increased over 200 percent since 2000, anybody who got a sub-prime loan or a predatory loan back then would have enough value in their property now to sell, so it would not show as a foreclosure loan.

But if you look at the HMDA data and you look at the sub-prime lenders that are infiltrating our neighborhoods, they are doing more lending than conventional lenders. So we cannot look at the foreclosure rate; we need to actually look at the HMDA data because in the high-cost markets, it will not show up.

And then another question was: what tools can Congress enact that can end the lending disparity that we are seeing? And nobody talked about the Community Reinvestment Act.

We can strengthen the lending being done in our neighborhoods by banks. I have had a lot of meetings with banks and they are receiving outstanding ratings on their CRA requirements, but yet, they are not lending in our communities.

They have ceded these neighborhoods to the sub-prime lenders because they are already receiving outstanding ratings on their CRA either lending or investment tests. And they are not in our neighborhoods. And they have decided that they do not want to go in there and they are willing to let sub-prime lenders take that market.

So I am thankful that you invited me here today and for sharing my thoughts on behalf of NeighborWorks Association and Inglewood NHS. I thank you for your leadership in addressing these critical issues.

[The prepared statement of Ms. Guilfoil can be found on page 180 of the appendix:]

Chairman NEY. Thank you for your testimony.

Mr. Hummel?

STATEMENT OF MR. ALAN E. HUMMEL, CHIEF EXECUTIVE OFFICER, IOWA RESIDENTIAL APPRAISAL COMPANY, ON BEHALF OF THE APPRAISAL INSTITUTE

Mr. HUMMEL. Thank you, Mr. Chairman.

Much of the testimony and discussion today has centered on the credit services side of the issues, which is appropriate. But collateral valuation is a large part of the lending equation and, if not properly addressed, could render otherwise meaningful legislation lacking.

Appraiser independence is crucial to advancing confidently toward the American dream of homeownership and financial security that goes with it. Sadly, your constituents are paying the price for the absence of such appraiser independence, bearing the heavy costs of investigations and massive financial failures.

Here is how the system fails consumers committing to the largest investment of their lives. A bloated appraisal is a time bomb.

If I buy a house with an inflated appraisal, I may not learn the consequences until years later. When the time comes to move, to refinance, to use my house as collateral, I may learn that it was never worth what I thought it was.

Nobody will buy the place and my credit is threatened. The security of my American dream has turned into a nightmare. And I am not alone.

Last year, Congress heard impassioned testimony from Americans ruined by predatory mortgage transactions, compounded by bad appraisals. There have been 6,000 mortgage defaults in Monroe County, Pennsylvania, alone. Now even more have lost their homes. And the human toll does not even show up on a spreadsheet.

Unfortunately, America has been to a school of hard knocks since Congress passed the savings and loan bailout in the 1980's. Faulty appraisals are still dictated by interested parties, the schoolyard bullies of real estate.

It is common knowledge that if an appraiser does not play the game and come in at whatever value is needed to close the deal, these bullies will take their lunch money. I do not exaggerate. A Michigan appraiser told a mortgage firm that a property was undergoing major renovations, only to be asked, "What is it going to take to have this home appraise?" ignoring the partially completed construction.

When an Arizona appraiser refused to come in right, the mortgage broker informed him that, "I will let the 170 loan officers that operate out of this branch know that you are by the book and lack the intelligence to effectively get around the law."

These abuses are not supposed to happen. But feeble oversight and underfunded State authorities are ill-equipped to stop them. It is as if the truant officer is tossing delinquents the car keys.

It is bizarre that a current Federal law is distorted to favor those with lower educational achievements over appraisers who have pursued their professional studies at the highest levels. Yet that is how a critical clause in the S&L reform continues to be misread. Fortunately, Title IV of H.R. 1295 addresses this issue.

It is encouraging that 40 percent of appraisers continue to support their professional organizations, refusing to drop out and leave the field to less qualified licensees, who may be more vulnerable to inappropriate pressure. Still, tired of the hassle, many ethical appraisers are abandoning the mortgage markets for more professional endeavors, leaving less accomplished appraisers to serve the homebuyers.

Both bills before the committee offer better ways of doing things. We believe that appraiser reform is a necessary part of any solution combat mortgage fraud and predatory lending.

We support Title IV of H.R. 1295 because it bans inappropriate pressure on appraisers, increases accountability of government regulators, and promotes professional standards. We believe that concerns about State legislation can be harmonized with our goal of open, even and fair property valuations throughout America.

Thank you.

[The prepared statement of Mr. Hummel can be found on page 196 of the appendix:]

Chairman NEY. Thank you for your testimony.

Mr. Nabors?

STATEMENT OF MR. JIM NABORS, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. NABORS. Good afternoon, Chairman Ney.

Chairman NEY. Do you want to put your microphone on there? Thank you.

Mr. NABORS. Good afternoon, Chairman Ney and members of the subcommittee.

I am Jim Nabors, president-elect of the National Association of Mortgage Brokers. I want to thank you for inviting me and NAMB to testify today on solutions to predatory lending.

As the voice of mortgage brokers, NAMB has more than 26,000 members in all 50 States and the District of Columbia. I want to first commend the committee for its leadership on this issue. Mortgage brokers are proud of our contribution to the record rate of homeownership.

We spend a significant amount of time with our customers and have a strong understanding of each part of the homebuying process. Predatory lending practices strip borrowers of home equity and threaten families with foreclosure, therefore destabilizing families and communities.

NAMB seeks to rid the industry of any unscrupulous actors that prey on the vulnerable homeowners.

NAMB believes there are three critical components to curbing predatory lending practices successfully: one, preventing predatory tactics without unduly restricting equal access to affordable credit for borrowers; two, promoting industry self-regulation and strengthening industry professional standards and relieving the regulatory burden imposed by the current patchwork of State and local laws; and three, providing and enhancing consumer education because an informed consumer is less likely to fall prey to predatory lending.

But first, I would like to discuss the issue of yield spread premiums. We take this opportunity to discuss the benefits that YSPs provide to consumers and clarify the misconceptions that many hold about them.

Yield spread premiums can be defined as compensation received from an originator in the form of a payment that represents the difference between the mortgage interest rate and the lender's wholesale cost to fund. All originators, whether a bank, lender or mortgage broker, receive compensation upon the sale of a mortgage in terms of the spread above the wholesale cost of funds.

The yield spread premium represents a component of the broker's or lender's compensation that is either not included, part of or all of the compensation received. Many lenders act as if they are brokers and that prior to mortgage loan closings, the lender has, in essence, pre-sold the loan to an investor.

As a result, most banks and other lenders not only receive compensation that is tantamount to yield spread premiums, but also receive service release premiums, or SRPs, upon the sale of the loan into the secondary market. The key difference is that mortgage broker yield spread premium compensation is disclosed to the consumer, but for similar yield spread compensation, whether it is yield spread or service release premiums from the lenders, is not.

A YSP is a tool that allows a consumer with little or no cash and impaired credit the option of a low-cost or no-cost home loan because the closing costs and broker and lender compensation are included in the interest rate, which is paid by the consumer over time. Without low-cost or no-cost home loans, many consumers, many of them first-time homeowners, would be unable to purchase a home because of insufficient cash reserves to cover upfront closing costs.

An issue that has surfaced when discussing proposals to address predatory lending is whether YSPs should be included in the points and fees threshold under HOEPA. NAMB believes it is imperative that any legislation exclude YSPs from the calculation of points and fees.

The YSP is already captured in the APR threshold and provides consumers the protections intended and outlined in HOEPA. Including the YSPs in the points and fees threshold will artificially cause loans originated by mortgage brokers to be considered high-cost, while excluding other identical loans originated by lenders that cost consumers the same in terms of points and fees and payments.

NAMB believes that all distribution channels should be treated in a uniform manner and that the option of a no-cost or low-cost loan be preserved for the consumer.

In addition, NAMB seeks legislation which will implement uniform national lending standards to address predatory lending practices effectively, preserve access to affordable credit and improve the overall expertise of the mortgage origination industry. NAMB supports measures that seek to protect consumers from predatory lending practices, including formal licensing, pre-licensure education and continuing education requirements.

However, we believe to be truly effective, such measures should not just apply to mortgage brokers, but to all mortgage originators. NAMB also supports a nationwide registry of all mortgage loan originators.

Such a registry should include verified information concerning the originator, adjudicated infractions and prior licensing information. Without detailed information about the individuals, such a registry will not be useful to State regulators, enforcement entities and potential employers.

I appreciate the opportunity to offer NAMB's views on predatory lending reform. I will be happy to answer any questions this committee may ask.

[The prepared statement of Mr. Nabors can be found on page 218 of the appendix:]

Chairman NEY. I want to thank you.

I wanted to point out, I think the point you made—there are a lot of points—but the national registry is critical because that will help to catch people. We have used the example before of if somebody goes to another State and you cannot catch them and they are doing the same violations.

But if they are in that registry, you have a better chance, I think, of being caught.

Mr. NABORS. Absolutely.

Chairman NEY. Mr. Hummel, I wanted to really give you a lot of credit for, I think, being horrifically candid with the Congress. It is not every group that will come and say, you know, this is—here it is, laying yourselves open out there.

I think it is a huge problem. And your willingness to work within the bill, I think, will be a very good thing.

Mr. HUMMEL. Mr. Chairman, I thank you. And I also thank you for the language in the bill, particularly Title IV and the three points that it addresses. Prohibition against inappropriate pressure on the appraiser, when we are in sub-prime or non-prime situations, when individuals unknowingly get upside down before they have made their first payment because appraisers have not acted appropriately because of inappropriate pressure, that is obviously a problem.

The provisions for oversight and enforcement of all the mortgage professionals, not just the appraisers, but also the unregulated mortgage brokers, many of which have no sanctions should they give inappropriate pressure on appraisers. And obviously, an increase in appraisal quality through professionalism that your language would instill.

Chairman NEY. And in the small communities—I mean, I am going to be frank with you—I have done it myself, where in a small community, somebody will say, "Well, this is the appraiser we are going to use." And I will say, "No, that is not the one I want."

"Well, this is the one we use." "Well, it is not who I want." Because in a small community, you know not to take that person. I am not saying that they have done something illegal, but you sure do not want them appraising your house because it may be up here and then you move in and you are already going to be losing, like driving a car off a parking lot.

Mr. HUMMEL. That is exactly the problem that we encounter when the correct qualified professional is not used.

Chairman NEY. And in urban areas, it is harder because not everybody knows everybody, so it is even harder. And in rural areas, it is tough too because people do not know certain things. And how do you get them up to educational levels?

So I think internally, to try to correct this dilemma, is the best way how we are trying to craft changes. And I just appreciate your help on that.

Mr. HUMMEL. Thank you.

Chairman NEY. I wanted to ask Ms. Bouldin-Carter about, in trying to help people and to help them understand, do you think it is a matter of more regulation or is it a matter of more education?

Ms. BOULDIN-CARTER. I think it is a combination of both. With financial literacy—

Chairman NEY. I mean, to stop predatory lending.

Ms. BOULDIN-CARTER. Absolutely. With financial literacy families begin to understand the documents that they are signing. They start to recognize what the terms are of the loan. And they are better able to make a decision that is going to suit their individual family needs.

With regulation, we will have the necessary oversight to make sure that things are put into place, where we are regulating what is wrong and that we are supporting all the things that are good.

Chairman NEY. With your organization down in Cincinnati, I mean, do you utilize also attorneys or can people be directed to Legal Aid? Or how do you do that?

Ms. BOULDIN-CARTER. What we do, we are a national organization. We just happen to be located in Cincinnati. But we look at it holistically.

When we are doing a training for practitioners, we include everyone. We include the consumer. We include lenders. We include practitioners and everyone that is involved in the process.

We have also done training with realtors. We have done training with appraisers. We look at everyone because everyone needs to be on the same page. And the ultimate goal is to have an informed consumer.

So we look at this process as a holistic process that has to incorporate everyone that is on the equity or the new homeownership team.

Chairman NEY. Thank you.

My time is going to be out in a minute, but Ms. Guilfoil, I had asked earlier, what about the fact that 25-some States or 26 States will be brought up to, I think, better standards under this bill? I guess what I am trying to get to is: are there parts of the bill you think that are effective in the legislation we have?

Ms. GUILFOIL. The Ney bill? Well, let me look here. I think that creating a floor, although certainly for some States where there is no floor, that would be helpful. However, there are definitely States where the existing legislation is stronger, in which case I think that there is a problem to have preemption.

Chairman NEY. Okay.

Well, I want to thank you, all the panelists.

The gentlelady from California?

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to ask Mr. Nabors: is there a standard fee for brokers for originating? And if not, if it differs from lender to lender, how do you make a decision about whom you refer to?

Mr. NABORS. I do not think there is a standard fee that mortgage brokers use across the country because of the difference in prices of the loans. For example, homes in California sell for a lot more than they do in Ohio. So the amount of the fee, the percentage of the fee, could be expected to be different.

But there is no standardization there.

Ms. WATERS. You are from Ohio, are you?

Mr. NABORS. I am from Ohio.

Ms. WATERS. What is it like in Ohio?

Mr. NABORS. Well, I am out in Sandusky, which is a really small town outside. But—

Ms. WATERS. What is it like in Sandusky?

Mr. NABORS. Well, the average house sells for between $80,000 and $120,000 or $130,000.

Ms. WATERS. There is someplace left like that in America?

Mr. NABORS. Absolutely. It is a wonderful place. You should come visit it.

But consequently, the cost of business is still the same, whether the house is located in Sandusky, Ohio, or anywhere in California. You still have to do the appraisal. And as an employer, as a mortgage broker, you have to pay rent and you have to pay your employees.

And so there are a lot of fixed costs.

Ms. WATERS. But there must be a difference between originating a loan for a house that you just described in Sandusky and a $1 million house in LA.

Mr. NABORS. Well, I would say one, I do not specialize in $1 million houses, but I think they ought to require an additional appraisal. But appraisals cost the same. I do not want to speak for Mr. Hummel.

An appraisal costs the same whether the house is worth $80,000 or $400,000.

Ms. WATERS. No, they do not. I just had this experience. And this is what I discovered.

I discovered that some lenders have in-house appraisers and they charge you one thing. Other lenders contract with appraisal firms and they charge something else. And I also understand there are mortgage bankers who are doing some loan originations and they mark up the appraisal fees from the people that they contract with.

People they contract with charge you $500; then the mortgage banker marks it up another $200. So it is not the same. I know that.

I have had a great learning experience recently in trying to negotiate a jumbo loan. And I will tell you, I learned a lot.

So it is different. I mean, I was so amazed at the difference between the appraisal price of one lender and a mortgage banker that I thought, "How do they do this?" They do what they want to do.

Mr. NABORS. Well, the in-house appraiser is a salaried employee of the bank. The outsourced appraiser is, for the most part, being paid as-is.

In Ohio, it is against the law to mark up third party fees. So if the appraiser charges us $250, which is the going rate right now in Ohio, we can only charge the customer $250. It is against the law in Ohio to mark up.

Ms. WATERS. Ms. Guilfoil, is that true in California?

Ms. GUILFOIL. Actually, I was just thinking about this. The appraisal fee that we charge for our loans has stayed the same from when the houses cost $120,000 and now they are going for $400,000; it is still the same appraisal fee. The fee has not been—

Ms. WATERS. What is it in California that would allow a mortgage banker to mark up the fee? I mean, is that not against the law?

Ms. GUILFOIL. It is not against the law. It is basically what the market will bear, which is partly why these—the APR and you need to know how to aggressively shop to know what it is that you are paying for these loans.

Ms. WATERS. Well, the average person does not know what a good appraisal fee cost is. I mean, I had no idea until I saw the difference. But I decided that I did not like kind of the overall attitude at one lender. And I said, "Well, let me check around and see." And I saw this great difference.

You know, literally what I think the average consumer is confronted with are a lot of fees that they have no idea what the standard is. You just have no way of knowing.

And in one sale of a piece of property I had, this little house I had for years I decided to sell, there was something in there, a $2,000 fee in Los Angeles, something about a county transfer fee. And I called the county to find out what this was.

And they said, "Hey, we do not have anything to do with that." And then when I talked to the real estate person, they said, "You can get rid of it."

I mean, it was not even real. So how is the average consumer supposed to know all this stuff?

Ms. BOULDIN-CARTER. Financial literacy.

Ms. WATERS. No.

Mr. HUMMEL. And through disclosure. One of the things that we have been big advocates of is on that disclosure, it should state what the appraiser was paid, not what is being collected for appraisal services because I know for a fact that services I provide for different lenders, dependent on the complexity of the assignment, they may order a different type of appraisal, which will cost more.

And it is possible that they do not have any appraisal.

Ms. WATERS. Oh no, they have drive-bys.

Mr. HUMMEL. They use a valuation model and they still call it an appraisal when a true appraisal has not been done.

Ms. WATERS. Yes, that is right.

Mr. HUMMEL. So that consumer is being misled into believing that they are getting professional services.

Ms. WATERS. But I learned about that. I learned about the drive-by appraisal.

Ms. GUILFOIL. Congresswoman, I think this is exactly why legislation is needed because you cannot expect the consumer to possibly understand all of these nuances. And I am a firm believer in financial education.

But we can only serve a very small percentage of people that are out there getting loans. And they are being taken advantage of.

The world of mortgage lending has become so complex over the last 10 years or so and the burden of responsibility is placed solely on the shoulders of the consumer. And that is an unfair position to place consumers and expect them to become fully educated without Federal relief.

Ms. WATERS. You are absolutely right. And while I have a great respect for financial literacy and all of that, I literally needed to take the deal to a friend who is in the business to take over this with me and help me to understand what I am getting into and how it all works.

And I want to tell you, I was embarrassed, sitting on this committee, when people think I know something about all of this, only to discover I knew very little. And I would not have been able to finalize this package in any reasonable way without the assistance of my friend, who is an expert.

And most people do not have that. So thank you very much.

Chairman NEY. Thank you.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Nabors, I have already spoken to mortgage brokers from North Carolina. And I certainly welcome that you need to talk with mortgage brokers and include them in any discussions on what Congress should do about this topic.

I have some questions based on your testimony and other testimony earlier today about yield spread premiums. I understand that yield spread premiums are paid by the lender rather than by the consumer.

And so it would be instead of the commission paid by the consumer upfront?

Mr. NABORS. Well, our customer would have multiple options. They could choose to pay whatever our fee is all upfront.

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. NABORS. They could choose to pay part of it upfront and have the other part paid by a yield spread premium. Or they could choose to have it completely paid by a yield spread premium.

Mr. MILLER OF NORTH CAROLINA. Okay. So there would be some instances when a consumer would pay both a commission and a yield spread premium?

Mr. NABORS. Yes. And that would be fully disclosed to them.

Mr. MILLER OF NORTH CAROLINA. Okay. Well, would the yield spread premium then, the combination depend upon what the consumer was paying in interest?

Mr. NABORS. It would determine what the interest rate would be to the consumer. And it would also depend on what the consumer felt was the best way they wanted to handle that transaction, whether they wanted a no-cost loan and they wanted—

Mr. MILLER OF NORTH CAROLINA. You agree that an upfront commission should be included in the fees and points trigger under any statute Congress passes?

Mr. NABORS. Yes.

Mr. MILLER OF NORTH CAROLINA. But yield spread premium, you think should not?

Mr. NABORS. Yield spread premium, we feel, is already captured.

Mr. MILLER OF NORTH CAROLINA. Well, if they are doing the same thing, if you shift it from one to the other, why shouldn't both be included in the points and fees?

Mr. NABORS. The problem is that the only ones required to disclose yield spread premiums are mortgage brokers. The rest of the industry that is getting yield spread premium is not required to.

So if you were to force mortgage brokers to include it in its calculations, it would—

Mr. MILLER OF NORTH CAROLINA. Right, but if it serves the same function as the commission upfront, if you shift it to the back end to a yield spread premium, shouldn't you therefore have some room left in the points and fees trigger to reflect it there without any effect?

Mr. NABORS. Well, I guess. As I said, our concern at NAMB is the fact that yield spread premium, mortgage brokers are the only ones that have to report it, so that other people would—other lenders and bankers who are charging the exact same fee because the payment is the same and the rate is the same would not fall into the HOEPA trigger.

Mr. MILLER OF NORTH CAROLINA. I have a couple of documents here that are apparently from public sources: one from the MBA's—Mortgage Bankers Association—sub-prime handbook and the other is apparently just off the Internet. And both, although they are both public documents, both do say that these say that these are not for distribution to the general public, but are for mortgage professionals only.

They both list their wholesale mortgage rate sheet. They both list credit scores down one side, maximum loans on the other and interest rates for people with different scores.

And then this one was from Argent Mortgage Company. It appears to say that any mortgage as much as one point higher than what would be here, based on the FICA score, would result in a payment rebate of .5. Is that a yield spread premium?

Mr. NABORS. I am sorry, could you say that again?

Mr. MILLER OF NORTH CAROLINA. Sure. Do we have a copy I can give you? I am not sure we do.

This is from Argent Mortgage Company. It has down one side the credit score. Across it, it is the amount that it will finance. And then, within that grid—it shows the loan to equity at the top.

And then within that grid, it shows an interest rate.

Mr. NABORS. Right.

Mr. MILLER OF NORTH CAROLINA. At the bottom, it appears to say that if the interest rate is 1 percent higher, that there is a bonus to be paid of .5, if it is one point higher. If it is two points higher, the bonus to be paid is .75.

Is that a yield spread premium?

Mr. NABORS. You know, I do not do business with Argent.

Mr. MILLER OF NORTH CAROLINA. But you do business. I mean, you do business with other lenders.

Mr. NABORS. Right.

Mr. MILLER OF NORTH CAROLINA. Is that the way yield spread premium rates works?

Mr. NABORS. I understand the tiered pricing. But I have never dealt with someone that had anything like that on the bottom.

Mr. MILLER OF NORTH CAROLINA. Okay.

North Carolina's law does not include yield spread premiums in the calculation of points and fees. But it does have a steering provision in law requiring a mortgage broker to make reasonable efforts with lenders with whom the broker regularly does business to secure a loan that is reasonably advantageous to the borrower, considering all the circumstances, including the rates, charges and repayment fees, terms of the loan and the loan options for which the borrower qualifies with such lenders.

There is no exception to that. That is a blanket requirement.

Why should there not be such a blanket requirement in the law? I believe that the Ney-Kanjorski draft—and we all can see that these are works in progress—provides an exception that if a borrower signs something saying they waive that duty not to be steered—not to have been steered—then there is no such requirement.

Why should there not be a provision like North Carolina's provision in Federal law? Why should there be an exception to that?

Do you think that should be your duty? That you should be under a duty to use reasonable efforts to get a borrower the best loan?

Mr. NABORS. I believe that mortgage brokers do use reasonable efforts to get their customers the best loan they can.

Mr. MILLER OF NORTH CAROLINA. Okay. And do you think that should be a legal requirement?

Mr. NABORS. I think yes, it should.

Mr. MILLER OF NORTH CAROLINA. Okay. And do you think there should be any exception to that? Do you think that consumers should be able to sign a one-page document, like this one here from the earlier testimony, saying that they waive that?

Mr. NABORS. Well, the question is what is in the best interest of the customer?

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. NABORS. Okay. Different circumstances. In some cases, what is really best for the customer may seem more expensive, right?

For example, if I can use an example, if you are applying for—for the most cases, we are talking about money purchase mortgages here, but we should also be talking about refinances and—

Mr. MILLER OF NORTH CAROLINA. I think we are talking about refinances here. When you look at loan to value and these loans are only being made where there is a whole lot of equity in the house.

Mr. NABORS. Right.

Mr. MILLER OF NORTH CAROLINA. I think we can assume that those are refinances.

Mr. NABORS. Right. But they could also be home equity loans, where someone just wants to draw the equity in their home out.

If you come to me and say, "Look, I need to borrow $20,000. My daughter is getting married in 2 weeks."

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. NABORS. I can come up with two options. I can come up with a lower case option that gives you the best rate at the lowest cost and you can have it in 60 days. Or I can come up with, through another lender, a higher rate with some higher fees and you can have the money in 10 days. That is your choice.

Now if the customer does not have the option of exiting out, we would pretty much have to tell them, “You have to take the 60-day option.” That is truly the best rate.

Mr. MILLER OF NORTH CAROLINA. Let me give you another example. Based on what this appears to say, and that is that a consumer wants to borrow $100,000, and they have an 80 percent loan to equity rate, their credit score is 620, according to the wholesale mortgage rate sheet, they should get a 7 percent interest rate.

Instead, they get a 9 percent interest rate. And the broker receives a rebate—a bonus, a yield spread premium, perhaps, of $75, $100; well, 75 percent would be, what, $750?

Chairman NEY. Mr. Nabors, the time is way over, but if you would like to answer that?

Mr. NABORS. Are you using the MBA sheet or are you using the Argent sheet?

Mr. MILLER OF NORTH CAROLINA. The Argent sheet. They are the same effect.

Mr. NABORS. As I said, I am not familiar with the Argent.

Mr. MILLER OF NORTH CAROLINA. I am not asking about this. I am not asking you about this. I am giving you the example, using this as an example. If that has happened, if a loan is simply 2 percent higher interest rate, no other difference, but as a result of that, the lender is paying .75 points or I think actually one point would be more the normal going rate, to the broker, would that appear to be a violation of a steering prohibition? And why would it not be?

Mr. NABORS. Well, one, I think it would be yield spread premium and have to be disclosed to the borrower. I have never seen one where it was a 1 percent markup paid you one point.

Mr. MILLER OF NORTH CAROLINA. It is usually two. I said two instead of—and that would give you one point. Should the law allow that?

Mr. NABORS. Well, if you are going to make 2 percent on a loan, okay? I can say there are many places that you can get a customer a better deal—and they are in a 2 percent premium or a 2 percent yield spread premium—than you can at 9 percent on a 620 borrower.

Mr. MILLER OF NORTH CAROLINA. Okay. But unless there is some difference like that, that does not appear on this sheet, if you just have a consumer who could have gotten a 7 percent loan on the very same terms, instead gets a 9 percent loan but the broker gets a 1 percent additional yield spread premium in addition to whatever upfront commission they would have, does that strike you as something the law should allow?

Mr. NABORS. If that is part of the agreement between you as a customer and me, as part of my total compensation, that has been disclosed to you, it would be okay. But if this is a bonus that is played outside the plan, if it is not disclosed on a good faith estimate or anything else—

Mr. MILLER OF NORTH CAROLINA. So if a consumer signs a piece of paper—

Chairman NEY. I have to note, we are so far over.

But, you know, if you would like to follow up with the question in writing though, Mr. Miller, and have it answered, without objection, we could do that.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I guess I want to take a point of special privilege. I heard Ms. Waters conceding that congressmen do not know everything. And you do not want to tell the general public that, do you?

This is a very complicated field. And while some of the questioning was going on, we had to concede, as writers of one of the bills here, that we started out trying to define what a sub-prime loan was, then conceded we did not have the capacity to put a definition in the legislation of what is a sub-prime loan.

So we started to go at just characteristics that were common in loans that are considered "sub-prime." But one of the points Ms. Waters, in her conversation with me, pointed out that we have to protect people. And indeed, we do.

We used to rely on the small communities where everybody had a lawyer or a priest or a minister, a mentor or a friend and that the mortgage market was relatively regional or small around that small town. Now we are into a global market.

Now a lot of us move on a constant basis. Some of us end up in California, God forbid.

But no, but as a result, we do not have someone to go to that is knowledgeable. And we basically rely on professionals.

And for better or for worse, realtors, builders, mortgage bankers are considered professionals. And yet, they are in a competitive world where they are really trying to make transactions and not necessarily charged legally with the responsibility of representing the best interests of the borrower. And we run into great conflict there.

And I wish that we could almost require all borrowers to take a financial literacy course to understand how to negotiate and what questions to ask. And I think that is what you offer some people.

But I am impressed with so many people that do not seek this out, do not understand it and do not care and are still rather blind in going into these transactions and, only after the fact, discover what has been disclosed to them in that stack of documents that every time I have ever entered into a mortgage, I have signed, but I could not tell you what is in them because I do not read them.

And I confess to that. And I know Ms. Waters sits home and reads every document in her closing and knows thoroughly what it means.

Ms. WATERS. Every line. Every line. Every letter.

Mr. KANJORSKI. But what we have to find is some common bond here, as to what we cover.

One of the questions, Mr. Hummel, I wanted to ask you in this area on appraisal: we did not include collusion, but we should, I think. And what are your thoughts on that, from the appraisal perspective?

Mr. HUMMEL. I wholeheartedly agree. And in our testimony, I believe we indicate that collusion should be included as one of the prohibited acts.

We have talked about extortion, coercion and bribery. But it is, in fact, you know, an "it takes two to tango" operation. The appraisers themselves are not going to be able to perpetrate the fraud themselves so collusion is a necessary—

Mr. KANJORSKI. I am sympathetic to that, but as a lawyer, I am thinking about: how do you prove collusion?

Mr. HUMMEL. There are standards in place already, the Uniform Standards of Professional Appraisal Practice, that allow other appraiser professionals to be able to review a document and state whether or not that is independent judgment.

Mr. KANJORSKI. Okay.

Mr. HUMMEL. Or whether or not that appraiser has acted in a manner that is not what his peers would have done; therefore, it would be in collusion with someone else.

Mr. KANJORSKI. And so I take it your testimony would be that we should certainly include collusion into the package?

Mr. HUMMEL. Certainly.

Mr. KANJORSKI. The other question on enforcement, what we tried to do with the Ney-Kanjorski bill was maintain State enforcement and not create a Federal bureaucracy. And particularly with the nuances of real estate law and financing law in the various States being as different as they are, we felt that the closer we could keep it to home, particularly at the State level, at the attorney general level, that would be the best thing to do.

What are your thoughts on enforcement?

Mr. HUMMEL. I am in agreement with using that methodology. And what does not exist now but would exist under Title IV of 1295 is the authority of such entities such as the appraisal subcommittees, who have funds available to them, but they do not have the Federal ability to make grants to States for enforcement.

States right now—the State appraisal licensing agencies—are in a predicament. They really would like to do what is right, many of them.

But their funds are restricted. Many of the funds colleted through appraised licensing fees go into the general fund and leaves them short of funds able to provide enforcement.

The legislation under Title IV of 1295 would allow Federal fund grants to go to the States for further enforcement. That way, we are keeping the enforcement within the State, where the appraisers are, where the attorney generals are, and given the resources available for that.

Mr. KANJORSKI. And you are saying we should add that provision? Or that provision being there covers that problem?

Mr. HUMMEL. I believe that that provision is covered within Title IV.

Mr. KANJORSKI. Okay, okay.

Now I if could, Mr. Nabors, the yield spread premiums, some testimony on the earlier panel said that they go as high as 10 percent. Is that your experience?

Mr. NABORS. I have never seen a loan that had 10 percent yield spread premium paid on it. And I have been in the business for almost 29 years.

Mr. KANJORSKI. What would your experience say the percentage would be?

Mr. NABORS. I would say the average fee a broker earns somewhere now is between 1 and 3.3 percent, depending on the amount of the loan. And I think that a 10 percent yield premium already had to throw that loan into HOEPA under the existing conditions.

But I have never seen that in my career.

Mr. KANJORSKI. Do you think we ought to do any requirement of not just disclosure forms, but a face-to-face language disclosure? That when certain categories of people come in for borrowing and they are going to be put in what we consider sub-prime lending rates, that they be told that this is not a premium rate; this is a sub-prime rate? And make that a requirement of the law? Would that make a difference?

Mr. NABORS. Well, one, I think another form for a customer to sign, I mean, they already are signing like 80 to 90 forms, that most part overwhelm them.

I think that the ability to us to go through financial literacy and do more education and to give them the ability to shop rates is going to be the safeguard against that problem. They are going to get—the way they are going to get the loan that they are entitled to is to shop more than one place, to call around and find out what program best fits their needs.

Mr. KANJORSKI. I understand that.

Ms. GUILFOIL. If I may? I just wanted to tell you that the reverse mortgage, which is very popular for seniors right now and it is very complicated to understand and it is not for everybody. There is a provision in the regulation that if it is a federally insured reverse mortgage, you have to obtain counseling and there has to be a firewall.

So the counseling, the person giving the mortgage—and in our market, Wells Fargo is a big provider of reverse mortgages—they cannot do the counseling. And you have to go to an approved, HUD-certified counselor to get the counseling, which we do.

And in many cases, we advise the people that, for what they are looking for, the reverse mortgage does not make sense, that they need a home improvement loan or an equity line or something. So it is not unprecedented to require a firewall of education on the kinds of loans that can strip people from their equity in their property.

Mr. KANJORSKI. And one side of a category because remember what you are doing here is you are limiting people's freedom to go out and buy a home in their timeframe, the type and under the conditions they decide to do. Suddenly, to some people, you would be saying, "Well, you have to go through some sort of process before you can have the same access to that home, as compared to most of us."

That is quite a constriction of freedom there. And how do we balance that out?

Mr. NABORS. Congressman Kanjorski, right now, any HOEPA loan under Section 32 provides additional disclosures, as well as an additional waiting period to close. So any loan that is under the new HOEPA triggers as proposed, again not all sub-prime loans, but those that would fall under the new HOEPA triggers, would include that.

Mr. KANJORSKI. That is the very highest category.

Mr. NABORS. Would already include that additional disclosure, as well as that additional waiting period.

Mr. KANJORSKI. What is that timeframe?

Mr. NABORS. Three days after the initial disclosure before they can actually close the loan.

Chairman NEY. Time has expired.

Ms. BOULDIN-CARTER. Can I just?

Chairman NEY. Yes.

Ms. BOULDIN-CARTER. I just wanted to say that one of the things about the financial literacy program that BorrowSmart offers is we do have a loan comparison chart where, in our classes, be it that we are talking to the consumer or the practitioner, we educate that you need to send your clients out to talk to three lenders; ask each and every lender apples to apples questions.

You then fill in the chart and return it back to the counseling agency. You are then sitting with an uninterested party who is going to help you look at the form and decide what is the best product for you, what are the costs of that product and what you can afford to pay.

Mr. KANJORSKI. That is great advice, but a lot of people do not take it. And the question is: should we enforce it by law or regulation? That is the question.

Ms. BOULDIN-CARTER. If you enforce it by law, people are going to go to the classes, but they may not necessarily get what is being delivered. If you make it available and make sure that we do something in terms of PSAs, 1–800 telephone numbers, as Congressman Scott has spoken about; we put it out there so that people know that they have an option.

Homeownership is about options, about education and about financial literacy. And we have to make sure that families understand it, because when they understand it, we do not have neighborhood decay and individuals take that house and continue to have a home.

Chairman NEY. Thank you. Just a point of clarification before we move to Mr. Scott, do the people take that checklist and take it to the lender and check it off, ask them the questions?

Ms. BOULDIN-CARTER. Absolutely.

Chairman NEY. Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. And I was able to catch some of the testimony, as I was in the process of another meeting back in my office, so I did not miss it all entirely.

Ms. Carter, first of all, let me thank you for your recognition of the value and importance of financial literacy and financial education and thank you for the kind words you had to say about this committee's efforts and our willingness to include financial education, a toll-free number and resources to help get financial literacy into the hands of our targeted group.

Because information is the key. He who has information is powerful. He who is not is a victim of predatory lending. That certainly has been the case.

Let me ask you, Ms. Carter, how can we keep track of unsavory lenders who target vulnerable populations, earlier rather than later, after the damage has been done?

Ms. BOULDIN-CARTER. I really believe that what happens is the counseling agencies in the individual communities are the best recordkeepers. These are the individuals that actually work with the consumers in their neighborhood. They know who are the lenders who are preying upon their families that they are working with.

When you were talking about families that are being offered these deals that are too good to be true, they just are not true. And as we train nationally, one of the things that we find out is the counselors that we are training or the practitioners that we are training, they can name names.

They can tell you who are the individuals that are in these urban communities, that are in these low-to moderate-income communities. One of the options that we would be able to—that I believe could be enforced would be the 1–800 number would be taken a step further so that practitioners would have an avenue to report who is doing the unscrupulous lending in their individual communities.

Mr. SCOTT. Yes, and that is exactly why we feel that the 1–800 number is so vital to any effort, because it is two-way. It gives us an opportunity to measure the size and scope of the problem. It allows us to be able to get that kind of information. If we can get individuals to call in and when they ask for assistance, we will be able to also ask them back a question or two.

That is what is critical. Education is not a one-way street. It is a two-way street.

A one-way street for information is called propaganda. A two-way street is education, give and take and back and forward. And that is why we feel an important ingredient in this process is that we have a fully staffed individual on each end of the conversation.

Mr. HUMMEL. Congressman Scott, if I may? You were asking how do you find about this unscrupulous lender before it is too late? I would like to tell you that the appraisers and appraisals are normally on the front end. And I can tell many times, prior to being engaged for that appraisal, what the intent of that particular lender is and whether or not they are trying to buy an appraisal or trying to understand the risks of their collateral.

And if we had available to us, being one of the practitioners, that ability not just to call an 800 number and say, “Hey, there is someone out here that is using inappropriate pressure and fraudulent practices,” and not only give a call to that 800 number, but to have a mechanism in place, that if that was a currently unregulated broker, that that person be regulated.

And that is part of what we are trying to accomplish here, I believe, is a more regulation of the unregulated individual so when they pull those stunts, we have the ability to provide enforcement.

Mr. SCOTT. And when you have that 1–800 number out there, those who have a desire to engage in that activity will know that there is something out there that could report them.

I am also concerned that many predatory loans are targeted to homeowners for second mortgages or home improvement loans. Can any of you provide recommendations for how financial literacy, financial education can be provided to families after they have purchased their house?

We are going to take this in steps. We know that the whole home purchase entity is a step-by-step process. It is the most fundamental activity we can do to start on a road of productive wealth, earnings, tax revenue for a community. It is the cornerstone of our community.

So not only do we want the literacy and education out there to, as we start the process, but also how you keep that home. What are the financial decisions that have to be made?

So I just wanted to get recommendations from you all that we might look at, that would help us with that.

Ms. BOULDIN-CARTER. Part of the training and the major focus of BorrowSmart is to educate the equity borrower. And the forms that we have available to the borrower, on one side of the form, as I have already spoke about, is the comparison shopping.

On the other form is a very simple, your monthly budget. What can I afford to borrow? What am I looking at? What type of interest rate would best fit me at this point in my life?

What do I want to do with that money? How am I going to continue to create wealth with homeownership if I take my dollars out of there? What is a good reason for me to take my dollars out of there?

This is exactly what BorrowSmart training does for the practitioner and for the consumer.

And quite frankly, Congressman Scott, we will be in Atlanta doing this training with HUD on June 8th. And we have already left notification for your staff in Atlanta.

Mr. SCOTT. Oh, great.

Ms. BOULDIN-CARTER. They are signed up to attend the training.

Mr. SCOTT. Wonderful. Wonderful. My crackerjack staff is on the ball. Wonderful.

Ms. Carter, in your testimony, you detail the important work that grass roots organizations are doing to promote homeownership. How can we supplement their efforts without recreating the wheel, so to speak?

Ms. BOULDIN-CARTER. I do not think we need to recreate the wheel; I agree with you very much. The problems with grass roots efforts are dollars, dollars, dollars.

There is so much to be out there and there are so many individuals that need to understand what homeownership means to themselves, to their communities and to the school districts. There are not enough dollars that are going into first-time homeownership counseling. And there certainly are not enough dollars that are going into equity counseling.

We need to have dollars so that when individuals go, there is someone there to open the door. We need to have enough non-profit counseling agencies so that individuals that have a question do not have to seek; they know that they can go to a local urban league, a HUD-based counseling agency, to a church, to United Way, that those agencies are there and that the necessary questions can be answered.

With financial literacy, you empower families. And those families are able to hold onto the wealth that you just spoke about.

Mr. SCOTT. Now you have examined the language in our bill on financial education and financial literacy.

Ms. BOULDIN-CARTER. Yes.

Mr. SCOTT. Various components of it; the 1–800 number, which we have had pretty good discussions on and everybody sees the value of that with the two-way fully staffed. Another part of that is to make grants available to grass roots organizations, to like the Urban League, like AARP, ACORN, NAACP, church groups, that have the credibility with the targeted groups.

Are you satisfied with where we are with the language in that bill? Do you see where we might need to add something to it?

Ms. BOULDIN-CARTER. My thoughts on that language—

Chairman NEY. Just to note, the time has expired. But if you would like to answer?

Ms. BOULDIN-CARTER. Okay. The only comment I would have on that—and I would be happy to talk with you later about it—is that we have to recognize that not all organizations are HUD-approved. And because they are HUD-approved, that does not mean that they are not a good counseling avenue.

So the only thing that I would like to say is that we need to look holistically to individuals that are out there, in the community, that are doing the grass roots counseling. Whether they be HUD-approved or not, they are value-added.

Mr. SCOTT. Yes, one final little point. I was just wondering: do you have any apprehensions or concerns about the effectiveness of this program if it is placed in HUD, especially in view of some of the latest evidence of dismantling of HUD and a lack of housing programs going in there, but being dispersed out to Commerce and out to Treasury?

Perhaps we may need to ask the question: is HUD the right place to put this program for it to be most successful, in an agency that would care about it and make it work? Is HUD that place?

Chairman NEY. We need a quick wrap up because we are way over.

Ms. BOULDIN-CARTER. And I am just not sure if HUD is the right place because of all of the areas that you mentioned and all of the things that are going on. And my final comment would be: if it is placed with HUD, HUD generally only funds HUD-approved agencies. So that would leave out a lot of community-based agencies and faith-based agencies.

Chairman NEY. Mr. Sherman?

Mr. SHERMAN. Thank you. Perhaps our two business witnesses could try to clarify, at least from their own experience, what kind of default rates sub-prime loans tend to have? We have had wildly different estimations on that.

And I realize you folks are at the originating side. But do you have any comment on this great dispute of whether the average sub-prime loan is 2 out of 100 or 20 out of 100 that go into foreclosure?

Yes? From the Appraisal Institute or the mortgage brokers?

Look, if this is outside our expertise, I realize it.

Mr. NABORS. It is definitely outside my expertise.

Mr. SHERMAN. Okay. Let me ask a question that is closer to your expertise. What is the average YSP that a sub-prime borrower is paying?

Mr. NABORS. Again, it can vary from area to area and how they want to be compensated. I can only speak for the knowledge I have in Ohio. It is usually about a 1 percent yield spread premium.

I would point out, there was just a Georgetown study that was given at the Federal Reserve that found that people that use mortgage brokers, on average, pay a 1 percent lower rate than if they go directly to a lender and pay 1 percent less in closing costs and fees than if they go directly to a lender.

Mr. SHERMAN. So you save 1 percent? You save money, even though you are paying the yield spread premium, you are paying less?

Mr. NABORS. Even with it included.

Mr. SHERMAN. Should there be a new disclosure requirement to simply tell the borrower exactly what the mortgage broker is receiving?

Mr. NABORS. Currently, there is. It is both on the good faith estimate and on the HUD–1 settlement statement.

Mr. HUMMEL. Congressman?

Mr. SHERMAN. Yes?

Mr. HUMMEL. I am sorry, but I now have an answer to your last question.

Mr. SHERMAN. Right.

Mr. HUMMEL. And the answer is actually coming out of a paper which I would respectfully ask be submitted within the testimony.

Mr. SHERMAN. I would hope the chairman would allow that document to be added to the record.

Mr. HUMMEL. And what is that indicating, from their studies—

Mr. SHERMAN. I ask unanimous consent that that be made part of the record.

Chairman NEY. Without objection.

Mr. SHERMAN. Thank you.

Mr. HUMMEL. And within that document, it indicates a wide range that you have been hearing, but anywhere from 10 to 34 percent, from the study that they have conducted.

Mr. SHERMAN. Ten to 34 percent go into what? I mean, because there are so many definitions of default. You can be late; you can be in default; you can be “in foreclosure” or you can be to the point where you lose the home. Do you know what they are defining here?

Mr. HUMMEL. With all due respect, I am only quoting what they indicated. And you can read the report from there.

Mr. SHERMAN. Okay, well, it will be part of the record. And we will all enjoy reading it.

Now you talk about inappropriate pressure on appraisers. It occurs to me that appraisers work for those placing the loan—you know, for the lender or the mortgage broker. And certainly, the people involved want the loan to close. Many of them are on commission.

And the appraiser wants to be selected for the next appraisal. I mean, I can see inappropriate pressure. If somebody pulls a gun on one of your guys, that is a problem.

But there is always the implication that the next job will go to the appraiser that helped this loan close. And it also occurs to me that a lender or mortgage broker who is paying your member double or triple the regular rate would be a particularly coveted assignment.

What do we do to prevent appraisers from being overpaid and selected on a made-as-instructed basis?

Mr. HUMMEL. That is the essence of what Title IV under 1295 attempts to do, and that is providing the oversight for those scoundrels that call themselves appraisers that do exactly what you are talking about. Now within my professional organization, it is very close to what 1295 suggests, is put in place an enforcement procedure so when this is brought to the attention of officials, that this person is not acting properly—that being the appraiser—they can have enforcement procedures.

Mr. SHERMAN. Who would bring this to the attention of the regulators? You have a borrower who is getting a loan and thinks he is buying a home that is worth $300,000 and is getting to move into a home and thinks he has a good deal.

You have people in the lending professions who are closing the loan. You have an appraiser who, in my example, is being paid double the regular rate.

Now who is going to drop a dime on this transaction, at the beginning? Now 5 years later, when you cannot pay and you cannot sell the home for the amount of the mortgage, I could see somebody being upset.

Mr. HUMMEL. Right, exactly. And that is the unfortunate situation is that they always find out after the time bomb has already exploded. And so what we are looking for, within this Responsible Lending Act, is provisions that, number one, put that appraiser on notice that we are going to come back, even if it is 5 years later.

Now unfortunately, that has already hurt someone. Number two, put into place the educational requirements at a level, instead of the minimum requirements we have now, educational requirements that it have the lenders going to the highest level, the qualified professional designated appraiser, rather than the State mandated minimum.

The type of legislation like that would encourage the use of these individuals. The types of environments that would allow appraisers—

Mr. SHERMAN. Well, let me propose one idea. I do not think it will catch on. What if all certified appraisers were simply selected by lot to do an appraisal so that it doesn't matter how high you came in on the last appraisal, for a particular lender has nothing to do with whether you get the next job?

Mr. HUMMEL. That is a system that is used well within the Veterans Administration. And it is a system that FHA had used in the past. And I find that to work very well.

Mr. SHERMAN. Turning to the other two witnesses, first, I have a new homebuyers fair in my district next week and I do not know if the gentlelady from Inglewood would want to come up or could recommend anybody else?

Ms. GUILFOIL. No, that is too far away.

It is the valley. Just kidding.

Mr. SHERMAN. And they ask us why we want to secede.

Ms. BOULDIN-CARTER. We will certainly send you some budgeting forms and some cost comparison forms and we will get them to you by the end of this week. We will be happy to do that.

Mr. SHERMAN. Why thank you.

Ms. GUILFOIL. Do you have a question? I mean, if you were serious, we do do homebuyer education.

Mr. SHERMAN. Yes, basically if you want to come, we have a table for you. And it is in the valley, which just makes it so wonderful.

Mr. NABORS. Congressman, our California affiliate would be happy to attend.

Mr. SHERMAN. Oh, absolutely. I think you folks may already be involved. But let's close the loop here. And I should be inviting all four of you.

So let me know.

The question I have for the first two witnesses are: do we need more uniform standards for certified housing counselors?

Chairman NEY. I would note we are out of time. But if you would like to conclude answers to that.

Ms. GUILFOIL. I think it is a simple answer. Yes, I think it is critical.

Ms. BOULDIN-CARTER. I think it establishes a baseline for everybody.

Mr. SHERMAN. Well, I look forward to seeing you all in the valley. And I know that Maxine is going to be our keynote speaker, opening the housing fair.

Ms. WATERS. I turn down all requests from the valley.

Chairman NEY. And we are going to hold very strict to 5 minutes for Mr. Davis.

Mr. DAVIS OF ALABAMA. Mr. Chairman, it has been 25, not 5, I thought this afternoon.

Let me kind of conceptually ask you all a little bit about the preemption debate because we have had a lot of questions about the specifics of what should be regulated, what should not be regulated. But I want to ask you kind of a broader set of questions.

Obviously, I think there is a pretty strong sentiment among not everyone, but most people on both sides of the aisle of this committee that there should be some kind of national standard. The debate arises over whether that standard should be a floor, with the States being able to ratchet above that standard, or whether that standard should be preemptive, which is what Ney-Kanjorski seeks to put in effect.

Now in most areas of civil law in this country, from products liability to medical malpractice to non-mortgage-based areas of consumer finance to the level of discrimination protection that is provided, to the extent of family and medical leave benefits that are extended, in most areas of civil regulation in this country, the States have a broad amount of ability to essentially do what they want to do, depending on the political climate in their States and the public policy sentiments in their States.

It is unclear to me, frankly, why mortgage lending should be treated differently from the way that we conceive of public policy in this country. It is unclear to me why there is something unique about the mortgage industry that makes it vulnerable to what you all describe as a patchwork of 50 States, when obviously that level of vulnerability exists in virtually every other aspect of American society.

Mr. Nabors, what is your response to that? What is it that is so unique about mortgage lending that makes you cry out for preemption?

Mr. NABORS. Well, I think that buying a home is the American dream. And keeping that home is a continuation of the American dream.

And so I think housing has always been treated differently than buying a car or anything else and needs to be. We need Federal preemption because of not only the differences in the States, but the localities.

It is causing tremendous problems with lenders who do not understand which area they are allowed to go into and which area they cannot. And it has caused, in many cases, discrimination.

Let's use the City of Cleveland as an example, as compared to the City of Dayton in Ohio. Ohio passed a law that says Ohio will regulate the mortgage industry. The City of Cleveland and the City of Dayton both determined that they wanted to go higher than those thresholds.

In the case of Dayton, the Dayton ordinance was ruled illegal. But in the case of Cleveland, it was ruled legal. So we have a conflicting law.

And another part of the problem is that the way a lender cannot tell, okay, can I do business in Cleveland? How am I going to determine, because they are on a national basis, that property is located in Cleveland per se?

Mr. DAVIS OF ALABAMA. Well, let me ask you a question about that proposition because I understand your argument, that the more regulations, the more regulatory frameworks there somehow would shield or a deterrent because people simply do not want to deal with such a wide variety of laws. Let me ask you this.

California, for example, has what I think is regarded as a pretty strong statute, a pretty strong regulatory environment. Is there any particular indication that the number of people getting mortgages has diminished in California since this statute was enacted? Anybody have an answer to that?

North Carolina. North Carolina has what is viewed as being a pretty far-reaching statute. Any indication that the number of mortgages extended in North Carolina has diminished since the statute was enacted?

Mr. NABORS. Well, you could say, okay, the number of mortgages have not diminished. But have they kept pace with the percentages of the increased volume of mortgages in other areas—for example, Ohio or Pennsylvania?

And I do not think North Carolina has kept pace with the other States, as far as new mortgages being generated.

Mr. DAVIS OF ALABAMA. Well, what about New York? New York City has a municipal ordinance. The State has a fairly comprehensive State ordinance. Any indication that New York is not a fairly robust market for people who want to participate in the mortgage industry?

You ladies are shaking your heads "no" at that.

Ms. BOULDIN-CARTER. No.

Mr. DAVIS OF ALABAMA. The point that I am making, Mr. Nabors, is I understand conceptually that obviously the industry wants as little regulation as possible. I understand that. And I understand that the industry wants to respond to as few regulators as possible.

But that would also be the wish of the automobile industry; that would be the wish of every industry that I know of in America. And the only reason to honor that, it would seem, would be if we somehow thought that there would be a deleterious impact on consumers.

If there would be an adverse impact on consumers, then we would actually constrain the availability of credit. Now what I am hearing is that, in the places that have a strong regulatory environment, there is no reason to think that credit has been unfairly constrained. There is no reason to think that credit is less available.

Do you ladies agree with that?

Ms. BOULDIN-CARTER. I mean, I think that what it does in all of the States—and I am from Ohio as well—I think that it does when we have regulations in place, it is a protection mechanism for those that are preyed upon the most. And if we have regulations that are going to be enacted by the Federal Government, then we have a standard.

If you want to go past that standard, that is fine.

Mr. DAVIS OF ALABAMA. Mr. Nabors, I would pose this question to you. Obviously, there is also wide agreement—certainly there was from the last panel—that the incidence of sub-prime lending in minority communities is not entirely market-based, that there may be an element of what we think of as actual discrimination in place.

We all agree that there is sub-prime lending to all kinds of families, older people, all kinds of people who do not necessarily economically fit in the category that would make them prone for subprime. In other words, what we have right now is not working.

So to some of us, that suggests that we do need a national standard. But it also may suggest that we need to allow the States to keep innovating.

And what I am trying to pinpoint is: what is the adversity to the industry, as opposed to just not wanting it? What is the genuine adversity to the industry if the States are allowed to regulate until somebody, somewhere gets it right? Because what we have right now is obviously not working.

Mr. NABORS. Well, we feel we need a national standard for two reasons. I mean, there are a lot of States out there that still do not have any regulations.

Mr. DAVIS OF ALABAMA. Now everybody agrees there needs to be a baseline, minimum national standard.

Mr. NABORS. There needs to be a base.

Mr. DAVIS OF ALABAMA. Nobody questions that.

Mr. NABORS. But in many cases, States have gone too far. Georgia would be a fine example. They needed to roll back what they had put in because it was actually hurting the consumer.

So we feel that the best approach is a national platform.

Mr. DAVIS OF ALABAMA. The last point I will make, because my time is out too, everyone cites the Georgia example, Mr. Nabors, but it strikes me that the Georgia example frankly is the lesser of the opposite proposition. Georgia enacted a law that went too far; the market responded. The legislature corrected that and now we are back to another baseline. That is kind of how the process works.

And frankly, out of 50 States, Georgia is the only example that I ever hear of an excessive law that was passed. And it was corrected.

So my sense, when I hear the Georgia example, is the overwhelming majority of the time, these States have not passed laws that have been excessive. And when they do it, the political process corrects that. That is kind of how our life works.

Mr. NABORS. Congressman, New Jersey would be another example.

Mr. DAVIS OF ALABAMA. Well, okay, let's take New Jersey. Has the level of lending in New Jersey gone down in the last several years? Has the availability of lending for people who need it diminished or dried up in New Jersey?

Mr. NABORS. I believe it has. Yes, sir.

Mr. DAVIS OF ALABAMA. You believe it has.

Mr. NABORS. I can get you statistics on that. I do not have the exact statistics. But yes, it has.

Mr. DAVIS OF ALABAMA. All right.

Thank you, Mr. Chairman.

Chairman NEY. I want to thank the members of the panel and thank the members of the committee here today, everybody for their patience and what was a long, but I think very important hearing. And without objection, the written statements will be made a part of the record for any follow-up.

The chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses and to place the response in the record.

With that, the hearing is adjourned.

Thank you.

[Whereupon, at 4:18 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 24, 2005

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS JOINT HEARING OF SUBCOMMITTEES ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT AND HOUSING AND COMMUNITY OPPORTUNITIES "LEGISLATIVE SOLUTIONS TO ABUSIVE MORTGAGE LENDING PRACTICES" MAY 24, 2005

Thank you, Chairman Ney for convening this fourth joint hearing of our two subcommittees to review issues related to the subprime mortgage lending industry in the United States.

In November 2003 we held a hearing which examined ways to eliminate abusive lending practices in the subprime lending market while preserving and promoting affordable lending to millions of Americans. Our second hearing, in March of last year, focused on the characteristics of subprime borrowers and the advantages and disadvantages the market poses to the financial security of these consumers. Our third hearing last June explored the role that the secondary market plays in providing liquidity to the subprime lending industry and creating homeownership opportunities for Americans with less than perfect credit records.

Today's hearing will focus on legislative proposals to abate and eliminate abusive mortgage lending practices. Earlier this year, Chairman Ney and Congressman Paul Kanjorski introduced H.R. 1295, the Responsible Lending Act, which contains a number of new and comprehensive solutions to mortgage lending problems and abuses. The other major legislative proposal to address this issue is H.R. 1182, the Prohibit Predatory Lending Act, which was introduced by Congressman Brad Miller and Congressman Melvin Watt. Chairman Ney, Congressman

Kanjorski, Congressman Watt and Congressman Miller deserve a lot of credit for their tireless efforts on this issue over the past year and I look forward to working with them.

As we have heard at our previous hearings, over the last decade or so, with low interest rates, a competitive marketplace, and various government policies encouraging homeownership, a record number of Americans have had the opportunity to purchase homes. A large number of these new homeowners have enjoyed one of the many benefits of homeownership -- using the equity in their homes for home improvements, family emergencies, debt consolidation, etc. Many of these consumers were able to purchase and use the equity in their homes because of the subprime lending market which provides millions of Americans with credit that they may not have otherwise been able to obtain.

Many borrowers are unable to qualify for the lowest mortgage rate available in the "prime" market — also known as the "conventional" or "conforming" market — because they have less than perfect credit or cannot meet some of the tougher underwriting requirements of the prime market. These borrowers, who generally are considered as posing higher risks, rely on the subprime market which offers more customized mortgage products to meet customers' varying credit needs and situations. Subprime borrowers pay higher rates and servicing costs to offset their greater risk.

Nationally, subprime mortgage originations have skyrocketed since the early 1990s. Finance companies, non-bank mortgage companies and to a lesser extent commercial banks have become active players in this area. In 1994, just $34 billion in subprime mortgages were originated, compared with over $213 billion in 2002 and $608 billion in 2004. The proportion of subprime loans compared with all home loans also rose dramatically. In 1994, subprime mortgages represented 5 percent of overall mortgage originations in the U.S. By 2002, the share had risen to 8.6 percent, and by the fourth quarter of 2004, the share had grown to 24 percent.

Unfortunately, the increase in subprime lending has in some instances increased abusive lending practices that have been targeted at more vulnerable populations, i.e. minorities and the elderly. These abusive practices have become known as "predatory lending." Predatory loan features include excessively high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flippings, loan steering, and unnecessary credit life insurance. Predatory lending has destroyed the dream of homeownership for many families while leaving behind devastated communities. Hopefully today's hearing will help us come up with solutions to address these issues.

Let me close by saying that I am committed -- as I think all of my colleagues on the Committee are — to finding ways to put an end to predatory lending while also preserving and promoting access for all homebuyers to affordable credit. I again commend Chairman Ney for his leadership, both in presiding over these important hearings and in advancing creative legislative solutions to the predatory lending problem.

I look forward to the testimony of our witnesses, and I yield back the balance of my time.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before
The Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit
"Legislative Solutions to Abusive Mortgage Lending Practices"
May 24, 2005

Thank you for yielding, Mr. Chairman.

In recent years lenders have used various techniques to provide credit to a large segment of the American population that may have otherwise been shut out of formal credit markets – those with limited or impaired credit histories and especially those in under-served low-income and minority communities. Unfortunately, too many families have been misled and forced into foreclosure, leaving their dreams of being homeowners unrealized. Their stories have been relived by thousands of American homeowners as predatory lenders ensnare them with contracts that are designed to collect huge sums in fees or that will use up all of the equity that one has accumulated. This is an economically devastating experience for many in the 1st Congressional District of Missouri.

I have been working with an effort to set national standards for sub-prime mortgage lending for the past two years. Lenders have long argued for national lending rules because they find it hard to comply with often conflicting state and local statues and many have pulled out of markets that have enacted laws they consider unworkable. I support this concept; however, the states' right to be involved in the enforcement of predatory laws must be preserved. We agree that the extension of credit is national, however, real estate lending is local.

My focus has been to find a way to preserve the subprime market while eradicating predatory lending by exacting severe penalties on those guilty of predatory lending. The penalties must be swift, severe, enforced fairly, regardless of the size of the offending institution. The subprime market is vital to the minority community. We must protect the good players and weed out the bad ones.

This is not an effort that Members of Congress and advocacy groups have undertaken alone. The mortgage industry has been instrumental in promoting a cleanup of bad mortgage practices and corrupt businesses. The industry wants to preserve its customer base and the resulting business. Their interest is in avoiding foreclosures also. We all know that we must have both legislation and programs of financial literacy to attack this beast.

We have a grave problem that must be addressed. We cannot sit idly by and do nothing. We cannot argue over political positions and come to no agreement or compromise legislation. We must get something done. This is the beginning of a process of negotiations not the presentation of a finished product. Let us keep that in mind and get about the business of getting relief to all of these victims of predatory lending.

Statement of the Honorable Harold Ford
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
Hearing entitled: "Legislative Solutions to Abusive Mortgage Lending Practices"
May 24, 2005

Thank you Chairmen Ney and Bachus and Ranking Members Waters and Sanders for holding this hearing on predatory lending.

I would also like to thank the witnesses for appearing before the committee on this issue this morning.

The impetus for this hearing and the legislation we will discuss are the predatory practices of some industry bad actors. I am a co-sponsor of both Ney-Kanjorski and Miller-Watt because I believe that both bills offer consumers protections and are a good starting point for dialogue on this issue.

According to one report, predatory lending costs consumers in Tennessee almost $150 million annually. In addition, HMDA data shows that African-Americans and Hispanics in my state are more than four times more likely to purchase a sub-prime loan than whites. My state along with many others has seen the benefit of the sub-prime market and its ugly side.

In response to an investigative report in "The Commercial Appeal" newspaper detailing the predatory lending practices of one company in my district, I introduced H.R. 1643, the Borrower's Bill of Rights.

The Borrower's Bill of Rights includes a 2-year financial literacy pilot program for 10 middle and 10 high schools across the U.S., requires plain English on all disclosures on loan forms, requires pre-loan counseling by a certified HUD counselor via in-person consultation or phone, limits the use of pay day loans and provides employees who have invested in company stock increased 401K protection.

The final legislation that leaves this committee should be bipartisan and include aspects of all three of the bills. I believe that a solution must be found to a practice that costs consumers in this country $9 billion annually.

TN has tried several times to pass anti-predatory lending legislation and to this point has been unsuccessful. Many states, including North Carolina have strong laws and argue that federal law should not "pre-empt" tough state laws. However, strong federal regulation would be a significant improvement over the current laws in my state.

This hearing is the first step in addressing this issue, I hope this dialogue will lead to a bi-partisan solution to a problem that affects everyone's district on this committee.

I look forward to the witnesses' testimony.

Thanks,

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT AND THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

HEARING ON LEGISLATIVE SOLUTIONS TO ABUSIVE MORTGAGE LENDING PRACTICES

TUESDAY, MAY 24, 2005

Mr. Chairman, I am pleased that we are meeting today to examine the issue of abusive and deceptive mortgage lending, and I commend you for convening this important hearing.

In recent years, the subprime mortgage industry has grown dramatically. In 1994, subprime lenders underwrote just $34 billion in mortgages. By 2004, this figure had ballooned to more than $600 billion. As the subprime industry has matured, complaints about abusive lending practices and concerns about conflicting state laws have also grown.

As my colleagues already know, I have spent several years studying these matters. As a result, I have come to the conclusion that there is a genuine need for strong, uniform national subprime lending standards with appropriate enforcement mechanisms to protect consumers.

Because the problem of abusive lending is complex, it also deserves a comprehensive solution. Beyond establishing uniform national standards, we need to improve housing counseling and better mortgage servicing. We also need to enhance appraiser independence and oversight, and strengthen mortgage broker licensing and supervision.

H.R. 1295, the bill that I have introduced along with Congressman Ney, achieves these five important objectives. Several of my colleagues have also introduced their own bills to address these issues. As a result, I am hopeful that in the coming months we can build on the growing bipartisan consensus in Congress about the need to address these matters.

Because the adoption of a uniform national standard is a key issue in these debates, I would like to focus briefly on why we need one. Establishing a uniform national standard will help to ensure that consumers receive the same set of protections no matter where they live or from whom they borrow. A uniform national standard will also ease regulatory burdens, level the competitive playing field, and ensure the affordability of loans for all consumers.

We are fortunate to have with us today a diverse group of witnesses. I already know that they will speak forcefully and candidly about their views in these matters. I also hope that they will share with us their ideas for how we can improve H.R. 1295, the Responsible Lending Act.

In particular, there are a number of questions that I hope these experts will address: How should we refine the bill's preemption language? Should we ban mandatory arbitration and single premium credit insurance on all loans? Should we also improve upon the bill's appraisal independence standard to incorporate a ban on collusion?

In closing, Mr. Chairman, we need to ensure that all homebuyers and homeowners are appropriately protected in today's complex mortgage marketplace. Today's hearing will further our debates in these matters, and hopefully build a consensus for enacting a subprime lending bill into law later in this session.

Opening Statement of Congressman Gregory W. Meeks
for the Joint Housing/Financial Institutions Subcommittee Hearing
in the Committee on Financial Services
May 24, 2005

I want to thank both the Chairman and Ranking Members of the two relevant subcommittees for holding this hearing to review a subject which is of critical importance to this country and certainly to my district. As we are all aware, the residential real estate market has been fueling the economy for at least the past four years while technology, airlines, automobiles and other sectors of our domestic economy have faltered. Secondary mortgage markets combined with plethoric home financing programs have allowed more Americans than ever to not only take part in the American dream of owning their own home but to become entrepreneurs through investing in real estate and/or using the equity of their primary home to start a small business venture.

In my own district, empty lots where one family homes once stood have been replaced by two to four family homes, and a beachfront that was cleared for urban renewal 40 years ago is becoming occupied by luxury homes. In many ways this is wonderful for the many young families that want to begin building wealth through the largest purchase that most Americans will ever make; the purchase of a home. Unfortunately, along with this enthusiasm for home ownership comes those who will prey on people's ambitions.

Not all Americans have excellent credit, and therefore the sub-prime market provides a necessary service for those Americans who have such a need. However, as with any other financial transaction in the world, there are those who will take advantage of the unsuspecting, unsophisticated or desperate. Predatory lenders, whether they be mortgage lenders, brokers or contractors, take advantage of consumers lack of knowledge or difficult circumstances through financial entanglements with excessive fees and/or interest rates that make the loan unsustainable. I have personally had to get involved with constituents in my district that have been victimized by such lenders.

As many states have, it is imperative that Congress get involved in this issue so that we can separate the wheat from the chaff and seek to eliminate the predatory players from the sub-prime market. This is why I am an original cosponsor of the Ney/Kanjorski bill and the Miller-Watt bill. I believe that a bi-partisan compromise that includes the comprehensiveness of Ney-Kanjorski with the fine tuning of Miller-Watt can provide a bill will benefit consumers and industry and keep our real estate market on a smooth track. Mr. Ney has approached me about his desire to develop a compromise bill. I and my office have been in communication with Mr. Watt and Mr. Kanjorski and I am confident that we can accomplish this goal.

Opening Statement of the Honorable Bob Ney
Chairman, Subcommittee on Housing and Community Opportunity

Hearing on

"Legislative Solutions to Abusive Mortgage Lending Practices"

Tuesday, May 24, 2004

Today these two subcommittees meet to continue their investigation of the subprime mortgage market and its importance to consumers. In the past few years, Chairman Bachus and I have taken a great deal of time to investigate and find solutions to the problem of abusive and predatory lending practices, especially in the subprime market. We first began by holding roundtables to discuss these practices, subprime lending in general, and ways to ensure credit availability for those who need and want it. In addition, last Congress we held a number of joint hearings to continue to investigate this issue that affects all participants in the mortgage market.

Today, we will move this process forward by examining potential federal legislative solutions to abusive lending practices. In March, I introduced, along with Congressman Paul Kanjorski of Pennsylvania, the Responsible Lending Act, which aims to stop abusive lending practices while allowing the mortgage market to continue to offer affordable credit. Congressman Kanjorski and I worked long and hard to craft legislative solutions that drew from the many hearings this committee held last Congress as well as the thoughts and suggestions of all of those who will be affected by this bill.

Congressman Kanjorski and I believe that we have struck a lot of good compromises in this bill. We believe this bill provides the most comprehensive, balanced, and effective set of legislative solutions that any Federal or State bill has ever offered for protecting mortgage borrowers from abusive, deceptive, and unfair lending practices. We also understand that, like all legislation, many people have ideas about how it can be improved further. As we stated from the beginning, we are willing to continue to work to improve and refine the bill. That being said, we strongly believe that the approach and the principles embodied in the Responsible Lending Act are the appropriate way to address this problem.

The United States mortgage market is the deepest and most affordable in the world. Due to the evolution of unique funding structures for mortgages, Americans pay less for mortgages than almost anyone else in the world. As a result, this country has the world's highest homeownership rate. However, many consumers have had to pay more for credit than they should because of abusive and deceptive lending practices. Many state laws, as well as the mortgage lending industry itself, have done a lot to stop these practices. Unfortunately, the resulting patchwork of state and local laws threatens to undermine their intent: to provide affordable mortgage credit to consumers who need it the most.

The time has come for a uniform national standard in this area. The Ney-Kanjorski Responsible Lending Act recognizes this fact and attempts to strike a balance between protecting consumers from unscrupulous practices and creating uniform regulations that will allow mortgage lenders to offer borrowers affordable credit options.

I look forward to hearing form our witnesses and I want to thank all of them for taking time from their busy schedules to be with us today. I now want to recognize my Ranking Member, Mrs. Waters.

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Testimony of Stella Adams
Board Member, National Community Reinvestment Coalition, and Executive Director North Carolina Fair Housing Center, Inc., and

Before the House Subcommittees of the Financial Services Committee on Housing and Community Opportunity and Financial Institutions and Consumer Credit

Regarding Legislative Solutions to Abusive Mortgage Lending Practices

Tuesday, May 24

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Introduction

Chairmen Ney and Bachus, and Ranking Minority Members Waters and Sanders and Representatives Miller and Watt, it is an honor to be here today as the voice for over 600 community organizations from across the country that comprises the National Community Reinvestment Coalition. NCRC is the nation's economic justice trade association dedicated to increasing access to credit and capital for minority and working class families. Our member organizations represent communities from your congressional districts. Organizations such as the Coalition of Neighborhoods in Ohio, the Community Action Partnership of North Alabama, the Community Action Committee of the Lehigh Valley in Pennsylvania, and finally the North Carolina Fair Housing Center where I am the executive director. We appreciate you convening today's hearing on an issue that all of our members have been addressing for the last ten years.

In North Carolina, my organization worked in coalition with the Community Reinvestment Association of North Carolina, several grassroots community organizations, and industry to craft, promote, and help secure the passage of the North Carolina anti-predatory lending bill in 1999. Although North Carolinians enjoy protection from predatory lending, there are still many states where consumers have little to no protections at all; we believe that should change.

Predatory lending is fast becoming a national epidemic. Abusive lenders have stolen billions of dollars in home equity and have taken thousands of homes in foreclosure proceedings. The abuse is spread throughout the entire transaction process to include appraisal fraud. Predatory lenders prey on the poor working class, minorities, the elderly and even our men and women in uniform. Congress has provided plenty of regulatory relief to lending institutions. It is now time for Congress to provide consumers' relief from the greatest property crime of them all – predatory lending. While much attention has been devoted to regulatory relief for financial institutions, we submit that the time is now for consumer relief. Congress needs to devote the same attention and provide consumer relief from abusive lending practices that steal from homeowner equity, which is the primary or only form of wealth building for most Americans

In my testimony today, I am going to describe the national dimensions of the problem that includes price discrimination and abusive lending. I am going to draw upon NCRC's Consumer Rescue Fund program, which is a national level program that identifies victims of predatory lenders on the brink of foreclosure and bankruptcy, and then arranges affordable refinance loans so that they can remain in their homes. I will also highlight the results from the national testing of subprime lenders from across the country. I will then offer recommendations for a national level bill that includes the best elements of the Responsible Lending Act (HR 1295, Ney-Kanjorski) and the Prohibit Predatory Lending Act (HR 1182, Miller-Watt-Frank).

Before I start my testimony, I ask the Chairmen and Ranking Minority Members if NCRC's most recent report using the new 2004 home loan data be added to the

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Congressional record. I would also like to attach to my testimony the names of community organizations that recently signed onto a NCRC letter to Congress concerning the recent bills introduced in the House.

What is Predatory Lending

A subprime loan has an interest rate higher than prevailing and competitive rates in order to compensate for the added risk of lending to a borrower with impaired credit. NCRC defines a predatory loan as an unsuitable loan designed to exploit vulnerable and unsophisticated borrowers. Predatory loans are a subset of subprime loans. A predatory loan has one or more of the following features: 1) charges more in interest and fees than is required to cover the added risk of lending to borrowers with credit imperfections, 2) contains abusive terms and conditions that trap borrowers and lead to increased indebtedness, 3) does not take into account the borrower's ability to repay the loan, and 4) violates fair lending laws by targeting women, minorities and communities of color.

Predatory lending generally occurs in the subprime mortgage market, where most borrowers use the collateral in their homes for debt consolidation or other consumer credit purposes. Let me be clear we are not against responsible subprime lending for consumers with less than perfect credit.

Pricing Disparities Cannot Be Explained Away

Price discrimination is not often discussed in the context of predatory lending, but we believe that it is a central element of predatory lending. When a borrower is steered towards a loan with an Annual Percentage Rate (APR) two or three percentage points higher than the loan for which she qualifies, the borrower will pay tens of thousands or hundreds of thousand dollars more in mortgage costs due to the discrimination. This represents an incredible loss of wealth, which could have been used to send a child to college or start a small business. In 2003, NCRC released a path-breaking study, entitled the *Broken Credit System*, documenting price discrimination on a national level. We found that after controlling for creditworthiness and housing characteristics, the amount of subprime refinance loans increased as the number of minorities and elderly increased in neighborhoods in ten large metropolitan areas. In addition to the NCRC report, two studies conducted by Federal Reserve economists also found that subprime lending increases in minority neighborhoods after controlling for creditworthiness and housing market conditions.[1]

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[1] Paul S. Calem, Kevin Gillen, and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, October 30, 2002. See also Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter, *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, in Fannie Mae Foundation's Housing Policy Debate, Volume 15, Issue 3, 2004 pp. 603-622.

[3] NCRC, *Fair Lending Disparities by Race, Income, and Gender in All Metropolitan Areas in America*, March 2005, available via http://www.ncrc.org or contacting NCRC on 202-628-8866.

NCRC has conducted two more recent studies documenting the persistence and stubbornness of pricing disparities. In a study released in March, we found that pricing disparities to minorities, women, and low- and moderate-income borrowers are pervasive throughout the great majority of metropolitan areas in the country.[3] Using 2003 Home Mortgage Disclosure Act (HMDA) data, we observed that subprime lenders offered a greater percentage of their loans than prime lenders to women, African-Americans, and Hispanics in 100%, 98.5% and 89.1% of the nation's metropolitan areas, respectively.

Strikingly, the disparities were worst in a number of medium-sized metropolitan areas. In Macon, Georgia, for instance, subprime lenders made 59.3 percent of their home loans to African-Americans while prime lenders issued only 13.7 percent of their loans during 2003 to these borrowers. In Corpus Christi, TX, subprime lenders offered 53.1 percent of their home loans to Hispanic borrowers while prime lenders made just 28.3 percent of their loans to Hispanics in a metropolitan area whose population is 55 percent Hispanic. The finding that many medium sized metropolitan areas in states with relatively weak anti-predatory loans experienced large pricing disparities indicates a need for national legislation.

We also discovered that as the level of racial segregation increased, the portion of subprime loans in minority neighborhoods increased faster than the portion of prime loans in minority neighborhoods, controlling for the affordability of homeowner units. Again, this finding reveals that lender decisions are not driven only by legitimate differences in creditworthiness. Instead, the finding suggests intensified targeting of minority neighborhoods as segregation increases since segregation makes it easier for lenders to identify and target minority neighborhoods.

On the heels of the metropolitan level study, NCRC released a report entitled, *The 2004 Fair Lending Disparities: Stubborn and Persistent.* This report was one of the first studies to examine the new 2004 HMDA data with pricing information for subprime lenders; the new HMDA data only became available this April on a per lender basis.[4] Sampling 15 large lenders that made more than 5 million home loans, NCRC found glaring price disparities. Of all the conventional loans made to African-Americans, 29.4 percent were subprime. In contrast, of all the conventional loans issued to whites, only 10.3 percent were subprime. Hispanics and Native Americans also received a disproportionate amount of subprime loans. About 15% and 13.6% of the conventional loans made to Hispanics and Native Americans, respectively, were subprime loans. Finally, 15.4 percent of the loans made to women were subprime whereas 11 percent of the loans made to men were subprime.

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[4] Prior to the 2004 data, researchers have used a list developed by the Department of Housing and Urban Development of subprime and manufactured housing specialists to document patterns of subprime and prime lending. For more information about HUD's list, please see NCRC's *The 2004 Fair Lending Disparities: Stubborn and Persistent.*

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The similarity in disparities between the new 2004 data and the 2003 HMDA data was striking. In 2003, for example, 28 percent of the loans received by African-Americans were subprime whereas the figure was 29 percent for the 2004 data. NCRC's studies over the years reveal that pricing disparities remain consistent and unsavory lender behavior is responsible for a significant amount of the disparities. Lawmakers must act to protect homeowner equity.

We also encourage Congress to carefully study a report that will be released this Wednesday by the National Council of La Raza, the nation's largest Hispanic civil rights and advocacy organization. *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market*, which will be available to download from the NCLR website, www.nclr.org, shows that Hispanics disproportionately receive high cost mortgages that hinder their ability to build equity. This report is more evidence that minorities are much more likely to receive high cost loans than other borrowers.

Fair Lending Testing Provide Vivid Examples of Disparate Treatment and Pricing

NCRC has recently completed a Department of Housing and Urban Development Fair Housing Initiative Program (FHIP) Private Enforcement Initiative Grant. Through this initiative, NCRC conducted subprime fair lending testing of large lenders in six major metropolitan areas throughout the United States. The results provide detailed and vivid examples of disparate treatment and pricing in subprime lending based on race and gender.

NCRC conducted forty-eight tests of 12 subprime lenders with retail outlets serving the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Los Angeles, and New York City. We conducted this national testing project with the assistance and cooperation of local NCRC members, community organizations, civil rights activists, and consumer protection organizations.

The testing uncovered a 45% rate of disparate treatment based on race. In particular, the testing uncovered several practices that may have a disparate impact upon African-American consumers, and predominately African-American communities. Additionally, the testing uncovered a number of instances of sex discrimination. Finally, the testing uncovered the need for changes in the policies and practices of many of the lenders in order to make loans more accessible to all consumers on an equal basis. Moreover, in a number of the tests, loan staff failed to follow publicly stated lender best practices, such as referral up to a prime loan for qualified mortgage applicants.

NCRC carefully developed testing methodology. NCRC employed matched paired site visit tests in 40 of 48 tests. The second test type was matched paired telephone tests. In all of the testing (which was pre-application testing), the tester contacted the lending institution and indicated that they (the tester and spouse) were interested in obtaining a home equity loan. All testers were given a profile indicating that they were qualified for a prime loan. All tester profiles indicated that the testers were married and were long

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time homeowners with substantial equity in their homes. All testers had a low loan to value ratio (below 80% after the requested home equity loan), a good debt to income ratio (below the 36% often used for conventional loans), and the tester represented that they had good credit. While tester profiles were substantially similar, African-American testers were given profiles which made them slightly more qualified, in that they had more income, better ratios, higher credit score, longer time in the home and on the job.

The testing results indicated that 45% of the time there was a difference in treatment by the lender favoring the White tester. The types of differences in treatment detected were:

* Differences in interest rates quoted.

* Differences in information given regarding qualification standards, fees, required ratios, interest rates, loan programs, and terms of loans.

* Differences in levels of courtesy and service.

* Differences in materials and literature given.

* Differences in number and types of questions asked of the testers.

* The White testers were more often "referred up" to the lender's prime lending division.

* The White testers were more often quoted interest rates.

* The White testers were quoted lower interest rates, or range of rates.

* The White testers were given more detailed information.

* The White testers were often assumed to be qualified, and given recommendations based upon assumed qualifications.

* The loan officers spent more time with the White testers.

* The White testers were given more advice and recommendations.

* The White testers received more follow-up.

* The Black testers were often asked about the condition of their house; the White testers were not.

* The Black testers were more often asked what they wanted to do with the money.

The following vignettes provide detail of startling differences in treatment and price quotes.

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In Baltimore, testers met with the same loan officer at a branch of the subprime affiliate of a major national lender. The Loan Officer assumed the White tester was overqualified and without asking any financial questions, told her she could get better rates at the prime branch of the parent company. The Loan Officer also gave the White tester general rate ranges. However, the Loan Officer would not give the Black Tester any rate information, citing the need for a credit check. The Loan Officer crumpled and discarded the Black tester's application when she would not reveal her Social Security number.

In another test in Baltimore at a suburban branch of a major subprime lender, the White tester was told of a 5.75%, 30 year fixed interest rate, while the Black tester was told the 30 year rate was 8.85%. The White tester was told the 2 year adjustable rate was 4.99% and the Black tester was told the rate for that product was 7.6%. The Black tester was told that since her husband made more money (just slightly more), the lender would rely on the husband's income and credit. The White female tester was not asked about income, nor told about this policy.

At the Atlanta branch of a major national subprime lender, the loan officer recommended to the Black tester that she take out a $15,000 loan, although she was more than qualified for the $25,000 loan that she requested. The White tester got more information about the company and their loans, rates, products, and fees. The White tester was told that if her credit score was above 680 she could get premium rates of 4.9% to 5%. The Black tester was asked many questions but not given much information. The White tester received an application, whereas the Black tester received articles and release of information authorization. The Black tester received a follow up call to her husband.

In Chicago, testers visited the branch of the subprime subsidiary of a major national lender. The White tester was given extensive information about loan products, rates, and monthly payments. The loan officer recommended the White tester refinance and said a 30 year fixed rate would be 5.5% and cost $715.41 a month; with an interest only "ARM" the payment would be $451 a month; a 15 year fixed would be at a 4.3% rate with a payment of $980. The White tester was told of $1,400 in fees. Conversely, the Black tester was treated rudely, made to wait 20 minutes and then told the lender does not offer home equity loans. The Black tester was not given any substantive information, and was given a referral to other lenders.

As compelling as this testing evidence is, testing is not the end of our story. While testing focused on the pre-application stage of the lending process, NCRC's Consumer Rescue Fund (CRF) reveals alarming and distressing real-life stories of abuse throughout the application process and the long-term effects of unsafe and unaffordable loans.

Case Studies from the Consumer Rescue Fund

NCRC's CRF illustrates how abusive tactics have impacted entire communities and hardworking people. Through the NCRC National Anti-Predatory Lending Consumer

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Rescue Fund (CRF), NCRC and its members work directly with homeowners who have been victims of predatory lenders in order to give consumers a fresh start.

In the state of Ohio, we are working with over 100 consumers, most of them elderly minority people, who are being uprooted from homes they have lived in for over 40 years. These unsuspecting consumers fell victim to a home improvement scam and were financed into loans that they cannot repay and are now facing foreclosure.

In the communities of Staten Island and Long Island, New York, the Consumer Rescue Fund is assisting over 100 New York City police officers and fire fighters who purchased homes from an unscrupulous housing developer and mortgage broker. The broker manipulated the origination system by quickly dumping the fraudulent loans onto the secondary market. For these heroic public employees, the American dream of owning a home has now become their nightmare.

CRF loan files provide evidence that predatory lending often consists of multiple abuses which combine to push borrowers to the edge of bankruptcy and foreclosure. In a California case, a female originally purchased her home in 1999. Over the course of the next five years, the loan was refinanced or flipped four times; none of the refinances provided a tangible net benefit, judging by the exorbitant fees, prepayment penalties, and broker yield spread premiums. The first refinance, which included fees of 5.76 percent, already tripped over the points and fees trigger of both Miller-Watt-Frank and Ney-Kanjorski. By the fourth refinance, the borrower's monthly payments equaled 54.4 percent of her income. The fourth refinance was also a stated income loan which inflated her income by almost 50%. While some may argue that the borrower received a "tangible benefit" since she used the proceeds of some of the refinances to finance repairs and other needs, it is clear that the cumulative impacts of the refinances provide no net tangible benefit and confront her with an unaffordable loan. Moreover, allowing stated income loans that exceed trigger thresholds under federal bills is highly problematic as illustrated by this example.

Another CRF case involves an elderly women in Chester, Pennsylvania, residing in a 98% minority and low-income census tract. In 2000, the borrower responded to a mail solicitation and sought a refinance loan. The mortgage company financed single premium credit insurance and disability insurance into her loan amount, contributing to total fees of over 14% on her loan, well over the Ney-Kanjorski and Miller-Watt-Frank fee triggers. Despite developing a serious health condition that rendered her unable to work, she has not received regular payments from her disability insurance. Somehow, in spite of her reduced income, the borrower has remained in her home since 2000, but has finally sought help through NCRC's CRF. For this borrower, the lender has converted her home from a source of wealth to a source of burden and stress.

In a third case in Ohio, a lender charged 7.4% in origination fees and financed both credit life and disability insurance into the mortgage. Total fees equaled 14%, again well over the fee triggers of the Miller-Watt-Frank bill and the Ney-Kanjorski bill. The Good Faith

Estimate was not executed in good faith as it approximates only about half of the final amount of fees for the loan.

Lastly, but importantly, NCRC's CRF program is intervening in a significant number of cases where borrowers have been victimized by appraisal fraud. In an upcoming report, NCRC will document the pervasiveness of appraisal fraud across the country by combining the experience of the CRF program with other evidence. Our study will elaborate in detail appraisal fraud in a sample of CRF loans. The sample reveals that about one fifth of the homes were overvalued by more than 50% of their true value, and two thirds of the homes were overvalued by 15-50% more than their true value. Inflating appraisals leave borrowers with unaffordable loans that they are unable to refinance because the loan amounts are higher than the true value of their homes. The results are too often theft of homeowner wealth, equity stripping, and/or foreclosure.

Need for a Strong and Comprehensive National Bill

NCRC believes that state anti-predatory laws have not choked off access to safe and sound loans, but have successfully reduced abusive loans. While we believe that lenders can operate in the current regime of federal and state legislation, we would favor a national anti-predatory law if it is comprehensive and builds on the best state laws such as North Carolina's, New Mexico's, New Jersey's and New York's. It is remarkable that about half of the states in this country have passed anti-predatory laws, but that still leaves citizens in half of the other states unprotected from predators. Moreover, the anti-predatory laws that have been passed on a state level have been uneven. While a number of states have rigorous laws, several others have relatively weak laws that mostly mimic the federal Home Ownership and Equity Protection Act. Thus, a strong and comprehensive national law would provide uniform protection for citizens in all states if it expands upon the best state laws, does not weaken existing federal law, and also draws upon and codifies best practices established by industry.

The current evidence and academic research do not support the assertion that state anti-predatory law fundamentally curtails banks' lending activities. In a paper entitled "Do Predatory Lending Laws Influence Mortgage Lending," Peter Nigro of the OCC and Keith Harvey of Boise State University conclude that North Carolina's anti-predatory law did not affect the subprime market share of loans made to low- and moderate-income borrowers in North Carolina relative to five other Southeastern states. While the authors find a small decrease in the subprime market share to minorities, the change is "significant at the 10 percent level only." In other words, the change for minorities is barely statistically significant.[5]

[5] "Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law," September 2002, Keith D. Harvey, Boise State University, and Peter J. Nigro, OCC, see pg. 14 and 25.

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In a more recent study, Professor Michael Stegman and his colleagues at the University of North Carolina concluded that the North Carolina anti-predatory law did not restrict overall access to credit, but did decrease loans with abusive features such as loans with prepayment penalties beyond three years.[6]

NCRC is aware that other studies come to opposite conclusions regarding the impact of anti-predatory laws. Professor Staten of Georgetown University asserts that anti-predatory law reduces the number of subprime loans to traditionally underserved borrowers.[7] Nigro and Harvey conducted another study documenting declines in subprime lending after enactment of anti-predatory law by the cities of Philadelphia and Chicago.[8] These studies, however, suffer significant data and interpretative shortcomings. Staten's study relies on data supplied by a trade association of subprime lenders. Nigro's and Harvey's study does not adequately consider that lenders stopped lending in the two cities for a very short time period in order to pressure the cities and their state governments to nullify the laws.

Regardless of whose studies are viewed with more credibility, it is beyond doubt that an impartial observer would conclude that the current level of academic research does not support assertions that state laws unequivocally choke off lending. For each study that asserts constriction of credit, another study discounts that possibility. Moreover, only one study, Stegman's, examines the types of loans affected by anti-predatory law. Until more studies are conducted with more detailed data on loan terms and conditions, the most reasonable conclusion is that state anti-predatory laws stop abusive lending beyond borrowers' repayment abilities instead of causing large scale reductions in loans.

NCRC believes that existing evidence suggests that Congress should not rush headlong into adopting any ill-conceived federal law since lending markets remain vibrant under the current rubric of state and federal law. Congress has the time to carefully consider and develop a comprehensive and strong anti-predatory law.

Provisions of an Anti-Predatory Lending Bill

Building on the experience of our national coalition and state-level coalitions around the country, NCRC believes that a comprehensive bill must apply protections to a substantial number of subprime loans. The protections must eliminate abuses during the application stage and mandate that loans are affordable, appropriate, and provide tangible net benefits to borrowers. The bill must also ensure that appraisals are conducted honestly and do not

[6] "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment," Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, June 25, 2003, the Center for Community Capitalism, University of North Carolina at Chapel Hill.
[7] "Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law," October 2002, Gregory Elliehausen and Michael Staten, McDonough School of Business, Georgetown University.
[8] "How Do Predatory Lending Laws Influence Mortgage Lending in Urban Areas? A Tale of Two Cities," Keith D. Harvey and Peter J. Nigro, March 2002.

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inflate home values. As mentioned above, NCRC is about to release a study that documents the widespread harms of appraisal abuse, and how appraisal abuse steals homeowner equity, and destabilizes housing markets. Finally, a bill must prevent servicing abuse. Through our CRF program and in our best practices dialogues with lenders, NCRC understands all to well how servicing abuse is not only disastrous for borrowers but can threaten the viability of financial institutions.

We are pleased that both the Ney-Kanjorski and Miller-Watt-Frank bills recognize that a significantly greater number of subprime loans need to be covered with a federal anti-predatory bill than are currently covered by the Home Ownership and Equity Protection Act. Lowering the fee trigger to 5 percent is an appropriate and necessary trigger for extra protections. In addition, a federal anti-predatory lending bill must include charges paid to affiliates of lenders and indirect compensation received by lenders in calculating if points and fees exceed the trigger level.

The NCRC CRF case studies illustrate how abusive loans often involve fees in excess of 5 percent of the loan amount. In addition, Fannie Mae and Freddie Mac adopted guidelines as early as 2000 clearly stating that they will not purchase high cost loans with fees in excess of 5 percent. Major financial institutions in the industry have therefore recognized that loans with fees in excess of 5 percent are prone to abuses if not executed very carefully.

The following provisions must be included in any national anti-predatory bill. This list is not comprehensive, but covers critical features:

Points and fees - Point and fee triggers appear similar for HR 1182 and HR 1295. For most loans, both bills would apply additional protections when points and fees exceed 5 percent of the loan amount. HR 1295 would not consider charges paid to affiliates of the lender when calculating points and fees. In addition, it does not consider indirect compensation received by the lender. HR 1295 would also exclude yield-spread premiums and other indirect compensation received by mortgage brokers. HR 1295 would exclude prepayment penalties in more cases while calculating points and fees. Finally, HR 1295 would exclude discount points when calculating points and fees in more cases than HR 1182. NCRC recommends that the definition of points and fees not weaken existing federal law but expands upon that law to insure the strongest consumer protections.

Steering – NCRC's data analysis and fair lending testing reveals that steering is a significant problem in subprime lending, and must be addressed in any bill. HR 1295 contains a provision that strives to outlaw steering or making a high cost loan to a borrower who can qualify for a prime loan. This is critically important as NCRC's reports discussed above document the widespread occurrence of steering on a national level and the tremendous amount of wealth stripping that results. We recommend, however, that the current language in HR 1295 be tightened up to avoid any loopholes to the stripping provision. The bill currently allows a lender to make a high cost loan to a

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borrower creditworthy for a prime loan if the borrower "voluntarily" agreed to the high cost loan. "Voluntary" agreements to high cost loans are exceedingly difficult to document and thus can be claimed on most cases of steering.

Prepayment Penalties – One of the first NCRC CRF cases involved a prepayment penalty that almost prevented a pre-foreclosure sale. In this case, not only was the original homeowner victimized, but all the usual stakeholders in a housing transaction (the buyer and real estate agent) also suffered harm. This example illustrates the damage that onerous prepayment penalties pose to the functioning of the housing market in minority and low- and moderate-income neighborhoods. HR 1295 would prohibit prepayment penalties on all loans after 3 years, but many if not most subprime loans have prepayment penalties occurring in the time period between two and three years. Congress should carefully consider stringent limits to prepayment penalties between two and three years.

Financing Points and Fees – NCRC's CRF program reinforces the need to prohibit or limit financing points and fees so that loans do not become unaffordable. HR 1295 allows points and fees to be financed into mortgages of $40,000 or more if the points and fees do not exceed 5 percent of the loan amount. Considering that prime loans often do not have fees exceeding one percent of the loan amount, the limits in HR 1295 are on the high side. NCRC would support a prohibition on the financing of points and fees into high cost mortgages. In addition the predatory lending bills last year prohibited the financing of points and fees beyond 3 percent of the loan amount.

Repayment Ability – Both bills stipulate that monthly debts, including mortgage payments, cannot exceed 50 percent of income, but the bills differ regarding allowing a consumer to affirm his or her income. The difference in required documentation is important. As NCRC's CRF program illustrates, "self-verification" procedures or stated income loans facilitate fraud and unaffordable loans since unscrupulous lenders will fabricate borrower incomes and then have unsuspecting borrowers sign the loan documents.

Single Premium Credit Insurance – HR 1295 bans the financing of single premium credit insurance (SPCI) and debt cancellation or suspension agreements on high cost loans, but does not include SPCI in the definition of points and fees. This is problematic because if SPCI is not included in the fee trigger for a high cost loan, we are concerned that a backdoor has been created for SPCI to return. As the NCRC CRF program shows, this product is much less expensive when paid for on a monthly basis then when financed into the loan amount. More importantly, major subprime lenders have themselves discontinued single premium insurance products. Prohibiting these products on all loans would best protect consumers and insure that an industry best practice remains intact.

Flipping – HR 1295 applies protections against flipping for high cost loans, but HR 1295 also establishes a tangible benefit test that is less stringent than a tangible net benefit test. HR 1295 also includes a series of safe harbors or exemptions that have the potential for enabling abusive refinancings. Under the current language of HR 1295, the NCRC CRF

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case example above could be construed to be permissible since the refinance loan offered a tangible benefit of cash for various needs, but was clearly not a tangible net benefit to the borrower, considering that the high fees rendered the loan beyond the borrower's repayment ability. Any flipping language in a federal bill must be air tight and supported by a strong definition of a high cost loan.

Pre-Loan Counseling – NCRC supports pre-loan counseling modeled after the successful counseling requirement in the North Carolina anti-predatory lending law. In that state, a consumer is required to receive counseling by a counseling agency approved by public housing departments before a lender can issue a high cost loan to a borrower. A pre-loan counseling requirement is somewhat analogous to a home inspection conducted by an inspector of a customer's choice before the customer purchases a home. Home inspections have not burdened the real estate market and provide needed protections to consumers. Perhaps, a review by an independent third party should apply to all loans if the lending industry is concerned about singling out subprime loans. This would then make pre-loan counseling a regular and accepted procedure just like home inspections.

Mandatory Arbitration – HR 1295 prohibits mandatory arbitration clauses in high cost loans, but does allow arbitration if the consumer "voluntarily" agrees to arbitration. The concept of a voluntary agreement is worrisome in that it may favor the lender since a consumer may have difficulty asserting that he or she did not voluntarily agree to an arbitration procedure. Again predatory lending is about fraudulent and deceptive practices. More importantly, Congress should codify the best practices established by lenders, such as Countrywide, which no longer issue loans with mandatory arbitration.

Limits on Liability for Secondary Market - Currently, under federal law, a financial institution that purchases a high cost loan from a lender or broker is liable for all claims and defenses arising from violations of law. We have concerns that HR 1295 goes too far in limiting liability. Borrowers cannot raise defensive claims, for example, unless they can demonstrate that a purchaser of a loan had knowledge of or exhibited reckless indifference to violations of the bill. Damages are also limited unless a purchaser had knowledge of or exhibited reckless indifference to violations. The standards of actual knowledge or reckless indifference are very hard for borrowers to prove in court. Applying liability for purchasers of loans is critical because a significant amount of subprime lending is conducted by brokers and mortgage companies who sell their loans to investors and financial institutions. Borrowers often have no recourse if the purchasers of loans have no liability. We should not weaken existing federal law given that lenders are currently operating under this standard. Any changes must require making consumers whole for their losses.

Reporting to Credit Bureaus - HR 1295 requires lenders making high cost mortgages to report monthly borrower payment history to credit bureaus. This is a vital protection. Several years ago, former Comptroller of the Currency, John Hawke, raised alarms concerning lenders holding customers captive by not reporting their credit history.

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Comptroller Hawke pointed out correctly that consumers would have no way of proving their creditworthiness for lower cost loans if the credit bureaus did not have current information of their payment history due to lenders' withholding payment information. A requirement to report to credit bureaus will protect homeowner wealth by enabling borrowers to lower their interest payments and thus build up their equity faster.

Mortgage Servicers - HR 1295 applies needed protections against abuse by servicers of mortgages including force placement of insurance and failure to correct errors relating to payments. HR 1295 requires establishing escrows for payment of taxes and hazard insurance for high cost loans. NCRC's CRF cases include a number of instances where borrowers had trouble with unaffordable loans because they did not realize that their subprime loans did not have escrows. The CRF cases clearly demonstrate a need for this provision.

Appraisal Fraud - HR 1295 applies protections regarding appraisals for high cost mortgages, including physical inspections of the property and two appraisals in the case of two sales within 180 days of each other to protect against property flipping. The bill also prohibits lender influencing or intimidating appraisers. This provision is encouraging and we believe that it can be strengthened to address critical funding and staffing shortages of state regulatory agencies. In addition, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council must be provided with meaningful oversight and enforcement powers regarding state regulatory boards.

Certification of Brokers and Mortgage Lenders Making Subprime Loans – HR 1994, the Predatory Mortgage Lending Practices Reduction Act, establishes certification requirements for mortgage brokers and lenders making subprime loans. This is an important step for establishing ethical conduct by lenders and reducing the amount of predatory lending. A national registry of brokers and lenders should be established that show which brokers and lenders are certified and which ones have lost certification. Many states have this type of registry revealing the current status of licensing for home improvement contractors; it is time to establish transparency for lenders and brokers.

Conclusion

NCRC's position is clear as reflected in the coalition letter signed by our members and transmitted to the committee. We support the enactment of a strong national anti-predatory lending bill and urge Congress to carefully craft a bill that truly serves the interest of consumers. Strong leadership and decisive action must be taken to stop the epidemic of predatory lending. As John Wills so eloquently stated in his book God's Politics, "the poor and working class should not be the object of our actions but the subject of our actions." I hope that you will keep this in mind as you consider legislation to provide consumers relief from predatory lenders. Thank you and I look forward to addressing all of your questions.

BorrowSmart
Public Education Foundation
1821 Summit Road, Suite 111
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888-876-7889

Testimony before the
Subcommittees on Housing and Community Opportunity
and Financial Institutions and Consumer Credit

on

"Legislative Solutions to Abusive Mortgage Lending Practices"

Submitted by
Lisa Bouldin Carter
National Executive Director
BorrowSmart Public Education Foundation

May 24, 2005

My name is Lisa Bouldin-Carter and as National Executive Director of BorrowSmart Public Education Foundation, I deeply appreciate Chairman Ney and Chairman Bachus' attention to the critical issue of financial literacy. A financially informed consumer can provide the first defense against abusive lending practices. Having worked as a credit counselor and having run a HUD approved, non-profit housing counseling agency for more than twenty years, I have seen first hand the horrors of predatory lending and the benefits of financial education. I applaud the Subcommittees' efforts to develop legislation that would strengthen consumer protections against abusive lending practices and promote financial literacy.

My career has run the full gamut of providing financial literacy education for homeowners and those aspiring to home ownership. I have provided housing counseling from "thought to acquisition," offering down payment assistance, foreclosure prevention, and counseling for senior citizens considering reverse mortgages. It is exciting and personally rewarding to incorporate my knowledge of the home buying and home ownership process into financial education programs directed to consumers who may be vulnerable to predatory lending practices.

Consumers, especially those with less than perfect credit, often lack the financial savvy to understand their mortgage options whether they are buying a home or refinancing a mortgage. Fortunately, there are many programs designed to help the first-time homebuyer acquire a mortgage, but unfortunately there was a dearth of financial education targeted to homeowners seeking to tap into their home equity. Recognizing how vital it is for homeowners to understand the potential pitfalls and the potential benefits of refinancing, the

National Home Equity Mortgage Association ("NHEMA") filled this vacuum of information by creating the BorrowSmart Public Education Foundation in 2002 ("BorrowSmart"). [Visit our website at www.borrowsmart.org.]

The BorrowSmart Financial Education Program

As a 501(c) 3 non-profit headquartered in Cincinnati, Ohio, BorrowSmart has created unique financial education programs that help both consumers and credit counselors understand the risks, rights, and responsibilities involved in borrowing against the equity in one's home. Our goal is to educate consumers on how to wisely use their most important asset – their homes – to obtain affordable credit and meet their personal financial goals.

BorrowSmart programs have been designed to focus particularly on consumers with impaired credit, as many simply do not understand the basics of mortgage finance, making them vulnerable to predatory lending practices. We believe that the implementation of BorrowSmart across America would reduce such practices by unscrupulous lenders and brokers.

Like most non-profits, we must conserve our limited resources and have found that delivering financial counseling works best when partnering with organizations that work at the grassroots level. Thus, BorrowSmart is geared to "training the trainer," which means we partner with a community- or faith-based organization and teach them how to teach their constituencies on smart money management, including borrowing from their home equity. Generally, the program is taught in a half or full-day seminar and is underwritten by one of the many responsible lenders or organizations that support the BorrowSmart Public Education Foundation.

Our training focuses on money management skill development, making good budgeting decisions, how to work with lenders, understanding the closing process, how to shop for the best loan, and spotting red flags for possible fraud or inappropriate loan practices or terms. We also address what to do when one's financial situation changes due to unforeseen circumstances and the mortgage is delinquent or the homeowner is facing foreclosure.

Among the many facets of financial literacy, understanding one's credit score and its implications on borrowing and home ownership is one of the neglected aspects of financial knowledge for most consumers. Giving borrowers a firm grasp of their rights and responsibilities while enhancing their financial knowledge and skills is an important aspect of BorrowSmart's financial literacy education. In addition to understanding basic fair lending principles, borrowers must be able to recognize the warning signs of abusive lending practices, which may be technically legal but sometimes applied in a way not fully understood by the borrower. Thus, we provide the knowledge, skills, and tools home equity borrowers need to "borrow smart."

All of our programs, services, and materials are provided at no charge to help current and prospective home equity borrowers. We have conducted seminars and workshops from coast to coast assisting consumers in large cities as well as smaller communities.[1] Moreover, our materials are available in both English and Spanish.

Reaching Consumers through Faith-based and Community Initiatives

We have expanded and strengthened our outreach to a wide variety of lending organizations, financial institutions, and regulators, but it is through our partnerships with community based and faith based programs where we have been able to reach the greatest numbers of consumers in need of financial literacy. For example, BorrowSmart premiered its Foreclosure Training in California for housing counselors and homeowners collaborating with FAME Renaissance and SCANPH.

The First African Methodist Episcopal Church of Los Angeles (FAME) is the oldest congregation in Los Angeles. The ministry reaches beyond the walls of the church with initiatives to address the community's most pressing needs, including health, substance abuse, homelessness, emergency food and clothing, housing, tutoring, entrepreneurial training, and employment services.

The Southern California Association of Non-Profit Housing (SCANPH) is a non-profit membership organization dedicated to the development, preservation and management of permanently affordable housing for low-income people enabling them to educate homeowners in Foreclosure Prevention and Homeownership Retention.

We are collaborating with the Urban League and the City of Orlando to offer foreclosure prevention and homeownership training to housing professionals and financial institutions in the Greater Orlando area. This is an initiative that we hope to expand to include other Urban League affiliates across the country.

In all the various communities where BorrowSmart training sessions have been held, we always encouraged borrowers to seek counseling prior to purchasing a home and again if they are refinancing one so that they do not unwittingly make unwise decisions regarding home ownership. We have found that the simpler the language used in loan documents the better the understanding of the borrower. But they need so much more than clear disclosures and plain language. Borrowers need to understand the terms of the mortgage and the options that can help them obtain a more affordable loan.

Too often unsophisticated borrowers focus on the size of their monthly payment and fail to take into account the risks associated with borrowing against equity. For example, an adjustable rate mortgage note might offer an initially low monthly payment, but will the homeowner be in the financial position to pay the mortgage when the rate adjusts? This is not to say that a borrower is necessarily ill-advised to consider a loan with an adjustable rate, anymore than one with an early prepayment penalty or discount points. Such features can provide a borrower with the ability to obtain a home loan with a significantly more affordable monthly payment – something of major importance to probably all of us. Of

[1] See attachment A for a schedule of BorrowSmart programs.

course, these tools to provide greater flexibility for borrowers are not inherently good or bad – they must be considered in the context of a borrower's particular circumstances and goals.

Prepayment penalties, for example, can be an excellent way for homeowners to make a mortgage payment more affordable, but they must understand if they pay off the loan before the prepayment penalty period expires, then it can be quite costly. Consumers need to look at their own circumstances and also ask what the mortgage payment would be with or without a prepayment penalty. Most non-prime lenders reduce the interest rate by 1% if the mortgage has a two or three-year prepayment fee, thereby reducing borrowing costs substantially. However, if the homeowner thinks he is likely to sell or refinance his loan while the prepayment limitations apply, then the lower monthly payment may not be justifiable. Borrowers must watch out, too, for excessively long prepayment periods, such as five years.

Borrowers can also make their loan payment more affordable by buying down their interest rate through discount points, but the borrower must determine whether the cost of the rate reduction is worth it. For example, if the cost of the discount point can be recouped within a few years, then it may be a good choice for the borrower. All of our financial literacy education is directed toward empowering consumers to make the right decisions for themselves and their families.

Each participant in a BorrowSmart program uses financial planning worksheets that enable families to do cost comparisons in considering the affordability of a loan product. We teach financial counselors to encourage consumers to work through their own financial situations and consider at least three lenders and compare products to assure a loan fits into their budget and needs. Based on the outcome a consumer is looking for, they are guided to the best loan product for their financial situation. Given the plethora of loan products and options, it is critical borrowers understand that they have many choices, but they must shop for the best deal. This is one example of how financial literacy can encourage non-prime borrowers to make informed choices.

Financial Literacy: A Life-Long Learning Experience

Providing financial literacy education is opening a door to life-long learning so that consumers attending the home ownership classes gain information that can be used in other aspects of their lives. Financial literacy programs work best when families looking to purchase or refinance their homes seek assistance from housing counseling agencies. These families make a conscious choice to become financially empowered, and they are most likely to turn to a trusted advisor like their church or local community group.

Many homeowners are first generation purchasers and are looking for someone to provide guidance. These families seek to understand the financial process to assure their success and increase their knowledge as they enter into a purchasing decision previously unknown to them. They become engaged and are willing participants in housing counseling classes.

In cases where housing counseling is forced upon a family, they often occupy the required seat without participating in class discussions or integrating the knowledge they could have obtained into their financial decisions. Some simply have the mindset that counseling is a waste of time. I have witnessed unwilling adult students disrupt the class to the detriment of those who are there to learn. Based on my years of first-hand experience counseling consumers, I believe that borrowers, regardless of the reason they are seeking a loan, will make wiser decisions if they choose to participate in financial literacy classes rather than if they are mandated. However, I believe that lenders and brokers should be required to encourage them to seek counseling from a qualified credit or housing advisor.

Obtaining financial literacy education helps level the playing field so families will understand the impact of the choices they make based on their credit and the loan product they select. Armed with knowledge, they can steer clear of inappropriate loan terms and watch for predatory practices and abusive terms. They can compare loan products to find not only the most affordable loan, but also the loan that best fits their personal circumstances.

HUD's Role in Expanding Financial Literacy

While BorrowSmart and other financial literacy programs are helping thousands of people, more needs to be done. I applaud Rep. David Scott for his unwavering mission to make housing counseling more widely available and to let people know that qualified credit counselors are just a toll-free phone call or web-site visit away.

I commend Chairman Ney and Rep. Kanjorski for incorporating Rep. Scott's recommendations and including a housing counseling title in their bill, HR 1295, The Responsible Lending Act of 2005. This title would establish, and very importantly fund with $75 million annually, an Office of Housing Counseling at the Department of Housing and Urban Development. Having served as Executive Director of a HUD-approved credit counseling agency for 15 years, I can attest that the federal government can and needs to centralize its housing counseling assistance and devote more resources to counseling agencies across America. Unifying its far-flung counseling regulations, requirements, standards, and programs into one office – whether it be located within HUD or another agency -- will empower the federal government to be more effective.

I am especially impressed with H.R. 1295's recognition that homeownership counseling spans the entire homeownership process, including the decision to purchase a home, the selection and purchase of a home, issues arising during or affecting the period of ownership of a home (including refinancing, default, foreclosure, and other financial decisions), and the sale or other disposition of the home. What is also exciting is the certification of software programs that consumers can use with confidence to evaluate different mortgage loan proposals. BorrowSmart has developed worksheets to help borrowers make the right decision, but a widely available low cost or free computer program could help millions of prospective and current homeowners.

An Office of Housing Counseling could also centralize information on lending and education "best practices" by providing a central clearinghouse for information. In our own effort to promote financial literacy, BorrowSmart has formed alliances with many community and faith-based initiatives through national workshops and the creation of education materials for advocates and consumers. We would all welcome the opportunity to work with the Office of Housing Counseling and its Advisory Committee.

Strengthening Communities Through Financial Literacy

All housing counseling must have perceived value for all parties involved in the transaction. Financial literacy programs must be valued by the community so they will provide services for families seeking home ownership and equity loans. These financial literacy programs, which are held in counseling agencies, churches and community facilities, have the ability to change lives and contribute to the stabilization and growth of neighborhoods. Lenders, foundations, and the government should see this as a winning solution so they will fund financial literacy programs, and consumers see financial literacy education as part of the process of ensuring success in home ownership and affordable equity borrowing.

In closing, let me emphasize that financial literacy is a tool that strengthens families. Children who connect to communities because they are in a home are more likely to stay in school. Homeownership creates stronger tax bases to support hospitals, schools and other community services that are important in connecting and sustaining neighborhoods. The very basis of our society is to achieve the "American Dream" of home ownership and become involved citizens and community participants.

With housing counseling and financial literacy programs like those provided by BorrowSmart, we can reduce the amount of foreclosures, community decay and blighted neighborhoods. And just as importantly, homeownership enables individuals to create, preserve, and increase wealth for themselves and their families. With financial literacy we can change lives! We live in a society where thinking outside the box challenges financial institutions to move outside their preconceived notions of who can afford a home to create a new generation of consumers who are educated on how to manage money and become homeowners. We can create a learning environment for families so they have the ability to choose a financial product – including making an informed choice about a home equity loan – that fits their needs.

BorrowSmart commends the Committee for focusing attention on the need for financial literacy education and creating solutions to eliminate abusive lending practices. We are passionate in our commitment to provide financial literacy education nationally and help consumers make better informed home purchasing and ownership decisions. We hope to have the opportunity to work with you to further financial literacy for all Americans regardless of social or economic status.

Thank you very much.

ATTACHMENT A

BorrowSmart Training

"BorrowSmart's goal in conducting training for housing professionals is to enable them to update their skills in a small, interactive classroom setting. We want the professionals homeowners go to for answers to their housing questions to have the latest information available in order to educate consumers on the home equity borrowing process. We have found that the best relationship between homeowners and financial institutions exists when the consumer makes informed choices.

BorrowSmart training has been conducted in Cincinnati, Indianapolis, Denver, Dallas, Springfield, Ohio, New York City, Miami, Los Angeles, Chicago, Brooklyn, Wenatchee, Washington, Wilmington, Delaware, New Orleans, Spokane, Washington, Atlanta, Washington, D. C. and Laredo, Texas. Currently on the calendar are sessions in: Cleveland, Philadelphia, Charlotte, N. C., Orlando, FL, Jackson, MS, San Diego and Irvine, California.

National Collaborations

As more African American, Hispanic and other minority families purchase their first homes, lenders must be more creative and flexible in developing products to serve these expanding markets. BorrowSmart uses interactive training workshops to enable housing counselors to better assist their clients with the often-challenging prospects of homeownership. A number of dynamics affect homeownership. We need to be absolutely certain that we are educating consumers on the breadth of their responsibilities in protecting their investment.

We have collaborated with nationally recognized organizations like the City of Orlando, the NAACP, Urban League, WOW (With Ownership Wealth), The Southern California Association of Non-Profit Housing, St. John Missionary Baptist Church, the Fifth District AME Conference, The Chicago Housing Expo, the Louisiana Legislative Black Caucus, and the First African Methodist Episcopal Church of Los Angeles (FAME).

ATTACHMENT B

BORROWSMART PUBLIC EDUCATION FOUNDATION
2004 PROGRESS REPORT

WWW.BORROWSMART.ORG

1,197,971	Hits to entire site
132,858	Pages viewed
52,504	Visitors sessions
3,979	Average per day
00:09:10	Average visitor session length

BorrowSmart's Web site is designed as a resource for consumers and a tool for counselors. It is organized into four broad sections, each of which addresses a specific stage in the borrowing process. It also includes Links and other sources of additional information. (Website is currently being updated.)

BORROWSMART CONSUMER EDUCATION KITS

7,332	Education Kits distributed to counselors and consumers

BorrowSmart makes free kits available to counselors to use with their clients. These kits include: budgeting worksheet to calculate monthly loan payments, questionnaire to help consumers decide whether a home equity loan is right for them; worksheet comparing terms offered; a fact sheet on what to consider when borrowing against home equity; and a pamphlet providing an overview of the home equity process.

CONTACT BETWEEN BORROWSMART PARTNERS AND NON PROFITS

655	Non Profits trained in 2004

BorrowSmart is built on partnerships. The Foundation works to bring counselors and partners in a community together to support consumer education over the long term. Counselors benefit by strengthening contacts with lenders – contacts that can be critical when it comes time for a loan workout pan. Partners benefit by building a strong, well-educated customer base and reducing the risk of default.

SPECIAL EVENTS

- **Expanded the national education materials through our Foreclosure Prevention initiative to help preserve home equity and ownership.**
- **Established first National Media Partnership with Black Enterprise magazine.**
- **Partnered with Congressional member in three states on home equity lending forums and platforms.**
- **Launched Spanish version of BorrowSmart materials.**
- **Held first National Partner Training in Sarasota, Florida**

ATTACHMENT C

BorrowSmart Lender Partners

(As of May 15, 2005)

Accredited Home Lenders, Inc.
Budget Finance Company
Centex Home Equity
CitiFinancial Mortgage
Countrywide
Delta Funding Corporation
Equifirst Corporation
Express Financial Services, Inc.
First American Real Estate Information Services, Inc.
First Franklin
HSBC – North America
Lenders Direct Capital Corporation
National City Warehouse Resources
New Century Financial Corporation
Oak Street Mortgage
Option One Mortgage Corporation
Popular Financial Services Equity One Inc.
Saxon Mortgage Inc.
The Mortgage Outlet
WACHOVIA

ATTACHMENT D

BorrowSmart
Public Education Foundation

LISA BOULDIN-CARTER
NATIONAL EXECUTIVE DIRECTOR
BORROWSMART PUBLIC EDUCATION FOUNDATION

Lisa Bouldin-Carter is the first National Executive Director of the BorrowSmart Public Education Foundation. She is deeply involved with national issues concerning home ownership and consumers accessing the equity in their homes to finance personal or professional aspirations. Bouldin-Carter helps set the public policy housing agenda in collaboration with banking and lending institutions across the United States. In this national leadership position, she has a major impact on how the industry educates homeowners about accessing the equity in their homes.

Bouldin-Carter leads the Cincinnati-based national Foundation, which works through credit and housing counselors nationwide to educate homeowners about all aspects of home equity borrowing – budgeting, assessing financial need, etc. Her life-long advocacy for home ownership and her unwavering commitment and support of women and their families contributed to her selection and successful rise to a national leadership position. Since her appointment in 2003, Bouldin-Carter has worked to assure families are financially literate about using the equity in their homes. She is focused on closing the inequities that exist with older homeowners, African Americans and other communities of color and lower income individuals and families.

She is actively engaged in a multi-million dollar campaign to raise dollars to fund BorrowSmart's programming and educational materials. Bouldin-Carter is setting a new strategic direction for her organization that includes increasing BorrowSmart's profile nationally.

Director, Greater Cincinnati Mortgage Counseling Services
Prior to her appointment as National Executive Director of BorrowSmart, Bouldin-Carter served GCMCS for 14 years. Her community initiatives resulted in 2,000 new homeowners. She has a long-standing commitment to first generation low-to-moderate income and single head-of-household homeownership.

Community Involvement
Bouldin-Carter's passion is to help homeowners and first-time homeowners educate themselves so they are financially literate and economically sound. She has conducted housing and accessing home equity panel discussions and seminars for the Congressional Black Caucus and the National Housing Council. She is an alumna of the Greater Cincinnati Chamber of Commerce's Leadership Cincinnati Program, the Urban League of Greater Cincinnati Leadership Development Program and acknowledged as a 2005 Who's Who in Black Cincinnati.

Education
Educated at Central State University and the University of Akron, Bouldin-Carter has received awards recognizing her many contributions, including the Excellence in Training Award from the National Housing Council, NAACP Wright Overstreet Award, recipient of the Delta Sigma Theta 2004 Education Development award and received an Applause! ImageMakers nomination. She serves on the Greater Cincinnati Northern Kentucky African American Chamber of Commerce Board, the NAACP – Cincinnati Chapter Housing Committee and the Greater Cincinnati Chamber of Commerce Leadership Cincinnati Housing Committee.

Personal
Bouldin-Carter is the proud parent of two adult children, Brooke and Brandon. Her children are a reflection of her commitment and involvement in the global community. She has instilled in them the need to give back and share their talents with those who are less fortunate. Brooke is pursuing a MSW at the University of Cincinnati and Brandon is completing a B. S. in Education at Florida A&M University.

A Public education foundation providing the knowledge, skills and tools home equity borrowers need to **Borrow Smart**

BorrowSmart 1821 Summit Road • Suite 111 • Cincinnati, Ohio 45237 • www.BorrowSmart.org

YOUR MONTHLY LOAN PAYMENT: HOW MUCH CAN YOU AFFORD?

Monthly Income

Salary	$
Other (Social Security, child support, etc.)	$
TOTAL INCOME (add all monthly income)	$

Monthly Income

Mortgage	$
Food	$
Electric bill	$
Gas bill	$
Heating oil bill	$
Water bill	$
Insurance (car, house, life)	$
Car payment	$
Credit card payments*	$
Child care	$
Clothing	$
School/work supplies	$
Transportation (gas, bus fare, etc.)	$
Tuition	$
Savings*	$
Phone bill	$
Other bills (cable, internet access, etc.)	$
Medical expenses	$
Alimony/child support	$
Entertainment (movies, restaurants, video rentals, etc.)	$
TOTAL EXPENSES (add all monthly expenses)	$

TOTAL INCOME $ ____________ - TOTAL EXPENSES $____________ = $____________

This is the BIGGEST home equity loan payment you can afford.

If your TOTAL EXPENSES are bigger than your TOTAL INCOME, a home equity loan probably isn't right for you. Instead, concentrate on cutting your spending and reducing the debt you already have.

**If you aren't putting money aside for savings each month, or if you can only afford to make the minimum payments on your credit cards, you should avoid taking on more debt.*

1-888-876-7889

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LOAN SHOPPING: COMPARE TERMS

	Lender Name	Lender Name	Lender Name
Number of points your must pay			
Dollar value of points			
Loan origination or underwriting fee			
Total expected closing costs			
Cost of Private Mortgage Insurance			
Cost of credit life insurance			
Total amount of loan fees			
Annual percentage rate (APR) on loan			
Is the rate fixed or adjustable?			
If adjustable, how much can rate increase?			
Total monthly loan payment			
Length of the loan period (years)			
Total interest paid over the life of the loan			
Total amount paid over the life of the loan			
Is there a prepayment penalty?			
What would your APR be without the penalty?			
How much are you saving every month by agreeing to the penalty?			
Is there a balloon payment?			
How large is it?			
When is it due?			

1-888-876-7889

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Joint Hearing Entitled "Legislative Solutions to Abusive Mortgage Lending Practices"

May 24, 2005

**Prepared Testimony of Martin Eakes,
CEO, Self-Help and the Center for Responsible Lending**

Chairman Bachus and Chairman Ney, Ranking Member Sanders, and Ranking Member Waters, thank you for the opportunity to testify today on legislative solutions to address abusive mortgage lending practices.

I am the CEO of Self-Help Credit Union and the Center for Responsible Lending (CRL). Self-Help is a community development lender that creates ownership opportunities for low-income and minority families through homeownership and small business financing. Because we lend to people in underserved communities, such as minorities and immigrants, during the past 25 years we have learned a great deal about the subprime market where people with less than perfect credit borrow. Self-Help has provided more than $3.9 billion in financing to almost 45,000 homeowners, small business owners and nonprofits across the nation.

Unfortunately, we also have witnessed first-hand the harm done to borrowers when lenders are irresponsible and unethical. While we and many other community development organizations are focused on helping borrowers build wealth through homeownership, some unscrupulous lenders are siphoning that wealth away.

As the subprime mortgage market has boomed, climbing from $35 billion to $530 billion in the decade through last year, so too have abusive loans, which are concentrated in this market. This explosive market growth has occurred at a time when many states have passed stronger laws against predatory mortgage lending. Appendix A includes more details about the remarkable growth of the subprime market, including the high growth of subprime mortgage lending in states with anti-predatory lending laws. This fact sheet illustrates very clearly that is possible for subprime lenders to prosper while also complying with lending laws implemented on a state level.

In response to the increase in abusive lending practices, Self-Help formed an affiliate, the Center for Responsible Lending (CRL). CRL is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. Both Self-Help and CRL are based in Durham, North Carolina, a state where some of the nation's largest lenders have headquarters.

During the next five years, approximately 15 million homebuyers and homeowners will receive loans in the subprime mortgage market. The policies you are considering today will determine whether these loans help the working class and minority borrowers who use the subprime mortgage market to improve their economic status or whether they get pushed farther behind. Today, as you listen to different perspectives and consider the best policies to address predatory mortgage lending, I hope you will keep in mind this undisputed fact: Subprime mortgage loans go into foreclosure 10 times more often than mortgages in the prime market.

In our view, any new policies on predatory mortgage lending should be considered in light of these fundamental questions:

- Will homeownership continue to be a way to build wealth, or will it become an opportunity for unscrupulous lenders to steal owners' hard-earned equity?
- Will subprime lending encourage sustainable homeownership, or will we see families and entire communities destroyed through foreclosures?
- Will such policies perpetuate huge disparities in wealth between white Americans and people of color, or will they ensure that homeownership continues to be a wealth-building opportunity for <u>all</u> Americans?
- Will such policies turn back progress by reauthorizing predatory lending practices that have been formally banned in best practices announcements by most major lenders and explicitly outlawed by some states?

In my testimony, I'd like to emphasize the following three points:

1. **Predatory mortgage lending remains a very real threat to citizens who already struggle economically.**
   - Abusive lending practices cause significant numbers of foreclosures, and
   - They have a disparate impact on our most vulnerable citizens, such as the elderly and people in communities of color.
2. **The states have developed and refined workable solutions to predatory mortgage lending that reduce abusive loans and allow <u>responsible</u> subprime credit to remain affordable and abundant.**
   - In North Carolina, which has the longest experience with a state anti-predatory lending law, the subprime mortgage market has experienced similar growth as neighboring states. North Carolina borrowers in the subprime market are enjoying similar access to credit at a similar cost, with only one significant difference: They are not subjected to costly prepayment penalties and other abusive terms.
3. **A federal law, no matter how carefully crafted, will never be adequate to address predatory lending in all parts of the country. However, an effective**

bill would contain comprehensive and meaningful protections, such as a definition of "high-cost loan" that captures all major loan fees.

- The proposed Ney-Kanjorski bill (H.R. 1295) fails to provide meaningful protections against predatory lending. It replaces effective state protections with a weak federal standard, excludes many typical predatory loans from protections, and is significantly weaker than best practices approved by most major subprime lenders.

- The proposed Miller-Watt bill (H.R. 1182), based on the proven success of the North Carolina law, offers strong consumer protections while supporting a healthy subprime mortgage market.

- Federal preemption of state anti-predatory lending laws would be misguided, as any federal standards should supplement, not replace, existing state efforts.

<u>1. The Threat of Predatory Lending</u>

Abusive mortgage lending almost always occurs in the subprime market – home loans for people with impaired or limited credit histories. To account for less-than-perfect credit, responsible subprime lenders charge somewhat higher interest rates to compensate for the increased risk associated with these loans. Subprime home loans are typically packaged immediately and sold to investors in the secondary market, which in turn provides subprime lenders with a source of capital with which to make additional loans.

The subprime market is largely a market for refinance loans: approximately three-quarters of subprime originations in 2001 and 2002 were refinances.[1] Unfortunately, the combination of tremendous growth in subprime lending, the lack of standards for this rapidly growing industry, and subprime borrowers' frequent lack of financial sophistication has created an environment ripe for abuse.

In 2001, CRL estimated that predatory mortgage lending practices cost homeowners $9.1 billion each year. This figure likely underestimates today's cost, because the subprime market has expanded significantly. According to SMR Research, subprime mortgages are now the fastest growing sector of consumer finance.[2] Between 2003 and 2004, subprime mortgage volume increased from $332 billion up to $530 billion, while the issuance of subprime securities rose from $202 billion to $401 billion.[3] In 1994, by contrast, subprime lenders securitized just $10 billion worth of home equity loans.[4]

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[1] SMR Research Corp., Analysis of 2001 and 2002 Home Mortgage Disclosure Act data.
[2] SMR Research Corp., *Subprime Mortgage Loans 2005*, at <u>http://www.smrresearch.com/sml2005.html</u>.
[3] *The 2005 Mortgage Market Statistical Annuals*, Volume 1 – The Primary Market and Volume 2 – The Secondary Market, Inside Mortgage Finance Publications, Inc. (2005).
[4] Cathy Lesser Mansfield, *The Road to Subprime 'HEL' was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, S.C. Law Review, v51, n3, 473–587 (2000).

As a result of the growth of subprime lending, the pressing issue today is not availability of credit in America's communities. Rather, the debate has shifted to the terms on which credit is offered.

A. Predatory lending abuses have created a crisis for American families.
A typical borrower in the subprime mortgage market is "house-rich," but "cash-poor." Many are senior citizens on fixed, limited incomes. Others are families who struggle daily to maintain a tentative grasp on the lower rungs of the middle class. They are hard-working people with little wealth but with big dreams of a better future.

At Self-Help, we have witnessed the tragic consequences of predatory lending. Many of the most egregious cases involve senior citizens who were persuaded to refinance their home multiple times in a practice called "flipping." All too often, these citizens end up losing homes they had previously owned free and clear. In Iowa, the state Attorney General is aware of at least three instances in which predatory mortgage lending was a major contributing factor to suicides.

For most families, the equity owned in their home represents their greatest source of savings. When they lose that equity through an abusive refinance loan, they often lose their best chance to send children to college, start small businesses, weather crises such as unanticipated medical expenses, and enjoy some measure of security in old age. Even worse, because predatory lending can lead to increased foreclosures across a neighborhood, abuses can systematically destroy entire communities.

For quick reference, we provide an abbreviated description of common abuses in the subprime mortgage market:

> Excessive fees: Points and fees are costs not directly reflected in interest rates. Because these costs can be financed as part of the loan, the borrower does not pay in cash, and the real costs of the loan are easy to disguise or downplay. On predatory loans, fees totaling more than 5 percent of the loan amount are common.
>
> Abusive prepayment penalties: These penalties for early pay-off can harm borrowers in the subprime market by draining equity or trapping them in expensive loans. The cost of a penalty – often six months' interest -- may force a borrower to remain in an unnecessarily high-cost loan. In the prime market, only about two percent of home loans carry prepayment penalties, while up to 80 percent of subprime mortgages come with a prepayment penalty.[5]

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[5] See Standard & Poor's, *NIMS Analysis: Valuing Prepayment Penalty Fee Income*, at http://www.standardandpoors.com (January 3, 2001); see also Standard & Poor's, *Legal Criteria Reaffirmed for the Securitization of Prepayment Penalties*, at http: //www.standardandpoors.com (May 29, 2002); *Prepayment penalties prove their merit for subprime and 'A' market lenders*, at http://www.standardandpoors.com (January 3, 2001); see also *Freddie offers a new A-, prepay-penalty program*, Mortgage Marketplace, at 1-2 (May 24, 1999); see also Joshua Brockman, *Fannie revamps prepayment-penalty bonds*, American Banker at 16 (July 20, 1999).

> Kickbacks to brokers: When brokers deliver a loan with an inflated interest rate (i.e., higher than the rate acceptable to the lender), the lender often pays a "yield spread premium" – a kickback for a costly loan.
>
> Loan "flipping": A lender "flips" a borrower by refinancing a loan to generate fee income without providing any net tangible benefit to the borrower.
>
> Mandatory arbitration clauses: Lenders frequently include mandatory arbitration clauses in a home loan to prevent borrowers from seeking legal remedies in a court of law if they have been wronged. These clauses also insulate unfair and deceptive practices from fair and public review.

These abuses become very real to families who fall victim to them. The story of Ira Cheatham, a 73-year-old retired veteran of the Korean War, provides just one example of the real life impact of predatory lending. He and his wife had lived in a predominantly minority neighborhood of Portland Oregon for 21 years. By 2002, they had nearly paid off their mortgage.

Then in December of 2001, the Cheathams received a live check in the mail from Wells Fargo Financial for a little over $1,000. Ira had just retired, and the couple's retirement income had ended up being lower than they had expected, so they cashed the check, and in the process took out a very high interest loan.

Within a week or two after cashing the check, Ira and Hazel got a call from Wells Fargo, urging the elderly couple to consolidate this loan, along with all their credit card debt into a single mortgage. According to Mr. Cheatham, he had excellent credit and Wells Fargo promised that the couple would receive an interest rate between five and six percent, which would reduce their monthly mortgage payments. Based upon these promises, the couple agreed to refinance their mortgage.

When the loan papers were presented the Cheathams, the loan actually contained an interest rate of 9.9 percent and an annual percentage rate of 11.8 percent. Moreover, the Cheatham's loan contained 10 "discount points" ($15,289) that were financed into the loan, inflating the loan amount and stripping away the Cheatham's equity. Under the new loan, the Cheatham's monthly mortgage payments increased to $1,655, amounting to roughly 57 percent of the Cheatham's monthly income.

The Cheatham's problems were magnified because this predatory loan contained a substantial prepayment penalty. The couple was required to either remain locked in a high-interest mortgage or pay a large prepayment penalty. Eventually, the Cheathams decided to refinance their mortgage with another lender to obtain the five percent interest rate for which they qualified and which they had been promised. However, the couple was required to pay a prepayment penalty of approximately $7,500 to Wells Fargo in order to escape their predatory loan.

This is only one example of far too many abusive transactions that come to our attention. Again, I want to emphasize that the federal policies you are considering today will determine whether such lending practices continue, or whether families will actually benefit from the credit they receive.

B. The High Rate of Foreclosures in the Subprime Market
Because predatory lenders are known to target certain neighborhoods, the odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant. For instance, according to the Mortgage Bankers Association, at the end of the fourth quarter of 2004, 10.45% of subprime loans in Ohio were in foreclosure, the highest rate in the country.

Research is establishing a strong connection between abusive subprime mortgages and home foreclosures. For example, evidence from the Woodstock Institute in Chicago shows that recent increases in foreclosures have been fueled in large part by increases in subprime home lending in the last half of the 1990s. In addition to finding subprime lending "the dominant driver" of increases in foreclosures, the authors note that the impact of foreclosures is most keenly felt in "modest-income neighborhoods where foreclosures more often lead to abandonment and blight" and that those costs are "borne by entire communities, not just by the lender or borrower."[6] According to the study, from 1995 to 2002, foreclosure starts in the Chicago area grew 238 percent.[7]

More recently, the connection between predatory lending terms, prepayment penalties and foreclosures was confirmed by a study conducted by the Center for Community Capitalism at the University of North Carolina at Chapel Hill. The study found that the inclusion of prepayment penalties and balloon payments[8] in refinanced subprime mortgages dramatically increase the risk of foreclosure, even after controlling for credit scores, loan terms, interest rates, and economic factors. Specifically, after examining a large, nationwide sample of subprime loans, the UNC study found:

- Fully 20 percent of 30-year subprime refinance loans originated in 1998, 1999, and 2000 had entered foreclosure by the end of 2003.
- Refinance loans with extended prepayment penalties (three years or more) and balloon payments are much more likely to foreclose – by 20 percent and 50 percent, respectively – than refinance loans without such features. This is true after controlling for other relevant variables such as FICO scores, LTV, etc.

This study represents the first of its kind to establish that abusive loan terms are directly related to foreclosure.

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[6] Immergluck and Smith, Risky Business -- An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures, Woodstock Institute, March 2004.
[7] See Immergluck and Smith, note 5.
[8] A "balloon payment" is a large, lump-sum payment that is due at the end of a series of smaller periodic payments. Such payments may essentially force vulnerable borrowers to accept high-cost refinances or lose their home.

While we might expect some elevation of default rates in the subprime market, the statistics documenting Self-Help's experience with lending to borrowers with blemished credit and low incomes (including our loss rate of no more than 0.5 percent per year) suggest that foreclosures in the subprime market cannot be explained solely by borrower behavior. Rather, we must recognize that abusive lending pushes borrowers past their limits and imposes extensive costs in our communities.

C. The Disproportionate Impact of Predatory Lending

Because subprime loans go disproportionately to minority borrowers, predatory mortgage lending has a particularly harsh impact on people of color. The effect is that predatory lending perpetuates the wealth gap between whites and people of color, which is well established and growing. According to a recent report by the Pew Hispanic Center, in 2002 African Americans and Latinos had a median net worth of \$5,998 and \$7,932, respectively, compared to white Americans' median net worth of \$88,651.[9] In other words, white families' median net worth is about 11 times greater than Latinos' and nearly 15 times greater than the median net worth held by African Americans, up from a ten to one disparity as reflected in the 1990 census.

Among African American and Latino homeowners, the median family in each group held 88 percent of its total wealth in the form of home equity. These figures illustrate that home equity is a critical factor in determining economic progress among these populations.

These facts are relevant to this discussion because predatory lending puts that wealth at risk-- African-Americans and Latinos are overrepresented in the subprime mortgage market and have borne the brunt of abusive practices. According to a 2004 study published by ACORN, African-Americans were 3.6 times as likely as whites to receive a home purchase loan from a subprime lender and 4.1 times as likely as whites to receive a refinance loan from a subprime lender in 2002.[10] In 2002, for both home purchase and refinance loans, Latinos were 2.5 times as likely as whites to receive a loan from a subprime lender.

Most recently, CRL research also showed that abusive subprime prepayment penalties occur disproportionately in zip codes areas with a higher concentration of minority residents. After controlling for income and other relevant factors, we found that borrowers in minority communities have a significantly greater chance of receiving a prepayment penalty.[11] Studies such as these contribute to growing evidence that predatory lending imposes proportionately higher economic burdens on the most vulnerable communities.

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[9] Rahesh Kochhar, *The Wealth of Hispanic Households 1996 – 2002*, Pew Hispanic Center (October 2004).

[10] *Separate and Unequal 2004: Predatory Lending in America*, ACORN, ACORN Housing Corp., ACORN Fair Housing (February 2004).

[11] Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending (January 2005).

Predatory lenders are known to steer borrowers into subprime mortgages, even when the borrowers could qualify for a mainstream loan. Studies show that between 30 and 50 percent of borrowers with subprime mortgages could have qualified for loans with better terms.[12] This point is further illustrated by joint U.S. Department of Housing and Urban Development - Treasury Department research showing that borrowers in upper-income African-American neighborhoods were twice as likely as homeowners in low-income white neighborhoods to refinance with a subprime loan.[13]

2. State Laws are Working

Since the federal Home Ownership and Equity Protection Act (HOEPA) passed in 1994, the problem of abusive lending has grown worse. Unscrupulous lenders quickly found ways to circumvent the law. This situation illustrates how difficult it is for a federal law to remain current and maintain effectiveness against the creative practices of predatory lenders in different parts of the country.

In response to local surges in predatory lending activities, many states have passed predatory lending laws to supplement federal protections. North Carolina was a pioneer in this area, passing the first anti-predatory law of its kind in 1999.[14] Since then, that law has become a model for other states, while subprime mortgage lending in North Carolina has received a great deal of scrutiny. CRL estimates show that the new law saved consumers at least $100 million per year by preventing predatory loan terms that would have been expected to occur in the law's absence.[15]

More recently, the Fannie Mae Foundation published research by the University of North Carolina based on an examination of North Carolina's market before and after the anti-predatory law was implemented in 1999 and 2000. UNC found a decline in subprime refinance loans with predatory terms, and an increase in purchase subprime loans.[16] Specifically, the study noted a 72 percent drop in subprime prepayment penalties with terms of three years or longer along with a 43 percent increase in subprime home purchase loans. In other words, under the North Carolina law, borrowers in the subprime

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[12] Fannie Mae has estimated that 30-50% of subprime borrowers could have qualified for a loan with better terms. Freddie Mac estimates that 10–35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. *Id.* (*citing* Freddie Mac Special Report on Automated Underwriting (Sept. 1996) at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm; *see also Half of Subprime Loans Categorized as 'A' Quality*, Inside B&C Lending (June 10, 1996).

[13] Task Force on Predatory Lending, U.S. Department of Housing and Urban Development and U.S. Department of Treasury, *Curbing Predatory Home Mortgage Lending* at 48 (June 2000).

[14] It is worth noting that the bill passed with support from a strong coalition of bankers, credit unions, mortgage brokers, mortgage bankers, consumer advocates, the NAACP, AARP, and other community organizations.

[15] Keith Ernst, John Farris, Eric Stein, *North Carolina's Subprime Home Loan Market After Predatory Lending Reform*, Center for Responsible Lending (2002).

[16] Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, Vol. 15, Issue 3, Fannie Mae Foundation (2004).

market were buying homes in record numbers while being subjected to significantly less predatory lending in the refinance market.

A. The Performance of North Carolina's Subprime Market

The lending industry continues to claim that state anti-predatory lending laws have stunted the subprime lending market and hindered access to credit. That seems highly questionable in light of the continued explosive growth of the subprime market. Nevertheless, to address issues raised by industry, CRL has updated its analysis of the performance of the subprime market in North Carolina and other key states.

Using data from the Loan Performance database,[17] CRL examined the performance of the subprime market in North Carolina as compared to neighboring states. CRL also analyzed data from other states with strong anti-predatory lending laws (New Jersey and New Mexico) versus states with weaker laws (Florida, Ohio and Pennsylvania). The latter three states were selected because they take a less comprehensive approach to predatory lending, including in the way they define a "high-cost loan."

The data show that predatory lending is down in North Carolina, but the subprime mortgage market has continued to flourish. Subprime lending in the state has experienced similar growth to neighboring states, and borrowers are receiving the same types of subprime mortgages at better prices. In fact, borrowers participating in North Carolina's subprime market are almost indistinguishable from borrowers in other states, with one exception: North Carolina subprime borrowers are rarely subjected to large prepayment penalties.

North Carolina versus Neighboring States

1. Flow of Credit

As shown in Appendix B, subprime refinance lending has grown considerably in North Carolina since the state's law became fully effective in 2000. For subprime refinances, North Carolina's growth slightly exceeded other neighboring states except Virginia, which experienced growth far ahead of the country overall. For subprime purchase loans, again North Carolina's performance was second among these states, showing a cumulative increase of 366 percent growth during the period between 1998 and 2003.

2. Cost of Credit

When Self-Help helped champion North Carolina's anti-predatory lending law in 1999, we pushed for provisions that would encourage lenders to limit fees and instead reflect credit risk through the interest rate on the loan. When the cost of credit is reflected in rate rather than fees, understanding the real cost of the loan and comparing loan options is much easier for homeowners. Further, while fees are gone forever once they are stripped from home equity, a homeowner who is in a loan with a rate that is too high can refinance. In response to provisions in the North Carolina law that discouraged high fees,

[17] For more information describing the Loan Performance database, see Quercia and Stegman, note 15.

we anticipated a possible increase in interest rates, perhaps ranging from one-half to one percent.

However, as shown in Appendix C, the expected increase did not occur, and North Carolina's anti-predatory lending law has not adversely affected the cost of credit. Interest rates in North Carolina remain virtually indistinguishable from those of neighboring states. The same holds true for APR, based on that portion of the subprime market's Home Mortgage Disclosure Act data we have received to date. This shows that North Carolina borrowers are neither paying higher interest rates nor higher fees, and in fact suggests that borrowers were paying unnecessary fees before the law went into effect.

At the same time, borrowers in North Carolina receive loans without abusive terms. In 2003, only one percent of North Carolina borrowers had prepayment penalties of 36 months or longer on their subprime refinance loan. That figure stands in sharp contrast to states without strong laws. For example, in Tennessee, 58 percent of borrowers with refinances in the subprime market received prepayment penalties of 36 months or longer.

3. Borrowers Served by the Subprime Market

Even if credit flows had remained constant and interest rate and fees level or below those of neighboring states, we would still have cause for concern if the North Carolina market seemed to be underserving those with the fewest credit alternatives—borrowers with weaker credit, less income, or African-American and Latino borrowers that have historically had difficulty accessing credit. We are pleased to report that none of these concerns emerge from the data. For example, as shown in Appendix D, by two primary measures of creditworthiness—credit score (FICO) and loan-to-value ratio (LTV), the results for borrowers in North Carolina's subprime market are very similar to those in neighboring states.

4. Strong v. Weaker State laws

Similar results occurred in our comparison of strong and weaker state laws. Again, growth in the subprime market has been robust in states with strong laws. New Jersey, for example, continues to experience similar or lower interest rates compared to other states. In fact, interest rates and APR remain relatively constant among the states in the analysis. And again, while approximately 11 percent of subprime refinance loans in New Jersey and New Mexico had prepayment penalties of 36 months or longer in 2003, Ohio, Pennsylvania, and Florida each showed that 55 percent of their refinance loans included such prepayment penalties.

These positive results have been acknowledged by the lending industry. For example, last August a very favorable article appeared in National Mortgage News. In the article, Donald Fader, president of North Carolina Association of Mortgage Professionals, noted that the industry has continued to prosper under North Carolina's law. Mr. Fader is quoted as saying, "The membership in our organization has grown and there has been a high volume of business in the state."[18] In another instance, an analysis by a leading industry trade journal, *Inside B&C Lending*, found that top North Carolina subprime lenders "continue to offer a full array of products for borrowers in North Carolina – with little or no variation in rate" compared to other states.[19]

In addition, a Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher predatory lending laws have not reduced subprime residential lending volumes. In fact, branch managers thought that changed practices in response to state laws like North Carolina's are having neutral to positive impact on volume because they make customers feel more comfortable and "lower points and less onerous prepayment penalties make the economic terms more attractive."[20]

More recent comments by state officials suggest other state laws are having similar effects. The New Jersey Department of Banking recently stated:

> Based on our experience to date, we are pleased to report that we believe that the [New Jersey anti-predatory lending] law is fulfilling its twin goals: curbing abusive practices while also ensuring that responsible forms of credit continue to be made available to all New Jerseyans. This is reflected in the fact that consumer complaints about predatory practices are down, the number of entities seeking to become licensed lenders continues to rise, and all segments of the market remain stable. We note, for example, that according to *Inside B&C Lending*, New Jersey had the eighth highest volume in subprime mortgage lending at the end of the first quarter in 2004, showing an increase of 19% from the previous year.[21]

Attorney General Patricia Madrid recently said about New Mexico's state law, "In New Mexico, nearly a year and a half after the HLPA went into effect, my office is not aware of any New Mexicans who have been unable to obtain a home loan as a result of the law's protections."

3. The Characteristics of a Meaningful and Effective Federal Bill

Recently, two bills have been introduced in the House of Representatives to replace HOEPA and which purport to provide stronger protections for consumers against predatory lending. As Congress considers these bills, we urge members to carefully scrutinize the benefits touted by sponsors and to consider each bill in light of the practical realities of predatory mortgage lending. At a minimum, CRL believes that any meaningful bill would accomplish these goals:

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[18] Jennifer Harmon, *Looking Back at the North Carolina Law's Effects*, National Mortgage News, vol. 28, no. 45 (August 9, 2004).

[19] Cite. Also, some erroneously point to an industry-sponsored study (published by the Credit Research Center) as evidence that the North Carolina law decreased access to subprime credit for low-income borrowers. However, the study has been widely criticized. Significantly, the study was based on loans originated between 1997 and June 30, 2000; however, the N.C. law did not take full effect until July 1, 2000.

[20] *Lenders Will Try to Pin Down Effects of NC Mortgage Law*, Inside B&C Lending (March 5, 2001).

[21] *Channel Check: Surprisingly Strong Subprime Growth*, Morgan Stanley - Diversified Financials (August 1, 2002).

1. Adopt a definition of "high-cost loan" that captures all major fees, so that abusive loans are included in the definition.
2. Prohibit practices that are so abusive that they are inappropriate on any home loan, such as loan flipping -- repeated refinances that provide no benefit to borrowers.
3. Provide effective protections for high-cost loans.
4. Ensure that homeowners' rights are effective by providing meaningful remedies and the ability to enforce rights when the loan is sold.
5. Allow flexibility for states to address localized and new abuses.

A. H.R. 1295, sponsored by Representatives Ney and Kanjorski

Unfortunately, the bill introduced by Representatives Robert Ney (R-OH) and Paul Kanjorski (D-PA), entitled "The Responsible Lending Act" (H.R. 1295), would achieve none of the goals of a meaningful and effective federal bill. If implemented, this proposal would fail to protect homebuyers and homeowners against irresponsible lending and, in fact, would allow predatory mortgage lending to proliferate.

Although H.R. 1295 purports to expand consumer protections, it would in fact outlaw a small minority of predatory loans. CRL strenuously objects to H.R. 1295, for the following reasons:

1. The bill fails to take a comprehensive approach to excessive points and fees. The Ney-Kanjorski bill excludes almost all prepayment penalties and appears to exclude yield spread premiums from the calculation of whether a loan has points and fees at a level that triggers the protections in the Act.

- Protections for high-cost loans are only meaningful if all lender and broker compensation is included in the calculation to determine if a loan is a high-cost loan. Otherwise, unscrupulous lenders will evade the bill's scope simply by shifting compensation to these excluded fees.

- Prepayment penalties on subprime loans strip hard-earned home equity, trap borrowers in unaffordable loans, and are tied by statistical research to increased foreclosures. Under the Ney-Kanjorski proposal, penalties for paying off the home loan early are not counted towards whether a borrower has received a "high-cost" loan, except in rare circumstances where a lender refinances its own loan.

- Kickbacks to mortgage brokers, known as yield spread premiums, encourage the steering of borrowers into higher-priced loans than borrowers qualify for, but it appears this form of broker compensation is not treated like other fees in determining whether a borrower has received a "high-cost" loan in the Ney-Kanjorski proposal.

The chart below breaks out the costs to the borrower associated with two hypothetical loans that the Ney-Kanjorski bill would treat as perfectly good mortgages.

	LOAN #1	LOAN #2
Loan Amount	$ 100,000	$ 150,000
Total Points and Fees Paid	$ 24,482	$ 31,723
Points & Fees as % of Loan Amount	24.4%	21.1%
Fee Breakdown		
Origination Fees	$ 4,990	$ 7,485
Broker Fees	$ 4,000	$ 6,000
Discount Points	$ 2,000	$ 3,000
Single Premium Credit Insurance	$ 10,000	$ 10,000
Prepayment Penalties	$ 3,492	$ 5,238
Total Loan Amount if Fees Financed	**$ 124,482**	**$ 181,723**
Original Interest Rate	8.73%	8.73%
APR	11.33%	10.99%
Monthly Payment	$ 977.52	$ 1,427.02
EQUITY LOST AFTER REFINANCE IN 2 YEARS	**$ 24,482**	**$ 31,723**

Total Points and Fees Paid: *This line shows the cost of the loan from the homeowner's perspective. In Loan #1, the points and fees equal almost 25% of the loan amount. However, Loan #1 is not a higher-cost loan under Ney-Kanjorski, because the bill excludes a host of fees from its calculation of whether a loan falls into this special category.*

2. The bill fails to address certain practices inappropriate on any home loan

Fails to effectively address abusive loan flipping. The Ney-Kanjorski bill addresses flipping only for high-cost loans, allowing lenders to repeatedly flip borrowers into loans that provide no net benefit as long as the upfront fees are only 4.99 percent of the loan amount each time and only applying the prohibition when a refinance is within two years of the original loan. The bill's exceptions to its flipping provision create a road map for abusive flips that would be permitted under the law. A more appropriate response would be to apply a prohibition against flipping to <u>all</u> home loans.

Fails to prevent abusive prepayment penalties on subprime loans. While the bill limits prepayment penalties on all home loans to 3 years, it permits lenders to charge a high prepayment fee (typically 4%-5% of the loan). An increasing number of subprime lenders have reduced the amount of these penalties, and the Ney-Kanjorski bill lags behind the market leaders. For instance, HSBC (Household) limits prepayment penalties to two percent of the loan amount. As a result, the bill endorses a practice that requires borrowers who have loans with higher interest rates to pay bigger prepayment penalties in order to refinance into a more affordable loan. Further, if enacted, the proposal would preempt laws in the majority of states that have prohibited or further limited prepayment penalties.

3. Fails to prevent equity-stripping for borrowers who receive high-cost loans.

Protections for high-cost loans apply only in those rare circumstances when borrowers incur more than five percent of the loan amount in points and fees or interest rates above approximately 12.5 percent in today's market, loans that put borrowers at extreme risk of equity loss or foreclosure. The Ney-Kanjorski bill would allow a lender to finance up to five percent of the loan amount in conjunction with a high-cost loan, and would not require any counseling prior to obtaining a loan.

In many high-cost loans, borrowers never realize the significance of the exorbitant hidden fees on the loan because they don't pay for them in cash, but instead finance the points into the loan. Limits on financing high fees and a counseling requirement for high-cost loans are essential to deterring equity stripping through fees, making it much more difficult for lenders to mislead a borrower into agreeing to an overpriced loan and encouraging lenders to put risk into interest rate, a cost that is much more transparent to the borrower.

4. Fails to provide Meaningful Remedies

Fails to ban mandatory arbitration on all home loans. The Ney-Kanjorski proposal bans mandatory arbitration on high-cost home loans only, while the Miller-Watt-Frank bill prohibits the use of mandatory arbitration clauses in all home loans. Most of the leading subprime lenders, including Ameriquest, Countrywide, Option One, New Century, Citigroup, and Washington Mutual, prohibit mandatory arbitration on subprime loans, including subprime loans that fall well below any high-cost definition. As a result, the Ney-Kanjorski bill falls short of best practices in the industry.

Significantly reduces assignee liability protections under existing federal law. The Ney-Kanjorski bill would roll back protections available under current federal law that allow borrowers with high-cost loans to seek recourse if their loan has been sold on the secondary market. Because most subprime loans are sold, these severe limitations on assignee liability will mean that many borrowers will be unable to defend their home against foreclosure if they have received a predatory loan. Once they've lost their house, these borrowers may be able to win a suit against a lender for damages years later, but that is small consolation to a family that is forced out of their home. And this lender might well not be around or solvent to sue later: The Reinvestment Fund found that a quarter of all loans currently in foreclosure in Philadelphia today were originated by lenders no longer in business. In contrast, numerous states, including Illinois, Massachusetts, New Mexico, and North Carolina have found an effective approach to assignee liability that balances the ability of the secondary market to purchase subprime loans and the need for borrowers to be able to protect their home against abusive practices.

5. Broadly preempts state protections for homeowners.
Rather than preserve and strengthen existing state and federal protections for homeowners, the Ney-Kanjorski bill wipes out state anti-predatory lending laws that have

been proven effective at preventing abusive practices and significantly weakens some protections available under the federal law today.

Replaces effective state protections against predatory lending with a weak federal standard. H.R. 1295 preempts state anti-predatory mortgage lending laws that have proven effective at curbing abusive lending practices and would replace these state laws with a weak federal standard that falls far short of principles for effective legislation to eliminate predatory lending.

In addition, the bill includes numerous loopholes that undercut the stated purpose of the bill. While the Ney-Kanjorski bill purports to lower the points and fees threshold, changes to the definition of points and fees make the definition less inclusive than current federal law under HOEPA. Exceptions to a prohibition against subterfuge would in fact encourage loan-splitting, allowing lenders to avoid making a high-cost loan and thereby triggering protections for such loans. Exceptions to the ability to repay provision would limit its effectiveness and preempt ongoing state efforts to address such abuses.

B. The Miller-Watt-Frank Bill

In contrast, Representatives Brad Miller (D-NC), Mel Watt (D-NC), and Barney Frank (D-MA) have introduced legislation to amend HOEPA that draws directly on North Carolina's 1999 law. H.R. 1182 ("The Prohibit Predatory Lending Act") provides meaningful and effective consumer protections while relying on provisions with proven success in supporting the subprime mortgage market. Here are some of the key strengths of the bill:

1. Adopts a comprehensive definition of "high-cost home loan."

H.R. 1182 defines high-cost loans as loans with points and fees above five percent of the loan amount and takes a comprehensive approach to which fees count towards that five percent. In contrast to the Ney-Kanjorski proposal, the definition of points and fees includes yield-spread premiums, prepayment penalties and single premium credit insurance. While the North Carolina law does not include yield spread premiums in its points and fees definition, it has addressed yield spread premiums through additional duties imposed on brokers under a separate broker statute. Several additional states, including New Mexico, New Jersey, New York, and Georgia (even after later amendments to the law) include yield spread premiums in their definition of points and fees.

2. Provides protections for abuses that are inappropriate for any home loan.

The Miller-Watt-Frank bill addresses equity-stripping below high-cost thresholds by adopting the North Carolina prohibition against flipping a home loan without any reasonable, tangible benefit to the borrower.

3. Provides effective protections for high-cost loans

As in the North Carolina law, H.R. 1182 prohibits the financing of any fees on a high-cost loan, encouraging lenders to express any additional risk in the loan in terms of interest rate, rather than requiring borrowers to finance high fees out of their home equity.

Many other states have adopted a similar approach, allowing only two or three percent of the loan amount to be financed on a loan with high fees.

Following a precedent set in at least seven state laws (Arkansas, Georgia, Massachusetts, North Carolina, New Jersey, New Mexico, and South Carolina), H.R. 1182 requires counseling for borrowers before they enter into a high-cost loan.

The bill prohibits prepayment penalties on high-cost loans below local FHA loan limits, and also prohibits excessive fees for payoff information, loan modifications, or late payments.

In addition, the bill prohibits practices that increase the risk of foreclosure, such as lending without regard for whether the borrower is able to repay, encouraging a borrower to default, balloon loans, and call provisions.

4. Provides Meaningful Remedies for Borrowers.

The Miller-Watt-Frank bill prohibits mandatory arbitration clauses on all home loans.

Further, it preserves assignee liability protections. The Miller-Watt-Frank bill would maintain existing protections in the Home Ownership and Equity Protection Act (HOEPA) that have been in place and successful since 1994.

5. Allows flexibility for states to address localized and new abuses.

The Miller-Watt-Frank bill preserves existing preemption language under HOEPA, which states that federal standards are a floor, not a ceiling, and allows states to enact additional protections.

C. Preemption of State Laws:

1. Federal preemption of state anti-predatory lending laws would be misguided, as any federal standards should supplement, not replace, existing state efforts.
When the federal government first legislated against predatory home lending through the HOEPA floor, states were free to go further. This dynamic has served the nation well, allowing for a "cooperative federalism" in which state-developed solutions and federal regulatory efforts inform and support each other. While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular context.[22] States have served as "laboratories of democracy" with respect to predatory lending by helping to refine solutions for important issues.

[22] Acting Commissioner Donald Bryan, New Jersey Department of Banking and Insurance, Letter to Senator Corzine (May 11, 2005). *See also*, New Jersey Department of Banking and Insurance, *New Jersey's Predatory Lending Law Protecting Consumers*, Press Release (December 21, 2004).

2. Federal agencies have learned from state-based efforts to address predatory lending. In at least two cases, federal agencies have learned from and acted upon lessons developed at the state level. In adopting changes to their regulatory framework, the Federal Reserve Board and the Office of Thrift Supervision each exemplified the best ideals of federalism.

The Federal Reserve Board took important action in 2001 when it moved to incorporate single premium credit insurance within the scope of charges evaluated as a point or fee under HOEPA. But, the Federal Reserve did not arrive at this conclusion in a vacuum. Indeed, the first jurisdiction to reach such a conclusion was the state of North Carolina, which adopted a similar provision in its 1999 law. Even as North Carolina reached the conclusion that such products were harming consumers, it recognized that legitimate forms of credit insurance, calculated and paid on a monthly basis, did not have harmful equity stripping effects and should not be subject to the same scrutiny. Following the law's effective date, Freddie Mac and Fannie Mae and then many lenders publicly disclaimed such products and the market appears to have successfully transitioned to the monthly product. Consequently, the Federal Reserve acted responsibly when it saw that similar benefits could be extended through the federal HOEPA floor to borrowers in all states.

Similarly, some 35 states currently have statutory provisions relating to prepayment penalties on home loans. Yet, federal law had been interpreted to preclude these states from enforcing those laws against state-chartered finance companies and mortgage brokers in adjustable rate mortgages (ARMs) and other alternative mortgage transactions. Increasingly, subprime prepayment penalties in home loans have come under scrutiny and a number of states have moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision took commendable action when it revised federal regulations in a way that promoted cooperative federalism by restoring the states' rights to apply their laws to these state-chartered institutions.

3. States are best equipped to respond to abuses in their particular markets. We urge you today to continue in this vein and partner with states to provide protections for the nation's homeowners. In addition to losing the opportunity for synergy with state efforts, federal preemption of state law is not a practical response to predatory lending because states are in the best position to respond to many of the challenges presented by predatory lending, for at least three reasons: (1) many of the bad actors involved in predatory lending are state-chartered entities with minimal capitalization, (2) regional variations in real estate markets require different solutions to predatory lending, and (3) irresponsible lenders can invent new abusive practices virtually overnight, and the federal government is ill-equipped to react quickly to these changes.

First, federal enforcement of financial services laws depends largely on periodic examinations of the practices of large institutions. The broker who just hung a shingle from his door, however, can originate abusive loans without much fear of federal oversight—as can a state-chartered affiliate of a bank that is not likely to affect its larger parent's overall safety and soundness. State attorneys general and bank regulators have been instrumental in investigating abusive practices and in demanding redress for their citizens. They are also the primary regulators of non-depository finance companies, which dominate the subprime market. The federal government simply cannot be everywhere at once to monitor local real estate transactions.

Second, predatory lending laws should address the special characteristics of each state's underlying real estate regime and market. For example, the mechanism for ensuring that a borrower can raise defenses to foreclosure on predatory home loans may depend on whether a state has judicial or non-judicial foreclosure procedures. The appropriate loan-size threshold for when to prohibit prepayment penalties may depend on the real estate values in a given state. North Carolina prohibits prepayment penalties in first-lien home loans of less than $150,000. In California, the most reasonable threshold would perhaps be considerably higher.

Third, new financial services products are developed every day, frequently to exploit loopholes in laws against abuse. If HOEPA preempted state laws back in 1994, North Carolina never could have outlawed single premium credit insurance, and the abusive practice would still be widespread today. In North Carolina, the legislature prohibited the sale of financed credit insurance. Within two years, the similar "but-not-insurance" product of "debt cancellation agreements" was born, and many states have moved to cover such products as they address single premium credit insurance through legislation. State legislatures are better suited than Congress for responding quickly to such changes.

4. Lenders have experience complying with a variety of state laws that affect their business practices, and complying with state-based homeowner protection laws presents no heavier a burden. Given the evidence of success at the state level, Congress would do harm to homeowners by imposing a uniform standard in lieu of state protections. Every day, lenders deal with tremendous variety in state real estate laws and practices, including consumer protection laws.[23] The laws concerning who may act as a settlement agent differ from state to state. Foreclosure law differs from state to state. States have their own fraud and deceptive practices acts, interpreted by state court judges in accordance with state-specific common law.

Just as lenders find tools for complying with these and other variations, we believe that they are capable of complying with state-based homeowner protection statutes as well. The market has responded by producing computer products that claim to assist lenders in their compliance obligations across state borders.[24] In fact, the variation in these statutes is actually quite small, and we can expect states to move even closer to a consensus approach as regulation of predatory lending improves in its ability to curb abuses. With the incredible recent growth in subprime lending that has occurred, it is simply not credible to claim that variations in state laws have hamstrung this industry.

[23] Significantly, federal laws such as the Fair Housing Act and the Equal Credit Opportunity Act regulate the real estate finance market without broadly preempting comparable state regulations.
[24] *See* Bergquist, Eric, "Some Lenders Turning to Compliance Software", American Banker, v168, n62 (April 1, 2003).

Conclusion

As an experienced mortgage lender, we know that risk management is a key element of good lending. Responsible lenders are adept at assessing credit quality and property appraisals to determine whether a particular loan represents a good investment.

Today we are weighing the risks of competing policies that will govern subprime mortgage lending. On the one hand, we have the risk that qualified borrowers will not have sufficient access to subprime mortgage credit. Given the remarkable growth of subprime lending during the past decade and the successful implementation of state anti-predatory lending laws, this risk seems very slight indeed. On the other hand, we have the risk of families losing their hard-earned equity and their homes. Evidence strongly suggests this risk increases with subprime mortgages that include excessive fees, abusive prepayment penalties and weak provisions for lender accountability. In this era where credit is arguably more available than ever before, it seems clear that the risks associated with equity stripping and foreclosures far outweigh concerns about a market that is growing faster than any other area of consumer finance.

Fortunately, it is not necessary to choose between a healthy subprime mortgage lending industry and prosperous borrowers who are building wealth. When policymakers implement policies that demand responsible lending, we can have both. It is our sincere hope that these subcommittees will choose the right policies for the millions of senior citizens and families who depend on homeownership to build a better future.

Appendix A
Significant Increases in Subprime Lending

The subprime mortgage industry has thrived over the past several years, even with the prevalence of state predatory lending laws passed across the nation. This is a clear indication that predatory lending laws and regulations have not hindered the subprime market, as many industry officials had feared would happen. The following list of facts support the claim that predatory lending laws are not stifling credit to low-income and poor-credit borrowers:

- In 2004, there was a **record $530 billion in subprime originations** [1] -- **a 60 percent increase** over the previous year—**compared to a 33% decrease in the prime mortgage market** in the same period. Most major subprime lenders experienced a significant increase in volume in 2004.

Originations for Top 10 Subprime B&C Mortgage Lenders [2]

Lender	2004 Volume ($ in millions)	2003 Volume ($ in millions)	% Increase from '03-'04
Ameriquest Mortgage	$82,675	$41,700	98.3%
New Century Financial	$42,200	$27,400	54.0%
Countrywide Financial	$39,441	$19,827	98.9%
HSBC Consumer Finance	$33,250	$20,336	63.5%
Washington Mutual	$29,563	$19,452	52.0%
First Franklin Financial Corp.	$28,946	$20,081	44.2%
Option One Mortgage	$25,990	$20,136	29.1%
CitiFinancial	$23,543	$21,428	9.9%
Fremont General Corp.	$22,890	$13,110	74.6%
Wells Fargo Home Mortgage	$22,395	$16,485	35.9%
TOTAL	**$350,893**	**$219,955**	**59.5%**

- Subprime lenders originated **18.9 percent** of all mortgages in 2004, **more than doubling the 8.8 percent** market share they held in 2003 [3].

- The 24 states that had a predatory lending law in effect during 2003 had a **45 percent increase** in subprime origination volume since 2001, whereas states without a predatory lending law experienced only a **20 percent increase** in volume.[4]

[1] *Subprime Lenders Outpace The Mortgage Market in Record 2004,* Inside B&C Lending, February 14, 2005
[2] *Top 25 B&C Lenders in 2004,* Inside B&C Lending, February 14, 2005
[3] *Subprime Lenders Outpace The Mortgage Market in Record 2004,* Inside B&C Lending, February 14, 2005
[4] State origination data for 2004 not yet available.

Appendix B
North Carolina versus Neighboring States

FLOW OF CREDIT*

Growth in Subprime **Refinance** Lending per 100,000 Adults, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998-99	59%	70%	68%	63%	33%	48%
1999-00	11%	-6%	5%	11%	6%	0%
2000-01	42%	13%	16%	10%	43%	35%
2001-02	-4%	31%	12%	17%	45%	46%
2002-03	28%	32%	32%	34%	77%	53%
1998-2003	208%	214%	204%	211%	416%	345%

Growth in Subprime **Purchase** Lending per 100,000 Adults, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998-99	21%	48%	88%	34%	31%	48%
1999-00	11%	26%	12%	28%	30%	13%
2000-01	11%	34%	27%	29%	28%	11%
2001-02	-3%	25%	36%	21%	34%	29%
2002-03	46%	50%	61%	50%	40%	49%
1998-2003	110%	366%	484%	306%	308%	256%

* This data is derived from the Loan Performance Database are for borrowers' whose loans meet the following criteria: Full Doc, 30-Years, No Jumbo, 1st Lien, single-family home, owner-occupied. These criteria were chosen because they reflect those of a typical subprime borrower.

Appendix C
North Carolina versus Neighboring States

COST OF CREDIT*

Mean **Initial Interest** Subprime **Refinance** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	9.4	9.56	9.8	9.54	9.25	9.13
1999	10.06	10.02	10.03	10.12	9.88	9.75
2000	10.78	11.02	11.08	10.9	10.64	10.56
2001	9.73	10.11	10.06	9.96	9.47	9.51
2002	8.89	9.15	9.12	9.13	8.57	8.6
2003	7.88	8.07	8.06	8.08	7.62	7.62
2004 (partial)	7.47	7.69	7.82	7.67	7.22	7.16

Mean **APR Spread** of HMDA Verified Subprime **Refinance** Lending, 2004**

Year	GA	NC	SC	TN	VA	US
2004	4.31	4.40	4.51	4.43	4.10	4.13%

Percent of Subprime **Refinance** Loans with **Prepayment Penalties**, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	76	22	8	76	55	63
1999	87	33	16	87	85	74
2000	91	36	23	93	89	78
2001	90	28	34	95	84	79
2002	83	20	32	93	85	79
2003	16	11	39	94	85	74
2004 (partial)	16	13	5	93	86	71

Percent of Subprime **Refinance** Loans with **36 Month or Longer Prepayment Penalties**, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	54	14	6	58	40	41
1999	65	25	11	71	64	52
2000	64	20	16	73	65	51
2001	61	4	24	71	58	50
2002	46	1	18	60	43	42
2003	8	1	21	58	42	37
2004 (partial)	5	0	1	53	35	33

Continued next page.

Appendix C - continued

Mean **Initial Interest** Subprime **Purchase** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	9.66	9.59	9.88	9.73	8.63	9.32
1999	10.07	10.15	9.89	10.15	9.73	9.87
2000	10.57	10.63	10.71	10.73	10.35	10.44
2001	9.58	9.81	9.76	9.81	9.24	9.51
2002	8.66	8.59	8.52	8.8	8.32	8.42
2003	7.42	7.74	7.7	7.92	7.39	7.46
2004 (partial)	6.76	7.22	7.44	7.51	6.78	6.95

Mean **APR SPREAD** of HMDA Verified Subprime **Purchase** Lending, 2004**

Year	GA	NC	SC	TN	VA	US
2004	3.95	4.05	4.17	4.07	3.96	3.91

Percent of Subprime **Purchase** Loans with **Prepayment Penalties**, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	68	22	10	66	38	55
1999	78	39	19	83	68	73
2000	83	33	23	86	72	75
2001	76	23	28	82	68	71
2002	73	19	27	82	69	75
2003	22	8	38	89	71	73
2004 (partial)	25	11	4	91	70	68

Percent of Subprime **Purchase** Loans with **36 Month or Longer Prepayment Penalties**, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	32	11	4	36	21	26
1999	47	24	12	54	42	42
2000	46	14	12	55	45	41
2001	40	4	15	52	39	38
2002	29	1	11	41	28	33
2003	6	1	12	37	27	26
2004 (partial)	6	0	1	28	20	19

*This data is derived from the Loan Performance Database are for borrowers' whose loans meet the following criteria: Full Doc, 30-Years, No Jumbo, 1st Lien, single-family home, owner-occupied. These criteria were chosen because they reflect those of a typical subprime borrower

Appendix D
North Carolina versus Neighboring States

BORROWERS SERVED BY THE SUBPRIME MARKET

Mean **FICO** Subprime **Refinance** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	586	579	568	581	565	600
1999	581	580	581	580	576	590
2000	574	573	576	575	567	581
2001	576	575	572	579	572	592
2002	576	574	572	575	573	594
2003	587	582	580	582	581	604
2004 (partial)	607	602	597	601	605	605

Mean **LTV** Subprime **Refinance** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	80	79	80	80	80	77
1999	80	79	80	80	80	77
2000	81	79	80	81	79	78
2001	82	81	81	82	81	79
2002	82	83	83	83	81	79
2003	83	83	84	85	81	80
2004 (partial)	83	83	84	85	80	79

Ratio of **African-American to White, Non-Hispanic** HMDA Verified Subprime **Refinance** Lending per Adult, 2004**

Year	GA	NC	SC	TN	VA	US
2004	2.2	2.1	1.8	2.2	2.9	2.0

Ratio of **Hispanic to White, Non-Hispanic** HMDA Verified Subprime **Refinance** Lending per Adult, 2004**

Year	GA	NC	SC	TN	VA	US
2004	2.2	1.3	1.8	1.6	1.9	1.6

HMDA Verified LMI Proportion of Total Subprime **Refinance** Lending, 2004**

Year	GA	NC	SC	TN	VA	US
2004	51.9	47.6	56.0	53.9	67.7	51.2

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Mean **FICO** Subprime **Purchase** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	604	600	603	599	626	613
1999	601	601	596	595	609	605
2000	608	602	598	605	609	608
2001	615	616	613	612	627	619
2002	617	627	629	618	638	628
2003	642	634	633	626	646	639
2004 (partial)	651	634	628	621	655	641

Mean **LTV** Subprime **Purchase** Lending, 1998-2003*

Year	GA	NC	SC	TN	VA	US
1998	86	85	85	86	86	84
1999	86	84	84	84	84	83
2000	87	86	86	85	86	85
2001	89	89	89	88	88	87
2002	89	89	90	89	88	87
2003	90	91	93	91	90	89
2004 (partial)	87	87	90	90	86	87

Ratio of **African-American to White, Non-Hispanic** HMDA Verified Subprime **Purchase** Lending per Adult, 2004**

Year	GA	NC	SC	TN	VA	US
2004	3.7	2.3	1.6	3.3	2.5	2.6

Ratio of **Hispanic to White, Non-Hispanic** HMDA Verified Subprime **Purchase** Lending per Adult, 2004**

Year	GA	NC	SC	TN	VA	US
2004	4.3	5.3	2.8	5.1	8.4	2.9

HMDA Verified LMI Proportion of Total Subprime **Purchase** Lending, 2004**

Year	GA	NC	SC	TN	VA	US
2004	50.3	48.9	59.4	60.5	54.0	48.35

* Source: Loan Performance ABS Subprime Database (as of December 2004)
**** Source: CRL 2004 HMDA Lending Database (as of May 15, 2005).** The CRL HMDA database (as of May 15, 2005) includes 5.5 million home loans originated in 2004 by more than 300 reporting institutions, for a total amount in excess of $1 trillion. 20% of these loans by number of originations and 12% by dollar amount exceeded the subprime APR reporting threshold set by HMDA. The data contain information from a wide range of major subprime lenders, including Ameriquest, Citigroup, Countrywide, Household, GMAC, National City, New Century, and Option One Mortgage Corporation.

Appendix E
States with Strong Anti-Predatory Lending Laws
vs. States with Weaker Laws

A. FLOW OF CREDIT:

Growth in Subprime **Refinance** Lending per 100,000 Adults, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998-99	31%	70%	64%	28%	54%	46%	48%
1999-00	1%	-6%	-5%	-28%	9%	6%	0%
2000-01	30%	13%	44%	6%	17%	10%	35%
2001-02	61%	31%	129%	22%	18%	40%	46%
2002-03	79%	32%	78%	40%	28%	52%	53%
1998-2003	396%	214%	822%	67%	196%	261%	345%

Growth in Subprime **Purchase** Lending per 100,000 Adults, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998-99	47%	48%	21%	54%	58%	44%	48%
1999-00	14%	26%	14%	-3%	9%	8%	13%
2000-01	7%	34%	4%	-1%	15%	22%	11%
2001-02	25%	25%	35%	38%	21%	21%	29%
2002-03	48%	50%	39%	33%	60%	29%	49%
1998-2003	231%	366%	169%	173%	283%	195%	256%

B. COST OF CREDIT:

Mean **Initial Interest** Subprime **Refinance** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	9.28	9.56	9.14	9.21	9.27	9.43	9.13
1999	9.82	10.02	9.47	9.84	9.7	10.02	9.75
2000	10.5	11.02	10.49	10.53	10.52	10.76	10.56
2001	9.57	10.11	9.31	9.64	9.73	9.85	9.51
2002	8.78	9.15	8.43	8.84	8.83	8.79	8.6
2003	7.77	8.07	7.63	7.9	7.91	7.89	7.62
2004 (partial)	7.34	7.69	7.19	7.44	7.46	7.47	7.16

Mean **APR SPREAD** of HMDA Verified Subprime **Refinance** Lending, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	4.01	4.40	4.04	4.40	4.09	4.21	4.13

Percent of Subprime **Refinance** Loans with **Prepayment Penalties**, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	81	22	12	11	83	56	63
1999	90	33	47	46	92	72	74
2000	93	36	57	58	94	77	78
2001	93	28	60	65	95	85	79
2002	93	20	67	63	94	88	79
2003	94	11	31	29	91	89	74
2004 (partial)	95	13	0	2	88	91	71

Percent of Subprime **Refinance** Loans with **36 Month or Longer Prepayment Penalties**, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	64	14	8	6	72	42	41
1999	73	25	34	29	81	55	52
2000	72	20	34	35	74	54	51
2001	71	4	32	40	74	61	50
2002	56	1	25	30	60	52	42
2003	55	1	11	11	55	55	37
2004 (partial)	53	0	0	1	46	50	33

Mean **Initial Interest** Subprime **Purchase** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	9.71	9.59	9.03	9.24	9.4	9.38	9.32
1999	10.03	10.15	9.86	9.77	9.73	9.96	9.87
2000	10.62	10.63	10.55	10.36	10.53	10.75	10.44
2001	9.75	9.81	9.32	9.66	9.79	9.71	9.51
2002	8.7	8.59	8.3	8.82	8.76	8.79	8.42
2003	7.67	7.74	7.36	7.77	7.84	7.79	7.46
2004 (partial)	7.05	7.22	6.9	7.42	7.47	7.37	6.95

Mean **APR SPREAD** of HMDA Verified Subprime **Purchase** Lending, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	3.81	4.05	3.81	3.86	4.00	4.04	3.91

Percent of Subprime **Purchase** Loans with **Prepayment Penalties**, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	74	22	6	16	77	37	55
1999	89	39	38	52	85	54	73
2000	87	33	54	67	87	69	75
2001	84	23	50	60	84	71	71
2002	88	19	60	67	85	73	75
2003	92	8	31	36	86	78	73
2004 (partial)	88	11	1	3	85	79	68

Percent of Subprime **Purchase** Loans with **36 Month or Longer Prepayment Penalties**, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	44	11	3	6	66	19	26
1999	62	24	12	30	75	31	42
2000	60	14	17	41	68	33	41
2001	54	4	14	31	58	33	38
2002	46	1	11	31	48	31	33
2003	36	1	4	13	43	36	26
2004 (partial)	27	0	1	1	31	30	19

C. BORROWERS SERVED BY THE SUBPRIME MARKET:

Mean **FICO** Subprime **Refinance** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	593	579	610	603	587	589	600
1999	591	580	599	593	581	587	590
2000	587	573	588	586	574	578	581
2001	591	575	596	587	584	590	592
2002	588	574	592	598	585	594	594
2003	596	582	595	606	596	599	604
2004 (partial)	592	602	597	609	598	594	605

Mean **LTV** Subprime **Refinance** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	78	79	75	77	78	77	77
1999	79	79	76	78	78	78	77
2000	79	79	76	79	79	78	78
2001	80	81	77	80	81	79	79
2002	80	83	77	81	82	81	79
2003	80	83	76	83	84	82	80
2004 (partial)	80	83	75	83	85	81	79

Ratio of **African-American to White, Non-Hispanic** HMDA Verified Subprime **Refinance** Lending per Adult, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	2.2	2.1	1.9	1.5	1.9	1.6	2.0

Ratio of **Hispanic to White, Non-Hispanic** HMDA Verified Subprime **Refinance** Lending per Adult, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	1.7	1.3	1.5	2.1	1.3	1.6	1.6

HMDA Verified LMI Proportion of Total Subprime **Refinance** Lending, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	46.6	47.6	51.8	42.9	63.2	56.6	51.2

Mean **FICO** Subprime **Purchase** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	595	600	627	615	599	608	613
1999	599	601	611	597	602	604	605
2000	604	602	609	607	600	601	608
2001	613	616	619	605	609	618	619
2002	619	627	620	617	614	622	628
2003	629	634	634	638	626	639	639
2004 (partial)	635	634	643	633	624	635	641

Mean **LTV** Subprime **Purchase** Lending, 1998-2003*

Year	FL	NC	NJ	NM	OH	PA	US
1998	84	85	84	83	82	84	84
1999	84	84	84	83	82	84	83
2000	86	86	84	85	84	86	85
2001	87	89	86	87	86	88	87
2002	87	89	84	88	88	89	87
2003	89	91	86	89	91	91	89
2004 (partial)	87	87	86	88	89	89	87

Ratio of **African-American to White, Non-Hispanic** HMDA Verified Subprime **Purchase** Lending per Adult, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	2.6	2.3	2.4	1.3	2.7	2.0	2.6

Ratio of **Hispanic to White, Non-Hispanic** HMDA Verified Subprime **Purchase** Lending per Adult, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	4.4	5.3	3.6	1.4	2.0	4.2	2.9

HMDA Verified LMI Proportion of Total Subprime **Purchase** Lending, 2004**

Year	FL	NC	NJ	NM	OH	PA	US
2004	36.5	48.9	40.2	39.8	71.0	62.1	48.4

* Source: Loan Performance ABS Subprime Database (as of December 2004)
** Source: CRL 2004 HMDA Lending Database (as of May 15, 2005)

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May 24, 2005

U.S. House of Representatives
Committee on Financial Services
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
2129 Rayburn House Office Building
Washington, DC 20515

Re: "Legislative Solutions to Abusive Mortgage Lending Practices" Hearing

Dear Members,

Good morning distinguished members of the House Financial Services Committee, Subcommitees on Housing and Community Opportunity and Financial Institutions and Consumer Credit. It is my pleasure to submit to you this written testimony for your hearing entitled "Legislative Solutions to Abusive Mortgage Lending Practices" this 24th day of May 2005.

My name is Martina Guilfoil and I am the Executive Director of Inglewood Neighborhood Housing Services, as well as President of the National NeighborWorks® Association (NNA). NNA is the national membership association of the 230 NeighborWorks® Organizations throughout the country. NeighborWorks® Organizations work to revitalize over nearly 3,000 communities throughout the country, leveraging resources provided by congressionally-chartered Neighborhood Reinvestment Corporation (dba NeighborWorks® America). NNA members also utilize funding from CDBG, Section 8 and other federal funding to create and sustain economic wealth in low- and moderate-income communities across forty-nine states, the District if Columbia and Puerto Rico.

NNA's work relevant to this hearing includes mortgage counseling, pre- and post-purchasing counseling, individual development accounts and financial literacy programs. Our goal is to educate the low- and moderate-income homebuyer, many of who are first-time homebuyers, and provide them with the tools to *purchase* a home, but more importantly to *keep* their home. Our contribution to this hearing is underscored by the years of experiences our members have gained in advocating for the right to homeownership. Our members across the nation work tirelessly to educate potential homebuyers – we are in the trenches, counseling and advising homebuyers how to recognize the pitfalls of predatory lending.

NeighborWorks® organizations were created in the mid 1970's in response to the problem of redlining in communities across America. People were denied the credit they needed in order to improve their homes. NeighborWorks® made loans to families so that they could continue to live in safe and decent housing. Today the challenges we face have swung the other way. The challenge in our neighborhoods is not the lack of credit, but rather what someone will have to pay for it and under what terms. A variety of financial products have been created that jeopardize homeownership, the general financial stability of families and the health of neighborhoods. Predatory and abusive lending practices undermine the work of Inglewood Neighborhood Housing Services and its peer groups under the National NeighborWorks® Association. All members of NNA strive to combat predatory lending practices through the most effective instrument available – **EDUCATION.**

Financial literacy and pre- and post-purchase mortgage counseling have enormous positive impact in safeguarding those we serve against loan products that ultimately place them into a fragile economic position. The NeighborWorks® Campaign for HomeOwnership boasts default rates better than FHA and VA, and comparable with conventional lenders among homebuyers assisted, yet our achievements will become increasingly ineffective without strong anti-predatory legislation.

NNA members cannot possibly educate all unsophisticated and unaware homebuyers and homeowners. Most of those we serve do not hold the financial expertise and steadfast persistence required to understand the complexities of the mortgage loans being offered by lenders. Their journey is made even more difficult by designing lenders who prey on their inexperience and lack of financial knowledge. It is for this reason that a national anti-predatory law is necessary.

I would like to present some brief stories from our members across the country that describe the detrimental effects of predatory lending practices and their lasting impact. I relate these stories – stories you have no doubt heard several times over – to emphasize how the establishment of a strong national standard would serve to avert future stories of economic misfortunes from ever being told.

One of our groups in Mayville, NY, **Chaulauqua Home Rehabilitation and Improvement Corporation (CHRIC)**, details several of the most commonly used predatory lending practices still in practice today:

> John Thomas is a disabled, 43-year old African-American who received approximately $60,000 from insurance and Social Security benefits following the death of his wife and mother of his three children. He moved his family back to Dunkirk, NY, the place of his birth and a support network of family and friends. Mr. Thomas found a conventional mortgage with NorthWest Mortgage at a rate of 10.5 percent in December of 1997. He made a down payment of $28,000 on a $41,000 house. He invested another $16,000 in home improvements, painting, and furnishing his home for his children.
>
> Mr. Thomas began a methodical effort to repair hazards and the home's electrical and plumbing systems. Lacking confidence that he could borrow from any bank (his personal bank had previously denied him a mortgage) Mr. Thomas called Household Finance through a flyer sent to him with a 1-800 number.
>
> Household Finance told him they would make the loan, but wanted him to re-finance first. They told him they could refinance his home and give him a separate loan for home improvements. Mr. Thomas was aware there would be some cost, but did not know how much.
>
> Household Finance re-financed the NorthWest mortgage at 11.99 percent in January 2000, explaining to Mr. Thomas that his interest rate would go down after two years. His 15-year term Northwest Mortgage with a monthly payment of $356 went to a 15-year term Household Finance mortgage with a monthly payment of $654. The second home equity loan carried an interest rate of 23.9 percent and a monthly payment of $272.

In May of 2001, Mr. Thomas made a payment of $641 on a principal balance of $58,970. After the payment was credited, his principal balance was still $58,970. All of the payment was applied to interest and "other charges". As CHRIC interviewed Mr. Thomas and reviewed his loan papers, the disclosure notices indicate that this mortgage was set up with a 15-year balloon payment. CHRIC had to explain to Mr. Thomas that fifteen years from the date of his loan he will be required to fully repay the balance or re-finance the unpaid balance with another mortgage.

Mr. Thomas feels like he has been duped. He has gone from a positive equity position to a negative one in a very short time. He blames himself in part, taking responsibility for making poor decisions. Yet he also feels that he was misled, deceived in part by lack of full disclosure, and encouraged to make bad decisions by persons with a financial self-interest.

Our group in Chicago, **NHS of Chicago,** has been at the forefront of creating strong Illinois state anti-predatory lending laws. The recently enacted state law has prevented future predatory practices like the one described below, from proliferating in the state of Illinois.

CS, a 70-year-old widow, has lived in her home in Chicago's Austin community for over 25 years. Her monthly income is $1,250 (Social Security and pension). From 1993 to 1998, CS obtained three separate loans from sub-prime lenders in order to make repairs to her home. By July 1998, her mortgage payments had increased to **$784.00** a month with a total mortgage debt of $68,000, but she was current on her payments. In July 1998, in an attempt to borrow $4,000 to repair her front steps, she responded to a mortgage broker's solicitation stating that loans were available in amounts up to 125 percent without need for income verification.

The mortgage broker told CS that she would need to borrow more than $4,000 to "make the loan worthwhile" and originated a $93,500 loan at a 12.5 percent rate, increasing her monthly P & I payment to $890.43, and depleting her equity by $25,000. In this transaction, the broker received a fee of $8,925 (9.6 percent of loan amount). There was an additional $1,500 in fees paid to the lender. All of these were included in the financing. With tax and insurance costs, CS' housing expense was now **$1,035** monthly.

Two stories from our group in Aberdeen, WA, **Aberdeen NeighborWorks® of Grays Harbor County** show that age, whether young or old, cannot prevent the unqualified from making poor decisions.

Two couples in their 70's and 80's who believed they were securing a reverse equity mortgage were given forward mortgages by Wells Fargo with payments that exceeded their repayment ability. They both ultimately lost their homes due to their inability to meet the high mortgage payments and were forced to leave their homes after 30 and 40 years. The information on both cases was sent to the Washington State Attorney General's office who is currently investigating the lender. Another couple with the same scenario but different lender was assisted in locating alternative housing after also not being able to maintain monthly payments on a mortgage refinance.

A young first time home buying couple were days from committing to mortgage loans with predatory terms. The lender would create two loans (80/20), one with an ARM and a balloon payment in five years and the other with an extremely high interest rate. The combined monthly payments were a substantial portion of the couple's monthly income resulting in ratios outside customary, acceptable levels. We calculated and determined the young couple would have lost the house within six months as a result of inability to maintain the payments.

In Los Angeles County, our member-group, **Neighborhood Partnership Housing Services (NPHS)**, nicely illustrates the uninformed borrower.

A homeowner came to NPHS to seek assistance on refinancing his second trust deed. The lender was carrying the paper and was charging 29 percent interest. The borrower felt the rate was high, but thought since it was a private loan, a higher interest rate was customary. NPHS assisted the borrower using a partner financial institution and completely refinanced for a reduced rate and better terms.

Members of the Committees - I cannot impress enough - predatory lending firms like Household Finance, Wells Fargo and others fully understand their predatory practices and the extremely high margins they obtain from exploiting the inexperienced homeowner or homebuyer. They have found a market niche to earn considerable profits. This niche, however, is clearly directed at exploiting the uninformed, unaware and in most cases, minority neighborhoods . How ever these firms may wish to defend their practices, any poor, elderly black man from Mayville, NY or young couple from Aberdeen, WA can quickly rebuff and tell you of the extraordinary deleterious effects of predatory lending.

Similar stories can be told by NeighborWorks® organizations across the country and in each of the districts you serve. In states and localities without strong anti-predatory lending, the result is clear: economic ruin for families. A strong federal law would substantially prompt abusive lenders to rethinking their business plans. The above anecdotal stories could have been avoided had there been a strong national law eliminating predatory lending practices. As various studies have shown, elimination of predatory lending does not entail an elimination of profitable subprime lending. A strong national law simply levels the playing field.

NNA does not ask that you enact burdensome legislation that extinguishes firms' profitable niches. Nor do we condone the argument of ignorance. We simply advise you to construct thoughtful and articulate legislation that serves a practical purpose – helping individuals purchase or refinance a home using clear and fair lending products and services that are more easily understood by the consumer. Congress must balance the benefits of economic enterprise with the obvious costs associated with that pursuit. For example, the Center for Responsible Lending estimates that abusive home mortgage lending practices cost homeowners $9.1 billion each year. During a session where members decry the potential loss of $4 billion-plus of the CDBG program, this $9.1 billion is worth your legislative attention. NNA urges Congress to enact legislation with provisions aligned with the recommendations set forth in this written testimony.

NNA and INHS vigorously support a national anti-predatory lending law that employs provisions similar to those found in current state laws, most notably, the state of North Carolina. Our membership supports a national law that serves as a floor, allowing states with more legislative safeguards to be excused from preemption by federal law. A more detailed synopsis of the provisions we recommend is included below.

On par with NNA's goal to educate homebuyers and homeowners, NNA suggests that any federal law enacted be sensitive to these critical areas: education and disclosure, transparency, reasonableness and fairness. NNA strongly encourages these legislative committees to err on the side of the consumer - as academic evidence and anecdotal hearsay illustrate, the consumer is the party left worse off.

Take away a predatory lender's ability to hide fees and subtle provisions and you promote an efficient and fair lending process. This levels the playing field for homebuyers who cannot understand all the complex aspects of the agreement to which he/she enters. It is reasonable for firms like Ameriquest and Countrywide to hedge the risk of borrowing to an individual with poor credit by pricing their loan accordingly. This does not, and should not, sanction the use of unreasonably high fees or penalties, deceptive lending practices, or exploitation of an interested, but unqualified borrower.

I encourage these committees to review my following recommendations and observations when debating the merits of a national anti-predatory lending bill.

- ☐ **Federal Floor**: States must continue to enact their own legislation based on the prevalence of predatory lending in their region – the niche described above is more easily exploitable in some markets. Therefore, in areas of substantial predatory lending practices (e.g. North Carolina pre-1999), more stringent state laws are necessary. A federal standard, especially a weak law, will do little in a predatory practice-heavy state whose laws have become pre-empted and therefore meaningless. States like North Carolina, Illinois, New Jersey and New Mexico have laws that have been proven effective. Eliminating these effective and fair laws by a preemptive federal law is as unwise as it is costly.

- ☐ **Full Disclosure and Education**: The homebuyer must be aware of how fees are accounted for in the loan, and at what price. The abusive and misleading practice of financing fees into the loan amount is essentially duping the homebuyer into an agreement no knowledgeable person would ever enter. As your colleagues in the Senate so judiciously acted to require full-disclosure of publicly-traded firms, so must be required of subprime lenders to borrowers. The lender must make efforts to determine the borrower's repayment ability. This entails information gathering and processing. Complete information is not only more economically efficient, it is also morally fair. It is unreasonable to apply the fallacious argument of "you should have known" to an eighty-year-old grandmother who repeatedly re-finances her mortgage (and incurs more fees) because she did not know any better.

- ☐ **Excessive Fees and Penalties:** There must be an economically-justified limit on penalties and fees. The law must appropriately balance the risk a lender assumes when financing an individual with poor credit with the fees charged to that individual. An individual must not be financially penalized *ex ante* for bad credit history and must certainly not be penalized, but rather encouraged, to pay on their mortgage in a timely fashion. For an individual to incur a prepayment fee as a "reward" for improving his/her credit is unacceptable. Fees must reasonably match the credit risk – nothing less is fair or prudent.

Thank you for the opportunity to share my thoughts and on behalf of NNA and INHS I thank you for your leadership in addressing this critical issue on a national level. If I can be of any service, please do not hesitate to contact me, or the Director of NNA, David C. Brown, dbrown@nnwa.us.

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Statement of Micah S. Green
President, The Bond Market Association

Testimony before
U.S. House of Representatives
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit

Hearing on Legislative Solutions to Abusive Mortgage Lending Practices
May 24, 2005

I would like to thank Chairman Ney and Chairman Bachus for the opportunity to testify today at this important hearing on predatory lending. I am Micah S. Green, president of The Bond Market Association, which represents securities firms and banks that underwrite and trade fixed-income securities both domestically and internationally. I am also representing today the views of the American Securitization Forum (ASF), an adjunct forum of The Bond Market Association, which is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, ASF members act as investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers and professional advisors working on transactions involving securitizations of residential mortgages and other types of financial assets.

The secondary market for mortgage debt—the segment of the financial industry that purchases and repackages loans as mortgage-backed securities or MBS—witnessed tremendous growth over the past decade. At present, there are about $5.6 trillion in mortgage-related bonds outstanding, or nearly a quarter of all fixed-income securities. Such significant participation by the capital markets in the mortgage lending business benefits consumers in the form of lower interest rates and more widely available credit. No doubt there are thousands, if not millions, of families who were able to find mortgage financing and purchase a home on more affordable terms because of the secondary market. The growth in the secondary mortgage market overall has led to a much greater availability of credit for subprime borrowers, or home-buying families who, because of credit problems, traditionally have had less access to the mortgage market.

As the volume of subprime loans has grown, however, demonstrated cases in which lenders followed abusive practices have surfaced. There is no question that abusive loan terms and lending practices—commonly known as "predatory lending"—are bad and should be stopped. The Bond Market Association and the American Securitization Forum acknowledge this reality and the role the secondary market can play in addressing this problem. We have worked with lawmakers and regulators at the state and local level as well as Congress and other federal policymakers for the past five years to promote sensible anti-predatory lending policies.

Thanks to the determined efforts of Chairman Ney and Rep. Kanjorski, we now have legislation, the Responsible Lending Act (H.R. 1295), that addresses the problem of predatory lending in a balanced way. Chairman Ney and Rep. Kanjorski have taken special care to reach out to all stakeholders in the debate over predatory lending. As a result, they have crafted an informed and effective bill which we support.

The Responsible Lending Act deals with the problems that arise from dozens of sometimes vague and conflicting state and local laws by creating a uniform national standard for the terms under which high-cost loans are made. Critically important, these terms are objective and measurable. Under this legislation, borrowers facing foreclosure could bring defensive claims against loan assignees under certain circumstances. Assignees could also be the subject of affirmative claims, or those brought outside of the context of defending against a specific foreclosure claim, unless they could prove that a reasonable level of loan review would not have revealed the lending violation in question. By observing an objective standard for loan review that could reasonably be expected to screen loans with potential predatory lending problems, secondary market participants can avoid potential liability. The Responsible Lending Act also provides loan purchasers with a "right to cure", or the opportunity to amend a loan and compensate the borrower when they identify loans made in violation of the terms set out in the bill. All claims would be limited to actual damages unless a borrower can prove reckless indifference on the part of the assignee.

The Need for Federal Pre-emption

Federal regulators' primary weapon against predatory lending is a 1994 amendment to the Truth in Lending Act that became known as HOEPA, for the Home Ownership and Equity Protection Act. The law created the concept of a high-cost loan as one with an annual percentage rate or fees that exceed a specified threshold. The Federal Reserve Board (Fed) has the authority to adjust the benchmarks. The Fed also promulgates the regulations to implement the law.

Certain features of loans designated as high-cost by HOEPA are restricted. These include prepayment penalties and negative amortization, among others. HOEPA also advanced the idea of assignee liability, or the notion that purchasers of mortgage loans could be held liable for the actions of mortgage originators. As discussed in the next section, HOEPA subjects loan purchasers to the claims and defenses a borrower could bring against the originating lender. The law initially only applied to about 5 percent of the subprime mortgage market. Following a Federal Reserve Board decision to lower the threshold interest rates in 2001, HOEPA's reach has grown but still only extends to a limited market segment. Because of its relatively limited applicability, HOEPA has not proven to have significantly limited the availability of subprime mortgage loans.

In recent years, however, several states and localities have built on HOEPA's general approach with new anti-predatory lending laws to the point that much more of the subprime market is now affected. Loans are categorized as high-cost—some laws refer to such loans as "covered"—if the annual percentage rate or fees associated with the loans exceed a given threshold. At least 47 varying state and local laws regulate subprime lenders in addition to HOEPA.

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It is not only the terms of the different state and local laws, but also the volume of varying and often conflicting standards that impose unreasonable burdens on the secondary market. Maintaining the expertise needed to comply with varied statutes in an array of jurisdictions adds unnecessary levels of complexity cost and risk to the subprime securitization process. Several provisions in the different state and local laws require careful legal judgments that cost time and money. Every legal question also carries with it an added element of risk. More importantly, whether a given loan may be regarded as "predatory" under various state and local laws often requires subjective judgments and knowledge of facts that are beyond the reach of secondary market purchasers and assignees. In these circumstances, no amount of loan review or investigation performed by secondary market purchasers can determine the presence or absence of lending violations, thus presenting economic, reputational and other risks that cannot be managed. The choice presented in these cases is either to accept unmanageable risks or to avoid acquisition of covered loans altogether. Not surprisingly, many potential secondary market purchasers have been forced as a matter of business necessity to choose the latter option, thus depriving the mortgage origination market of new capital and limiting the availability of mortgage loans to families with subprime credit.

Ultimately, any increase in cost, risk and complexity in secondary market operations leads to higher costs for borrowers. Loan purchasers will demand higher yielding loans—if they choose to purchase high-cost loans at all—when faced with the uncertain legal environment that exists today with the patchwork of state and local anti-predatory lending laws. Loan originators, in turn, will simply charge borrowers higher rates and fees—if they continue to originate high-cost loans at all.

By preempting state and local laws and replacing them with a uniform and balanced standard, the Responsible Lending Act eliminates the conflicts and inefficiencies that result from the varying state and local anti-predatory lending standards. Besides lowering the cost of credit, securitization has expanded its availability and helped develop a truly national mortgage market. It follows that a national legal standard should govern this market, which the Responsible Lending Act achieves.

Assignee Liability

Developing an effective assignee liability standard—one that punishes bad actors without exposing innocent loan purchasers to a level of unmanageable risk that drives them from the market—is also hampered by the patchwork of state and locals laws. The different state and local laws sometimes use subjective triggers to assign liability to the loan purchasers.

Currently, civil actions brought against lenders for infractions of HOEPA may also be brought against an assignee of the lender if the violation is "apparent on the face of the loan document."[1] An assignee or the purchaser of a mortgage will not be subject to the claims and defenses of the borrower if a "reasonable person exercising ordinary due diligence, could not determine" the mortgage was a high-cost loan under HOEPA.[2] Unfortunately, neither this standard nor subsequent court decisions have effectively settled the question of what "apparent on the face" means in practice. Recent state laws have compounded this problem by creating still more standards for assignee liability.

It is important to note the presence of loans originated using predatory practices in the pools of loans backing mortgage securities is not in anyone's best interest. Not only do predatory lenders target individuals with risky credit profiles, but the terms of predatory loans often promote default. The more defaults experienced by the pool backing an MBS issue, the less attractive the security becomes to investors who ultimately bear this risk. In order to maintain investor support and capital market liquidity to fund continuing operations, securitizers of mortgages—which include mortgage originators as well as financial institutions that purchase and package mortgage loans in the secondary market—have a clear incentive to eliminate from pools any loans they can identify that violate applicable predatory lending laws. In order to do this efficiently, however, the lending standards must be clear and objective, and this is not always the case.

The different state and local laws sometimes use subjective triggers to assign liability to the loan purchasers. An Illinois state law, for example, makes the purchaser of a loan liable if the loan originator was found to have used "deceptive practices"—a pattern of behavior that cannot be detected in a review of a standard loan file. Laws such as this create legal circumstances inconsistent with the notion of fundamental fairness. A loan purchaser should not face liability for lender actions in which it did not participate, cannot observe, and that cannot be detected in a review of the loan file.

A New York City law that was struck down by the courts would have required an arbitrary level of due diligence on loan pools in order to escape liability for subprime lending violations. Complying with the level of due diligence set by this statute would significantly raise the cost of purchasing covered mortgages, which would increase borrower costs. In many cases, the screening prescribed by the New York City law would have been impossible. Assignees cannot know whether or not certain subjective loan origination standards were met. The purchaser does not have unique insight into what type of loan or specific loan features are suitable for that borrower. Assignee liability under such circumstances is unreasonable. Assignees would have neither the

[1] 15 U.S.C. 1641(a)
[2] 15 U.S.C. 1641(d) 1

opportunity to identify violations in advance of purchasing the loans, nor the ability to mitigate legal exposure once they do identify violations.

Using anything but a single set of objective and readily detectable standards to determine whether an assignee has liability is a regulatory approach that threatens to undermine many of the benefits of the secondary market. Faced with this type of environment, secondary market participants may find it less attractive to purchase and repackage subprime loans.

The Responsible Lending Act sets out a definition of "higher cost" loans. The bill then goes on to define in clear language the terms and restrictions placed on such loans. As a result of these clear and objective standards, assignees employing the normal practice of loan review can have confidence they will be able to effectively screen for loans containing lending violations.

H.R. 1295 properly restricts the claims that can be brought against assignees to those available under HOEPA as amended by the bill. To do otherwise would be impractical. Assignees can effectively screen pools of loans for compliance with a known set of standards, such as the loan terms in the Responsible Lending Act. Exposing assignees to every conceivable law that could give rise to a claim, however, is not practical.

The Responsible Lending Act describes two types of claims: defensive and affirmative. A borrower's right to bring such claims is based on certain factors not present in current law. The right to bring a defensive claim against an assignee is limited in the first instance to situations where the default is reasonably related to a violation of the lending terms prescribed by H.R. 1295. The point of this provision is to protect against loans with predatory lending violations that cause harm. If there is no connection between a borrower's default and the originating lender's violation of the anti-predatory lending laws, the balance of legitimate interests weighs in favor of the innocent assignee who, pursuant to existing legal doctrine, must have acted in good faith and without actual knowledge of a lending violation. If such a nexus exists, however, the balance of interest weighs in favor of protecting the borrower. The important exception to this rule is the case where the assignee is not innocent. H.R. 1295 provides that a borrower may bring a defensive claim against an assignee that had actual knowledge of the originator's violation or displayed a "reckless indifference" to a violation of the lending terms of H.R. 1295. This provision recognizes that despite a well-structured law, bad actors will always exist and should be held accountable.

Affirmative claims—those outside of the context of an enforcement of loan terms that are reasonably related to a borrower's default—can be brought in the case when an assignee cannot demonstrate that a reasonable level of loan review could not have detected the loan violation. In addition, the legislation provides a safe harbor from liability for assignees who meet clearly articulated criteria. This mechanism serves to benefit both assignees—by clarifying the instances in which they face liability—and borrowers—by screening bad loans from the secondary market. The safe harbor is contingent upon the existence of policies that prohibit higher cost mortgages that contain lending violations, a contract with loan sellers stating they would not sell loans that contain violations and employ "reasonable due diligence" to prevent the purchase of loans with violations. Consistent with longstanding industry custom and practice, reasonable due diligence could be achieved by reviewing a statistically significant sample of loans and not necessarily reviewing 100 percent of loans.

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Reasonable Damages and a Right to Cure

As noted above, the goal of the Responsible Lending Act is to protect borrowers against harm caused by predatory lending practices. This does not mean predatory lending victims are due an economic windfall. As with most laws, H.R. 1295 would protect the borrower against harm caused by a legal violation. What is eliminated under the Responsible Lending Act is the right to receive statutory damages from an innocent assignee. The borrower does not lose any right to bring a lawsuit against the lender that violates the law and can be made whole by an assignee under the appropriate circumstances.

Statutory damages, like punitive damages, are not compensatory in nature. They are designed to deter bad conduct by creating an economic disincentive to engage in illegal conduct. The Responsible Lending Act appropriately applies this policy with consideration for loan purchasers that did not know of or participate in lender violations by imposing liability for actual damages only. Exposing innocent assignees to liability for damages in addition to actual economic loss is more likely to discourage the purchase of higher-cost loans altogether, not just loans with lending violations.

To take an example, consider a borrower who incurs a debt of $100,000, the proceeds of which are used to pay off a below-market rate affordable housing loan of $75,000, a tax lien on the property of $5,000, a credit card debt of $12,000, and closing costs of $8,000. Even if the loan violates anti-predatory lending laws, the borrower did gain the ability to discharge various forms of debt. If a consumer receives a $100,000 loan, the original principal balance is still worth $100,000. Even if the upfront cost to acquire the debt or the interest rate on the debt is excessive, the value of the original principal amount of the debt does not change. Barring reckless indifference on the part of the assignee, the harm to the consumer could be mitigated by amending the relevant loan terms and providing compensation for actual economic loss. Awarding damages that exceed actual harm to the consumer would effectively extinguish some or all of the underlying principal balance. This would not be appropriate considering the borrower has already derived benefit from the transaction.

Nevertheless, HOEPA has built-in punitive damages or penalties, disguised as statutory damages, entitling a consumer to the amount of finance charges paid by the consumer. It compels a judge to award the enumerated damages irrespective of actual loss or actual harm by or to the consumer and without regard to a lender's intent to violate the law or its good faith efforts to comply with a state's subjective prohibitions. The result of this pyramiding of penalties under the pretext of statutory damages can be the effective extinguishment of the debt, but not an extinguishment of the real economic benefits received by the borrower. By limiting damages, except in the instance where a borrower can prove reckless indifference on the part of the assignee, H.R. 1295 responsibly limits damages to actual economic losses.

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The Responsible Lending Act would also permit an assignee to correct an error within 60 days of discovery. One way to cure would be to amend the loan to delete the offending terms. Given that the objective of H.R. 1295 is to protect the borrower against abusive loan terms, this makes sense. It also saves the borrower the cost of a legal claim. Reducing the interest rate or simply refunding excessive points and fees on a loan so the loan falls below the triggering point for higher cost, restores the borrower to the same economic position they would have held absent a violation. If one purpose of the assignee liability provisions is to reduce the number of loans with lending violations, then a reasonable way to accomplish that objective is to permit assignees to cure the violations to compensate borrowers for actual harm incurred. Once again, the public policy question is whether the law should be designed to protect the borrower against harm, not to penalize an innocent assignee which by definition did nothing wrong other than unknowingly buy a loan that violated applicable law.

Conclusion

By pre-empting varied state and local laws with a common-sense federal statute, the Responsible Lending Act promises to help preserve the benefits of securitization for subprime mortgage borrowers. Securitization has effectively nationalized the mortgage market assuring that credit is available to homebuyers regardless of where they live. The patchwork collection of standards confronting loan purchasers from dozens of state and local anti-predatory lending laws threatens the ability of subprime borrowers to realize the full benefit of the modern mortgage markets.

The Responsible Lending Act seeks to protect borrowers by providing for reasonable assignee liability when a foreclosure or other problems can be linked to what is considered an abusive lending term. In the case where an assignee shows reckless indifference for lending violations or fails to comply with a regulatory safe harbor, the borrower can bring a claim regardless of whether they face foreclosure. Because the goal of the Responsible Lending Act is to protect borrowers, not to provide them with an economic windfall, damages that can be awarded in relation to such claims are generally limited to actual economic loss.

The Bond Market Association and the American Securitization Forum have been pleased to work with Chairman Ney and Rep. Kanjorski on this important legislation and our members look forward to continuing the dialogue as H.R. 1295 advances in the legislative process.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

THE BOND MARKET ASSOCIATION

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:

Micah Green

2. Organization or organizations you are representing:

The Bond Market Association

3. Business Address and telephone number:

1399 New York Avenue, NW
Suite 800
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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

[redacted]

Please attach a copy of this form to your written testimony.

Micah S. Green
President
The Bond Market Association

Micah S. Green became President of The Bond Market Association (formerly the Public Securities Association) on May 1, 2001. Mr. Green has overall responsibility for the management and activities of the organization, reporting to the Executive Committee and the Board of Directors.

The Bond Market Association is the trade association, representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. The Association's approximately 220 member firms collectively account for about 95% of the nation's municipal securities underwriting and trading activity and include all primary dealers and other key participants in the U.S. government and Federal agency securities market, and all major dealers in municipal and corporate debt securities, mortgage securities and money market instruments. One of the Association's most important roles is as an advocate and spokesman for the industry, representing its members in Washington, D.C., New York, London, and Tokyo, as well as with issuer and investor groups throughout the United States. The Bond Market Association has offices in New York, Washington and London. One of the other roles played by The Bond Market Association is establishing market practices among market participants. In that regard, the Association, and Mr. Green, played a very active role immediately following the tragedy of 9-11 to bring together market participants throughout the world to determine the capability of the bond markets to reopen in an orderly manner. This was placed on a very high priority by government officials as the open markets and a free flow of capital is now viewed as crucial during such times of crisis.

Prior to his appointment as President, Mr. Green was Chief Operating Officer of The Bond Market Association. In that capacity, he directed the day to day operations of the Association staff and was responsible for the management of both the New York and Washington offices of the Association. For over ten years, Mr. Green was Executive Vice President and head of The Bond Market Association's Washington office. He remains deeply engaged in legislative advocacy in the Congress and with the Administration. As one of the principal spokespersons for the bond markets in Washington, Mr. Green testifies before congressional committees, appears in the financial press and makes numerous public speeches to The Association's members and other interested groups.

Mr. Green joined The Bond Market Association in 1987, after serving as Tax Legislative Counsel for MCI Communications Corporation in Washington. Before joining MCI in 1985, he was the Staff Director and General Counsel for the House Subcommittee on Human Resources of the Committee on Post Office and Civil Service from February, 1983 to February, 1985.

From 1981 to 1983, Mr. Green was the Assistant Director, Legislative Liaison with the National Association of Realtors. He also served as Legislative Assistant for former Congressmen Don Albosta (D-MI) and Ronald Sarasin (R-CT).

Mr. Green received both his J.D. degree and B.B.A. degree from George Washington University. He is a member of the Maryland Bar. Mr. Green also served as Chancellor of the Exchequer Club, an organization in Washington, D.C. composed of representatives of financial organizations, including associations and companies in the banking, securities and insurance industries. He serves on the Board of Directors of The Bond Market Foundation. Mr. Green also recently served as the President of Congregation B'nai Tzedek in Potomac, Maryland, and is currently Chairman of its Board of Trustees. Mr. Green also serves on the Executive Committee of the National Jewish Democratic Council. He and his family live in Potomac, Maryland.

Testimony presented on behalf of the

Appraisal Institute
American Society of Appraisers
American Society of Farm Managers and Rural Appraisers

Before the House Committee on Financial Services
Subcommittee on Housing and Community Opportunity
and the
Subcommittee on Financial Institutions and Consumer Credit

On

"Legislative Solutions to Abusive Mortgage Lending Practices"

Presented by
Alan E. Hummel, SRA
Chair, Government Relations Committee, Appraisal Institute
Chief Executive Officer, Iowa Residential Appraisal Company
West Des Moines, Iowa

May 24, 2005

Joint Testimony Presented by
Alan E. Hummel, SRA
On Behalf of the
Appraisal Institute
American Society of Appraisers
American Society of Farm Managers and Rural Appraisers
Before the
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives

Chairmen Ney and Bachus, Ranking Members Waters and Sanders and members of the Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit, I am Alan E. Hummel, SRA, President and Chief Executive Officer of the Iowa Residential Appraisal Company in West Des Moines, Iowa. I am the Chair of the Appraisal Institute's national Government Relations Committee and Past President of the Appraisal Institute. I am pleased to be here today on behalf of the Appraisal Institute, American Society of Appraisers, and the American Society of Farm Managers and Rural Appraisers, three of the largest professional appraisal organizations in the United States, representing more than 25,000 real estate appraisers.

Thank you for the opportunity to testify before this joint subcommittee hearing on legislative solutions to abusive mortgage lending practices. There are two bills currently before this committee that answer many of the questions posed by the issue of mortgage fraud, The Responsible Lending Act, H.R. 1295, co-authored by Representatives Ney and Kanjorski and The Prohibit Predatory Lending Act, H.R. 1182, co-authored by Representatives Miller, Watt and Frank. We appreciate the work both bill sponsors and cosponsors because mortgage fraud is an issue that deserves the attention of Congress. It is also an issue that requires a holistic solution, as it involves all aspects of the real estate industry, including real estate appraisal. At this point, only H.R. 1295, specifically addresses appraiser and appraisal-related concerns by modifying Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the law enacted by Congress in 1989 which created the current appraiser regulatory structure. We support these provisions, and we urge they be enacted.

Real estate generates nearly a third, or $2.9 trillion, of the U.S. GDP. It creates jobs for over 9 million Americans. The appraiser is a vital independent service provider in mortgage transactions and their fee is not contingent upon whether the loan goes through or on the loan amount. Accordingly, through this independence, competent and qualified real estate appraisers are a crucial safeguard to this portion of our economy. A professional appraiser's objectivity, experience and ethics are fundamental in ensuring that participants in residential and commercial real estate mortgage transactions know the value of the real estate involved and understand the risks inherent in collateral lending. It is of paramount importance that an appraiser be properly qualified, adequately trained and have sufficient experience in the type of property under consideration.

Unfortunately, mortgage fraud exists, and in many of our communities it is rampant. The Federal Bureau of Investigation recently testified before this committee warning that "mortgage fraud is pervasive and growing."[1] When mortgage fraud occurs, financial institutions often recover only a portion of a fraudulent loan and can be saddled with additional costs, such as brokers' commissions and attorneys' fees. Loan fraud also threatens our nation's communities, leaving individuals with overvalued properties and burdensome loans. Artificially inflated sales can cause property taxes to rise while true property values decrease due to foreclosures, abandoned houses and uncared-for properties.

We are not happy to report that mortgage fraud can be perpetrated because of faulty appraisals, either because they were performed incompetently or, worse, fraudulently. For these reasons, we believe that any legislation addressing abusive mortgage lending practices must include reforms for the appraiser regulatory structure. Specifically, we believe appraiser-related mortgage fraud continues largely because of the following reasons:

- Unscrupulous third parties are allowed to pressure appraisers to meet predetermined values;
- Appraiser regulators provide inadequate oversight over licensed appraisers;
- Very little attention is paid to mitigating appraisal problems through improving appraisal quality.

Proposals addressing these issues are included in H.R. 1295, specifically in Title IV. I am happy to provide further explanation of our position below.

Inappropriate Pressure of Appraisers

As an important impartial third party in a residential transaction, real estate appraisers play a critical role in helping both lenders and consumers make sound investment decisions when purchasing homes and mortgages. An unbiased appraisal is important to the lender because it helps determine the loan-to-value (LTV) ratio, and is typically a part of a bank's risk management program. As with any investment, consumers typically should not pay (or borrow) more than the investment is worth, and the appraisal helps them determine the market value of this investment. It is in their best interest not to take out a mortgage that will cost more than a home is worth, as this is typically the largest investment they will ever make. Such a situation would place them "upside down" on their mortgage, meaning they owe more than the market value of the property, leaving them in a precarious situation.

Because artificially inflated appraisals may be used as comparable sales in future transactions, they have the potential to hurt not only the parties in the transaction but eventually the entire community. Despite

[1] Statement of Chris Swecker, Assistant Director, Criminal Investigative Division, Federal Bureau of Investigation, before the House Financial Services Subcommittee on Housing and Community Opportunity, October 7, 2004.

this, it is common for mortgage brokers, lenders, realty agents and others with a vested interest to seek out inflated appraisals to facilitate transactions because it pays them to do so. Lenders typically do not loan 100 percent of the market value of a home but more often at a certain percentage (80 percent, for example). The LTV ratio determines how much a lender is willing to lend on a particular property, and the "value" component of the LTV is determined by the appraisal. It is common for negotiated contract prices to be greater than the market value of a property, particularly in an appreciating market, as we have seen in many areas of the country recently. It is also common for the LTV ratio to be higher than the lender's limit, meaning that the homebuyer and seller might have to renegotiate a contract price or face that contract being null and void. If the contact is voided, the broker and loan officer and others whose compensation is dependent upon the closing of the loan do not get paid.

Should the appraiser artificially increase the value of a home, the result may decrease the LTV to the point of allowing a lender to (artificially) feel more comfortable about making a loan and all compensation to be paid to the vested parties. It is at this point where many brokers, lenders and others turn the screws on appraisers. Brokers might ask an appraiser if a certain comparable sale was used in their appraisal report, or a loan officer might ask if the appraiser applied a proper adjustment. While there are legitimate questions to ask of appraisers, a line is crossed when a predetermined value is required of an appraiser or when future work for the appraiser is contingent upon this value being met, and coercion, threats and intimidation are used as a means to an end.

Appraisers will frequently explain to lenders that national appraisal practice standards and state and federal laws require appraisers to perform assignments ethically and competently and that they are open to discuss and resolve any concerns or issues.[2] If the appraiser is acting ethically, they should be reporting an opinion of the market value of the property, not whatever value is needed to close the loan. Too frequently, this dialogue spirals downward to involve coercive tactics and intimidation, amounting more or less to a threat that if the predetermined value is not met, future work will not be forthcoming. Some have gone so far as to threaten that the appraiser's reputation will be damaged with other financial institutions ordering appraisals.

Such practices are unacceptable in our view, yet they occur all too common. A recent survey of appraisers by an independent research organization showed that 55 percent of appraisers have felt pressure to overstate an appraisal, with a quarter of those saying it happens nearly half of the time[3]. This corresponds with anecdotal surveys taken by our organizations of our respective memberships.

Unfortunately, it is also true that some unethical appraisers give into this pressure out of fear of losing a client and a steady stream of income. We believe appraisers who give into such pressures should be disciplined by the appropriate regulatory authority (state appraisal board, federal financial institution regulator, etc). We also believe that it should be made clear that such practices by clients are inappropriate and strictly prohibited. H.R. 1295 does this by strictly prohibiting coercion of appraisers by interested third parties, making it clear that appraisers are to remain objective third parties in a

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[2] The Uniform Standards of Professional Appraisal Practice (USPAP) states: "An appraiser must not accept an assignment that includes the reporting of predetermined opinions and conclusions. An appraiser must not communicate assignment results in a misleading or fraudulent manner. An appraiser must not use or communicate a misleading or fraudulent report or knowingly permit an employee or other person to communicate a misleading or fraudulent report."

[3] National Appraisal Survey, October Research Corporation, December 2003. www.octoberresearch.com/ai_survey.

transaction.

We read the Appraiser Independence provision of H.R. 1295 to authorize and empower the federal financial institution regulators to issue a regulation prohibiting various inappropriate practices against real estate appraisers. The new regulations would make clear that coercion, extortion, bribery and collusion (currently not addressed in the bill) by individuals pursuant to their appraisal duties is strictly prohibited. It would also define the specific sanctions against banks and other individuals involved with inappropriate conduct. As a regulation, this would have the force of law, which is absent from all current guidelines and statements issued on this subject to date.

The entire real estate industry can be a part of the solution to this problem as well, and should be encouraged to develop and articulate a best practices statement relative to the engagement of appraisers. We stand committed to work with Congress and our industry partners to achieve this goal.

Oversight and Enforcement of Licensed Appraisers

Another area that deserves more scrutiny and attention is enforcement by federal and state appraiser regulators. One of the results of the savings and loan crisis of the late 1980s was the passage of FIRREA in 1989, and its Title XI established the current appraisal regulatory structure. While created with the best of intentions, the attempt to tie federal and state regulators and the private sector together to oversee appraisers in the U.S has left us, sixteen years later, with a configuration that is, without question, extremely convoluted. (See Attachment One for a graphic depiction.)

Title XI created the federal Appraisal Subcommittee to oversee the activities of the state appraisal boards and commissions. Yet, the only *real* power the Appraisal Subcommittee has over state appraisal boards is the authority to "decertify" a state if it is found to be out of conformance with Title XI. This specific power is called by some the "atomic hammer," because if it were invoked, virtually all mortgage lending in that state would cease. Because of its severity, the Appraisal Subcommittee has never used this power, and it is unlikely that it ever will. This is why we support the concept put forth in H.R. 1295 that would grant the Appraisal Subcommittee authority to develop intermediate sanctioning power of state appraisal boards through a public rulemaking process. Such powers include the ability to write rules and regulations, powers currently not granted to the Appraisal Subcommittee.

State Appraisal Board Funding

In addition, many state appraisal boards are having acute difficulties maintaining effective regulatory systems. According to the 2003 Annual Report of the Appraisal Subcommittee, 43 percent of the state appraisal regulatory agencies that were reviewed either failed to resolve complaints against real estate appraisers expeditiously or were inconsistent in applying disciplinary sanctions; failed to pursue all alleged violations of the Uniform Standards of Professional Appraisal Practice; or did not adequately document enforcement-related files. Time and again, most states relate that while they do their best to keep up with the demanding workload, they simply don't have the resources to perform effectively.

That lack of resources creates a system that allows some unscrupulous and unqualified appraisers to continue practicing and provides little or no recourse for their actions. Some of these appraisers have been linked to mortgage fraud schemes throughout the country. For example, within the last few years, a real estate appraiser in New York was found guilty and convicted of a felony for grossly inflating appraisals. His state license was revoked, and he served a jail sentence for one year. Upon his release, he challenged the state appellate court to have his license reinstated. The court overturned the ruling of license revocation, determining that he had served his time sufficiently and that he must return to becoming a "beneficial member of society." Amazingly, this fraudulent appraiser charged with participating in numerous land-scam schemes is now a practicing appraiser--sanctioned--in New York.

New York is not alone in handling such cases carelessly. In Maryland in June of 2003, an appraiser who pled guilty to appraisal fraud admitted that the government lost between $500,000 and $800,000 due to his actions. In the fall 2003, he applied to renew his license. On the online application, he answered "no" to whether or not he had ever been convicted of a felony. According to his attorney, he answered the question honestly because in the federal system, one is not convicted until sentenced, and the appraiser was not sentenced until February 2004. Thus the Maryland Commission of Real Estate Appraisers and Home Inspectors renewed his license last October for another three years. A spokesperson for the Maryland Commission said to the *Baltimore Sun*, "All we have to go by is the honesty of the licensee. We are not required to perform background checks; moreover, the financial and personnel resources are not available at this time."[4]

The Government Accountability Office recently conducted a lengthy investigation on the appraiser regulatory structure, and one of the findings in their report was that funding of state appraisal board activities was a major hindrance to enforcement[5]. A GAO survey of state appraisal boards reported resource limitations as the primary impediment in carrying out their oversight responsibilities. For example, of the 54 states and territories that responded to the survey, 26 (48 percent) reported that the current number of investigators was insufficient for meeting its regulatory responsibilities, 37 (69 percent) cited a need for increasing the staff directed at investigations, and 22 (41 percent) cited a need for more resources to support litigation.

According to this survey, the average state appraisal board had approximately three staff members who were responsible for overseeing almost 2,000 appraisers. Many of these state agencies reported that they needed to share resources—administrative staff, office space, investigators, or all three—with other state agencies in order to perform their Title XI duties. The majority of states sharing resources were sharing investigators, who often had no real estate appraisal experience. The survey results indicated that investigations of complaints about problem appraisers suffered most from these shortages. The GAO report recommended that the Appraisal Subcommittee explore potential options for funding or otherwise assisting states in carrying out their Title XI activities, particularly the investigation of complaints against appraisers. We are not currently aware of the status of this directive.

Presently, the Appraisal Subcommittee's operations are funded exclusively by individual state certified and licensed appraisers through license fees collected by states appraisal boards. Individual appraisers

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[4] John B. O'Donnell, "Real Estate Appraiser Faces Sentencing Pleading Guilty," *Baltimore Sun*, February 27, 2004.

[5] "Opportunities to Enhance Oversight of the Real Estate Appraisal Industry," Government Accountability Office, May, 2003.

are assessed a $25 annual fee passed through to the Appraisal Subcommittee, which has resulted in a sizable reserve fund that exists with no identified purpose. The Appraisal Subcommittee told the GAO that it did not believe it had the legal authority to use these funds for grants to state appraisal boards. We see a few options available to Congress in this area:

1. Granting the Appraisal Subcommittee the authority to establish and manage a grant program to state appraisal boards for the purpose of conducting enforcement activities;
2. Requiring state appraiser licensing fees to be used for state appraiser licensing and enforcement. Currently, it is common for appraiser licensing fees to go into a state's general fund, causing the state appraisal board to compete with other state discretionary programs for funding.
3. Requiring the Appraisal Subcommittee to add "funding" as one criterion it looks at when monitoring a state program.

We encourage your committees to explore these options to help with the current state appraisal board funding crisis.

It is our view that problem appraisals are being allowed, and in some ways even encouraged, by a regulatory structure that promotes lax enforcement and ineffective oversight. H.R. 1295 would provide the Appraisal Subcommittee with a more robust oversight system for state appraisal programs, including a full range of supervisory sanctioning powers over state appraisal regulators. We believe this modification, if implemented fairly and through an open and public process by the Appraisal Subcommittee, will help encourage state appraisal boards to take action against unethical and fraudulent appraisers and improve enforcement in our profession.

Mitigation: Increasing Appraisal Quality and Professionalism
Important for discussions about new laws and increasing various federal and state enforcement powers is the need to mitigate problems before they occur so that less enforcement needs to take place. This is true in the real estate industry and appraisal community, where there is a great deal of competition and cost and turnaround times are critical to the success of a business. As they say: "You get what you pay for." We believe this to be true in the appraisal community where the cheapest and fastest appraisal may not be the best or most accurate appraisal. While cost and turnaround times should always be factors in a business decision, we believe quality should be as well.

An important goal of FIRREA was to ensure that appraisals are performed by competent appraisers. However, in practice, FIRREA has had the opposite effect because it stresses *minimum* qualifications. This emphasis has severely curtailed the continuing development of professionalism in the appraisal community. As we reflect upon FIRREA, it is clear that the requirements for licensing and certification were set too low.

FIRREA unfortunately settled for a minimum level of education and experience and failed to recognize the need for continuing professionalism beyond the licensed minimum. Accordingly, appraisers who have met only minimum state licensing and certification requirements tend to be less experienced and less qualified than appraisers with professional designations; 84 percent of users of appraisal services say this is the case[6].

In a poll conducted recently by the Appraisal Institute of significant users of appraisal services from which the above-mentioned statistic is gleaned, fully 50 percent responded that the quality of appraisal services and appraisal reporting has declined, whereas only 28 percent said appraisal services and reporting have improved. This is consistent with discussions various appraisal organizations have had with users of appraisal services for the past several years.

Interestingly, though, many of these users perceive the possession of a license to be the only necessary qualification on which to base whether or not an appraiser is "qualified" to perform an assignment, and stop short of fully considering the issue of competency for a particular appraisal.

It is our view that the culprit, at least in part, is a provision formulated against designated appraisers contained in (Section 1122(d)) of FIRREA, ironically referenced as the "Anti-Discrimination" clause. Under this provision federal financial institution regulatory agencies may not exclude a licensed or certified appraiser from consideration for an assignment in a federally related transaction solely by virtue of membership or lack of membership in any particular appraisal organization. Unfortunately, some financial institutions and individuals around the country have misinterpreted this clause to mean that users of appraisal services cannot establish qualifications criteria that would permit any consideration of an appraiser's membership in a professional organization. This misinterpretation is inconsistent with FIRREA's intent to enhance the quality of appraisal services and harms the public by discriminating against appraisers who hold designations and who may be the very best qualified to perform a particular assignment. Under this misinterpretation, for example, a federally regulated financial institution would not be able to consider a professional designation in deciding whether to award an assignment, despite the fact that it was earned and its achievement represents a strong commitment to professionalism.

While minimum standards and qualifications are a good place to start, limiting clients to only the minimally qualified makes no sense. Currently, nearly 40 percent of the approximately 80,000 licensed and certified appraisers in the United States belong to a professional appraisal organization, clear evidence that greater professionalism is being sought by many practitioners.

H.R. 1295 would make certain that professional designations can be considered by clients to help determine an appraiser's proficiency. This would not exclude anyone without a designation from receiving an assignment, but rather promote professionalism for the industry.

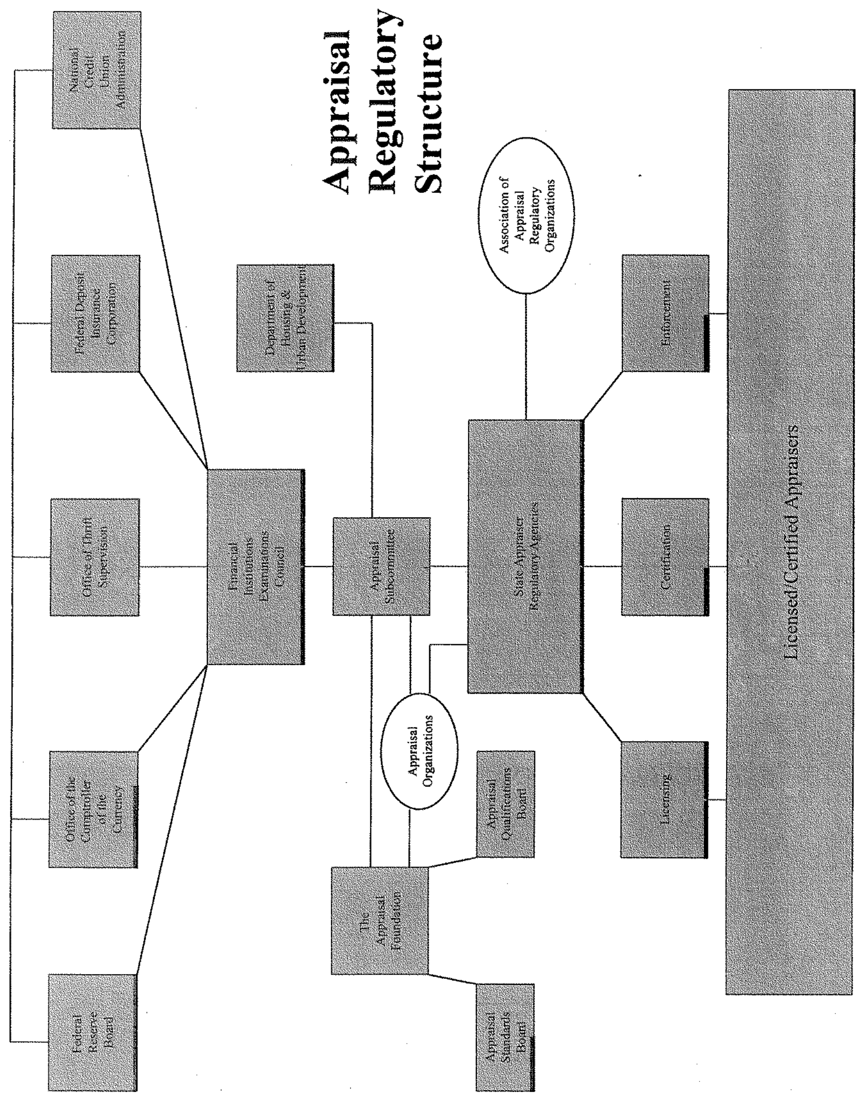
Conclusion

Our organizations have long held that current law relative to appraiser licensing and certification is in need of modification and revision, and that Congress should consider and enact legislation designed to uphold integrity in the real estate valuation process while protecting government-related financial interests and consumers. We have advocated for a regulatory system where federal and state appraiser

[6] "Appraisal Quality Post-FIRREA," A *Survey of the Appraisal Institute's 2000-2004 Client Advisory Committee Members*, March 21, 2004.

regulatory bodies are provided the resources and authority necessary to fulfill vital oversight of the profession. We have also made a case for professionalism to be fostered and encouraged and for states to streamline their operations to allow for the efficient flow of commerce.

Any legislation directed at curbing and preventing predatory lending and mortgage fraud must address current weaknesses in the appraiser regulatory structure. H.R. 1295 addresses these concerns by prohibiting inappropriate pressure of appraisers, providing greater accountability of federal and state appraiser regulators and promoting professionalism among appraisers. We stand prepared to work with Congress, consumer groups, and banking interests to help secure its passage.


Appraisal Regulatory Structure
National Credit Union Administration
Federal Deposit Insurance Corporation
Office of Thrift Supervision
Office of the Comptroller of the Currency
Federal Reserve Board
Financial Institutions Examinations Council
Department of Housing & Urban Development
Appraisal Subcommittee
The Appraisal Foundation
Appraisal Organizations
Appraisal Qualifications Board
Appraisal Standards Board
Association of Appraisal Regulatory Organizations
State Appraiser Regulatory Agencies
Enforcement
Certification
Licensing
Licensed/Certified Appraisers

Mortgage Bankers Association Testimony
Before the
U.S. House of Representatives Financial Services Committee's,
Subcommittee on Housing and Community Opportunity and
Subcommittee on Financial Institutions and Consumer Credit

Joint Hearing on Legislative Solutions to
Abusive Mortgage Lending Practices

May 24, 2005

I am Regina Lowrie, the President of Gateway Funding Diversified Mortgage Company located in Horsham, Pennsylvania and I have been in the mortgage business for more than 28 years. I founded Gateway Mortgage in 1994, with seven employees and $1.5 million in startup capital. The company now has more than 800 employees, more than 58 offices and is Greater Philadelphia's largest independent mortgage company, serving consumers in all of Pennsylvania, Delaware, New Jersey and Maryland.

I am also Chairwoman Elect of the Mortgage Bankers Association (MBA)[1]. Thank you very much for the opportunity to testify this morning on behalf of MBA at this joint hearing on legislative solutions to abusive mortgage lending practices.

I want to begin by saying that I believe that everyone in this room shares the same ultimate goal: to end abusive lending practices in the mortgage market. Mortgage lending abuse is a stain on an industry that has served consumers extraordinarily well and has been a key engine of our nation's economic growth over the last decade.

I also know that we all share the same goal of ensuring that families in all parts of this nation continue to reap the benefits of a robust and competitive mortgage market. This vibrant competition has driven the development of innovative credit options in recent years that have made mortgages available to thousands of families for whom mortgages were traditionally out of reach.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 400,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

The only difficult question I think we're all grappling with at this point is what is the best way to end abusive lending practices while still preserving this newly expanded access to capital?

The good news is we do have a fair amount of information about the best way to strike this balance. We know from experience what does not work: states and localities taking matters into their own hands.

In recent years, state and local governments have begun to enact a wide range of laws and regulations to deal with abusive lending. These laws, which often include subjective standards, create a tremendous compliance burden for companies. In the best case scenario, these burdens increase the cost of lending for consumers. In the worst case, they chase legitimate lenders out of the jurisdiction altogether, reducing access to capital. The evidence of the detrimental impact of these laws has been growing in recent years.

We also know what would work: a well-conceived federal anti-predatory lending law that sets forth strong consumer protections and objective and reasonable compliance standards. A uniform national standard would strike the right balance between preserving capital access and fighting abusive lending practices.

MBA, accordingly, strongly supports a uniform national standard. My testimony today will go into detail about the specific elements MBA views as critical in a national standard. It will also explain why we believe that the "Responsible Lending Act" (H.R. 1295), introduced by Congressmen Ney and Kanjorski, is the most promising vehicle for achieving this standard.

While MBA also recognizes the hard work of Congressmen Miller and Watt in developing the "Prohibit Predatory Lending Act" (H.R. 1182), as I will discuss, H.R. 1295 is a superior bill because it provides comprehensive protections and eliminates the current patchwork of state and local laws.

The Housing Market

This year the nation's homeownership rate rose to nearly 70 percent, the highest in our nation's history. This historic figure represents a five percent increase over the rate at the beginning of the last decade. Moreover, of particular note, it includes an increase in African-American homeownership of 16 percent and Hispanic homeownership of 17.2 percent between 1994 and 2004.

A significant part of the increase in homeownership is attributable to the recent development of the non-prime mortgage market. The non-prime market occupied one- twentieth of the mortgage market in 1994. By 2004, the non-prime market and the Alt-A market occupied one-third of the mortgage market.

The growth of the non-prime mortgage market has helped increase the nation's homeownership rate because this market basically serves families for whom homeownership has been traditionally out of reach. Non-prime borrowers commonly have low- to moderate income, less cash for a down payment and credit histories that range from less-than-perfect to none-at-all. These borrowers include first-time homebuyers, borrowers whose credit has been damaged by divorce or illness, single moms and dads, teachers and firefighters as well as business and professional people who have gone through difficult times but whose credit needs and dreams of homeownership have not abated. Before the advent of this new market, these borrowers were either simply denied the dream of homeownership or, in a very limited number of cases, served exclusively by FHA or other government-subsidized financing.

By virtue of the higher credit risk presented by non-prime borrowers, the foreclosure and default rates are greater. However, lower interest rates from rigorous competition, as well as an improving economy, have caused the default rates to drop. It would be a shame to deny legitimate borrowers non-prime credit because a very small percentage of loans go into foreclosure.

Tremendous competition in the non-prime market has brought many good things: The price of borrowing in the non-prime market has gone down as lenders have developed greater efficiency and expertise in assessing credit risk. At the same time, lender competition for borrowers has spurred the development of creative options such as prepayment provisions.

The Proliferation of Abusive Lending Laws

Unfortunately, yet not surprisingly, the rise of the new non-prime market has also attracted some unscrupulous actors who have taken advantage of the novelty of these loan products to victimize consumers in ways that are abusive and predatory. These practices range from outright deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding to saddle him or her with unfair loan terms.

In 1994, to address abusive lending in high-cost loans, Congress enacted the Home Ownership and Equity Protection Act (HOEPA). Under HOEPA, loans that meet certain criteria or triggers—currently loans with fees in excess of eight percent and having annual percentage rates (APRs) in excess of eight points over comparable Treasuries—are subject to specific restrictions and protections. These restrictions include the prohibition of certain loan terms, such as short-term balloon payment requirements, as well as the establishment of additional disclosure requirements. Under HOEPA, assignees of high-cost loans are subject to significant liability and for this reason almost no investors will purchase high-cost loans, which hurts liquidity and the availability of lower rates to borrowers in the high-cost loan market. Moreover, HOEPA protections are a floor, not a ceiling, allowing states to enact more restrictive predatory lending laws.

Since 1999, beginning in North Carolina, states also responded to lending abuses by passing at least 30 state and 17 local laws. These laws are ordinarily modeled on HOEPA but tend to have lower triggers, cover more loans and provide additional and disparate requirements.

While well-intended, this proliferation of diverse laws has created enormous compliance burdens for lenders, costs which are necessarily passed on to borrowers, increasing the costs of credit. Frequently, legitimate lenders eschew lending altogether in particularly "difficult" states, depriving that state's citizens the benefits of further competition and lower costs.

As a result of subjective state assignee liability provisions, ratings agencies have announced that they will not rate mortgage securities that include certain loans originated in certain states, i.e. Massachusetts. Fannie Mae and Freddie Mac have also announced policies limiting their involvement in certain states. Consequently, there is little securitization of certain mortgages in states like Massachusetts, further depriving the market of liquidity and borrowers of high-cost loans from the better rates that accompany loan securitization. Without a securitization outlet, lenders are unable to originate high-cost loans drying up legitimate, competitively priced lending for deserving families.

A National Standard

A far superior alternative to the patchwork of state laws is the enactment of a uniform national standard to combat lending abuses. Such a solution would provide significant and equal protection to borrowers throughout the country and a level playing field to increase competition and lower the cost of credit for all consumers.

Amend HOEPA

As a first step in establishing a national standard, HOEPA should be amended to extend its coverage to more loans and increase its protections. HOEPA currently only applies to refinanced loans. MBA also supports extending HOEPA coverage to purchase money loans and open ended lines of credit secured by real estate.

MBA also supports expanding HOEPA's protections by modifying the HOEPA triggers to bring more loans with high points and fees within HOEPA's coverage as a first step toward a uniform national standard. MBA also supports expanding HOEPA's protections by restricting more terms and practices for HOEPA-covered loans, for example by largely eliminating balloon payments and negative amortization in high-cost loans.

In addition, as a first step towards a uniform national standard, MBA supports the application of certain protections to all mortgage loans, not just those that meet the HOEPA triggers, as detailed below.

Determining the High-Cost Mortgage Threshold

Since many lenders will choose not to make high-cost loans, the choice of where to set and how to calculate the high-cost thresholds is enormously important. There are a number of states that have set their triggers well below the HOEPA trigger and included considerably more fees in the calculation. As a consequence, few triggered-loans are originating in these states, depriving borrowers of legitimate lending as well as the benefits of competition and lower costs.

Points and Fees Trigger

As indicated, HOEPA currently has two high-cost mortgage triggers:

(1) The points and fees charged on a loan are equal to or exceed eight percent of the total loan amount; or
(2) The APR of a loan exceeds eight percentage points above comparable treasuries for first mortgages.

MBA does not object to lowering the points and fees trigger to a level which is calculated in a reasonable manner and will not encompass loans that simply do not need HOEPA's protections or unnecessarily limit the options available to borrowers.

Prepayment Penalties Should be Excluded

In calculating points and fees, MBA strongly believes that prepayment penalties should be excluded. The option of a prepayment penalty in connection with a mortgage allows a borrower to choose a lower rate and lower monthly payments in return for agreeing not to refinance within a set period unless he or she pays a fee. A lower rate can be offered because the presence of a prepayment penalty assures a more reliable income stream for investors in pools of such mortgages and, consequently, better pricing for securities and consumers themselves. Conversely, including these penalties in the calculation would increase the likelihood that a particular loan will meet the high-cost threshold, causing lenders to drop this option resulting in decreased borrower choices and, increased borrower loan rates and monthly payments. Investor interest in buying securities backed by non-prime loans would be significantly reduced if not eliminated.[2]

[2] The Pentalpha Group LLC, "Analysis of the Impact of Prepayment Penalties on Residentail Sub-prime Lending Coupons" May 12, 2004.

MBA has long been committed to transparency and informed consumer choice and, in that vein, believes that prepayment penalties should always be optional and result from true consumer choice. Accordingly, MBA would support a requirement that originators provide borrowers with a choice of a loan rate with and without a prepayment penalty, if available.

Yield Spread Premiums

MBA also believes that yield spread premiums should be excluded from the points and fees trigger calculation. Yield spread premiums are payments by lenders to mortgage brokers as compensation for their role in a mortgage transaction..[3] Since these payments are reflected in the rate, the Federal Reserve has traditionally taken the view that yield spread premiums should be addressed as part of the annual percentage rate or APR for purposes of TILA ("Truth in Lending Act") and accounted for in the rate trigger under HOEPA. The Federal Reserve has said that to also count these payments as points and fees would be double counting.[4] MBA shares this view.

Like prepayment penalties, yield spread premiums offer borrowers additional financing options to address their particular cash situations and credit needs. As HUD recognized in considering the legality of yield spread premiums, these payments offer borrowers the option of choosing to defray origination costs by selecting a higher rate and higher monthly payments instead of paying them up front.[5] Forcing these premiums to be part of the point and fees trigger will reduce the availability of yield spread premiums and financing options for borrowers.

The approach of H.R. 1182 would include yield spread premiums in the point and fees definition which, as noted, would constitute double counting.

Limitations on High-Cost Mortgages

MBA supports increased limitations on high-cost mortgages including prohibiting certain terms and adding new protections as part of a national uniform standard. Any new limitations must have clear and objective standards to ensure easy and consistent compliance. Any additional disclosures and other requirements must tangibly and directly aid consumers. Borrowers are not well-served by additional ill-conceived disclosures.

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[3] HUD has made clear that these payments are legal under the Real Estate Settlement Procedures Act's (RESPA's) Section 8, as long as they are reasonably related to the goods and services provided. See, RESPA Statement of Policy 2001-1, Clarification of Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b), 64 FR 53052 (October 18, 2001); RESPA Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 FR 10080 (March 1, 1999).

[4] See 60 FR 62764 (December 7, 1995).

[5] *Ibid.*

Prohibited or Restricted Terms and Practices in High-Cost Mortgages

As part of a uniform national standard, MBA supports the prohibition of certain loan terms and practices. These terms and practices include selling single-premium credit life insurance in conjunction with loans, most types of balloon payments, negative amortization loans, most types of call provisions, requiring borrowers to waive their rescission rights, encouraging borrowers to default and provisions that allow for a defaulting rate of interest. While these provisions can be legitimate features of some mortgage transactions, their exclusion from high-cost mortgages may be warranted in the interest of protecting borrowers. MBA also supports reasonable limits on the financing of points and fees, limits on modification and deferral fees, limits on late fees and limits on prepaying payments from the loan proceeds.

Disclosures for High-Cost Mortgages

MBA also supports better disclosures for consumers entering into high-cost loans including provisions that make borrowers aware of housing counseling before the loan closes. The mortgage process is excessively complicated and, while lenders are working to make it more transparent and user-friendly, MBA believes it is also useful for borrowers to receive the guidance of qualified counselors before they enter into high-cost loan transactions. Informed consumers are one of the best weapons against unscrupulous lenders and brokers.

Assessing a Borrower's Ability to Repay

Assessing a borrower's ability to repay a loan is fundamental to the underwriting process. Nevertheless, some bad actors, in hopes of earning higher origination fees, have disregarded this critical criteria – something a legitimate lender would never do. Accordingly, MBA would consider supporting a requirement that lenders determine a borrower's ability to pay before entering into a high-cost loan.

Any new standard in this area must recognize how a lender makes such a determination and offer a clear safe harbor that recognizes lender compliance. At the same time, any new standard must also allow lenders latitude to determine that a borrower in unique circumstances is able to pay. It is not in the interest of a legitimate lender to originate a loan that a borrower cannot repay and it is important to preserve the ability of lenders to provide loans to borrowers in unique situations.

Protecting Against Loan Flipping

One of the most fundamental benefits of homeownership is the ability of a homeowner to draw on the accrued value of his or her home to meet financial needs, such as home remodeling, medical bills or even the costs of a family member's education. At the same time, abusive lending laws appropriately seek to prevent loan flipping. Loan flipping occurs when an unscrupulous lender initiates a high-cost loan to a borrower seeking to reap the benefits of origination costs that can result in stripping equity from the home.

It is critically important in addressing this area to preserve the legitimate instances where refinancing is beneficial to the borrower. To prevent loan flipping, Congress should identify the particular circumstances, through "bright line" safe harbors, where refinancing of high-cost loans is acceptable, including for example, when a lower rate is offered or a specified percentage of additional funds are provided. An overbroad legal standard would make a lender unnecessarily subject to liability for refinancing a consumer's mortgage, will force borrowers to either sell their homes as the only means of extracting needed funds or turn to other higher cost loan alternatives.

H.R. 1295 provides a balanced and objective standard that fairly protects consumers from excessive loan flipping and equity stripping without preventing a borrower of a high-cost loan from accessing their home equity.

Assignee Liability and High-Cost Mortgages

In MBA's view it is essential that a uniform national standard amend HOEPA to establish a clear and objective standard if assignees are to be held liable for the claims of high cost borrowers. Current HOEPA fails in that it contains a subjective standard giving rise to significant liability that holds assignees liable for the claims of borrowers "unless they can demonstrate by a preponderance of the evidence that a reasonable person exercising ordinary due diligence could not determine" that the loan was a high cost mortgage.

The subjectivity of this test under HOEPA and similar tests under some state laws have caused investors to avoid securitizing higher cost loans depriving high-cost borrowers of the lower rates resulting from securitization. If HOEPA is to be amended, MBA believes the establishment of an objective test of assignee liability should be among the highest priorities. When an assignee fails to meet specific criteria such as obtaining representations from originators or fails to conduct a specific level of due diligence, only then should liability be possible subject to defense by the assignee. Primary and secondary market participants require objective standards for determining liability. The ratings agencies and the government sponsored enterprises evaluate the assignee liability standards to determine risk and its affect on mortgage-backed securities. If that risk is indeterminate, it threatens the availability or significantly increases the cost of credit. Clear and objective assignee liability standards are essential as provided for under H.R 1295.

An Opportunity to Cure Errors

It is in the best interest of the lender and the consumer to rectify any errors in a high-cost mortgage transaction as soon as those errors are discovered. Accordingly, MBA strongly believes that a national standard should include a consumer-friendly, non-adversarial procedure where a lender has a first opportunity to promptly correct an error without additional legal liability. The standard must allow for the parties to cure an error in a way that maintains their relationship, steers the parties away from the expensive and adversarial nature of litigation and provides both with a simpler and more satisfactory result.

Protections Under a Uniform National Standard for All Mortgage Loans

As a first step towards establishing a uniform national standard to protect against abusive lending, MBA believes that increased protections for all mortgage borrowers should be considered. Items that may bear consideration include improved borrower education, increased broker licensing and new requirements for the use of appraisals.

Education

MBA is strongly committed to borrower education to help consumers understand the mortgage process and shop for the best mortgage that meets their needs. MBA also believes that education protects borrowers against lending abuses. Accordingly, MBA would support further government activity to facilitate borrower education as part of a national law to combat abusive lending.

Broker Licensing

Mortgage lenders are currently subject to a range of licensing, worth, capital and repurchase requirements that provide significant consumer protections. These rigorous requirements ensure that mortgage lenders adequately train and oversee the performance of all of their employees, particularly their loan officers. These same protections, however, are missing in the case of mortgage brokers who are self-employed and are not subject to the same requirements as mortgage bankers.

Appraiser Standards

Lenders rely on accurate and legitimate appraisals to verify the sale value of a home and give the lender confidence in extending a particular amount of mortgage credit. To avoid potential loss, it is critical that lenders receive appraisals that reflect the true value of property. Therefore, the appraiser's ability to exercise independence in making a value determination as an unbiased arbiter of a property's value is critical to a lender. As part of a national standard, MBA supports efforts to prohibit parties to a loan transaction from illegally influencing, or attempting to improperly influence, an appraiser through coercion, extortion or bribery in developing or reporting an appraisal.

Enforcement

MBA has consistently called for greater enforcement of current laws and welcomes new reasonable enforcement requirements to rid the industry and consumers of abusive lenders and brokers. In particular, we support a toughening of reasonable enforcement requirements under HOEPA and RESPA as part of a national uniform standard.

OCC-OTS Preemption

Consistent with its support for national standards to address lending abuses, MBA supports the actions of the Office of the Comptroller of the Currency ("OCC") and Office of Thrift Supervision ("OTS") to preempt the national banks and federal savings associations from state predatory lending laws. The OCC and OTS have established significant requirements to protect against lending abuses in lieu of state requirements.[6] Moreover, under a uniform national standard these institutions would be subject to the new standards as well. Such an approach assures that these institutions meet national standards benefiting industry and consumers alike. Notably, the Federal Reserve estimates that OCC and OTS regulated institutions comprise approximately 14 percent of the originations in the non-prime mortgage market.

Servicing Implications of H.R. 1295

We note, however, that H.R. 1295 would impose significant new risks and obligations on servicers, including shorter timelines for responding to qualified written requests and recording lien releases, mandatory escrowing and new disclosure obligations. These servicing provisions are not restricted to loans meeting the new "high-cost loans" definition but generally apply to all home loans. While we have a number of technical recommendations with regard to the servicing provisions, we would like to focus on a particularly onerous provision:

Federal Expansion of the Interest on Escrow Requirements

H.R. 1295 calls for the payment of interest on escrows if state or federal law requires it. There is no federal law mandating interest on escrows at this time. However 14 states currently have interest on escrow laws. Under the current federal statutory and regulatory regime, federally chartered financial institutions are preempted from some of these state laws. H.R. 1295 appears to change this, placing federally chartered institutions under the state's authority in this

[6] Pursuant to HOEPA, State attorneys general have the authority to enforce its provisions against OTS and OCC regulated institutions in a United States District Court, provided certain steps are taken. See 5 USC 1640(e).

area. Regardless of whether required by state or federal law, mandating that servicers pay interest on escrows dramatically increases the cost of doing business and the cost of credit to consumers. MBA has long opposed state interest on escrow laws and we object to any federal expansion.

Contrary to popular belief, mandating the payment of interest on escrows is not a "pass–through" situation. Mortgage companies do not earn interest on escrows that they collect on behalf of borrowers. In fact, the payment of interest on corporate demand deposit accounts -- where these funds generally reside -- is prohibited by federal law. As a result, mandating that servicers pay interest on escrows translates into a direct capital outlay for servicers. These capital outlays can be extensive and could significantly affect the cost of credit.

Moreover, because the bill mandates escrows for the majority of loans originated in today's market, the servicer would be unable to control these costs by choosing not to escrow. Servicers would also be held captive if states increase the rate of interest above market or fail to promptly reduce rates in declining rate environments. The potential for this risk is real. Servicers have experienced this very problem in the past when states imposed rates four to nine times higher than prevailing pass book rates. With such a windfall, borrowers began over-funding their escrow accounts, which in turn overwhelmed servicing staff's ability to maintain statutory cushions and refund the money. Servicers were forced to release escrows to control this problem. Moreover, because the bill is effectively retroactive to loans already originated, servicers cannot price these costs into the borrower's rate. The servicer is held captive. The bill will likely encourage states to impose interest on escrow laws -- further driving up costs to possibly unmanageable levels for servicers.

H.R. 1295

After careful review of H.R.1295, MBA believes that, while it is a tough bill, it addresses many of MBA's concerns. It strikes the right balance between providing strong consumer protections and ensuring clear, objective compliance standards to facilitate market competition. In particular, MBA supports the bill's replacement of the patchwork of state and local laws with a better and more comprehensive uniform national law. The bill's clear assignee liability provisions will facilitate consumer recourse and protect liquidity. The provisions that allow for non-adversarial, prompt corrective action to address errors and consumer claims will help many borrowers and lenders work out their problems more efficiently. The bill's balanced and objective standards will fairly protect consumers from excessive loan flipping and equity stripping without preventing borrowers from accessing needed credit. And the new disclosures, borrower education, and counseling provisions will also provide greater consumer protections. As the process goes forward, MBA will work to protect these provisions of the bill and to evaluate and refine other sections.

MBA believes that H.R. 1295 provides standardization, predictability and uniformity which will give the market -- consumers, lenders and investors alike -- clear standards which will increase competition and efficiency. This will ultimately decrease the cost of mortgage credit to the benefit of consumers.

H.R. 1182

As indicated, MBA applauds the hard work of Congressmen Miller and Watt in their efforts to address predatory lending. While well-intended, their bill, H.R. 1182 fails to take into account the operation of the mortgage market and the need for uniformity, standardization and predictability. Specifically, the bill sets forth new and more inclusive HOEPA triggers that would hurt competition among legitimate lenders. The bill does not set forth a uniform national standard but rather adds a new set of federal requirements to the patchwork of state and local anti-predatory lending laws and, at the same time, gives the states the opportunity to pass even more individual state laws. This approach will further the proliferation of state and local laws which will ultimately increase the cost of and threaten the availability of credit for borrowers.

Conclusion

Once again, MBA commends the House Financial Services Subcommittees for holding a joint hearing on the need for a national response to predatory lending. MBA believes that the only way to address predatory lending abuses while preserving the increased access to capital brought by recent credit innovations is to pass a uniform national standard that will bring predictability and uniformity as well as increased protections to the national mortgage market. This approach, embodied in H.R. 1295, would best serve the interests of borrowers, lenders and investors alike.

We appreciate the opportunity to testify and look forward to responding to any questions by members of the Committee.

National Association of Mortgage Brokers

Prepared Testimony of Jim Nabors

President-Elect of the

National Association of Mortgage Brokers

on

"Legislative Solutions to Abusive Mortgage Lending Practices"

before the

Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

U.S. House of Representatives

Tuesday, May 24, 2005

Good morning Chairman Ney, Chairman Bachus, and members of this committee, I am Jim Nabors, President-Elect of the National Association of Mortgage Brokers (NAMB). Thank you for inviting NAMB to testify today on legislative solutions to address abusive lending practices, preserving access to consumer credit, and protecting homeowners in America. In particular, we appreciate the opportunity to address the role of the residential mortgage community and specifically, mortgage brokers, in abating abusive lending practices.

NAMB is the only national trade association exclusively devoted to representing the mortgage brokerage industry. As the voice of the mortgage brokers, NAMB speaks on behalf of more than 26,000 members in all 50 states and the District of Columbia. NAMB offers educational courses and certification programs to mortgage professionals to maintain their expertise. By adhering to a strict code of ethics and best lending practices, NAMB members guide consumers through the mortgage loan origination process.

America enjoys an all-time record rate of homeownership today. Mortgage brokers have contributed to this achievement as we work with a large array of homebuyers and capital sources to originate the majority of residential loans in the United States. NAMB is committed to ensuring that abusive lending practices do not destroy the dream of homeownership for American families. NAMB recognizes that there are families that have suffered because of abusive lending practices, and we deplore these practices. NAMB supports efforts to expose and combat abusive lending tactics provided that these efforts do not inadvertently diminish consumer access to affordable credit or inhibit the ability of mortgage finance professionals to work closely with consumers throughout the homebuying process.

Before discussing the particular efforts we feel are necessary to combat abusive lending practices effectively, NAMB would like to applaud this committee for its leadership and for providing a forum to discuss and propose solutions to address the issues relative to abusive lending. In particular, we commend the bipartisan effort of Representatives Ney and Kanjorksi for their introduction of the Responsible Lending Act of 2005 (H.R. 1295). NAMB believes that the Responsible Lending Act of 2005 is a critical step in the right direction. We look forward to working closely with this committee in further refining the bill to appropriately address the multitude of issues surrounding abusive lending, including providing uniform protection to consumers.

NAMB believes there are three critical components to curbing abusive lending practices successfully: first, preventing abusive lending tactics without unduly restricting equal access to affordable credit for borrowers; second, promoting industry self-regulation and strengthening industry professional standards, while simultaneously relieving the regulatory burden imposed by the current patchwork of state and local laws; and third, providing and enhancing consumer education because informed consumers are less likely to fall prey to abusive lending tactics. These three key components form the foundation of our following comments.

Yield Spread Premiums

Much debate has occurred concerning the disclosure and payment of yield spread premiums (YSPs) over the years. Before discussing the benefits that YSPs provide to consumers, and clarifying the misconceptions many hold about them, we feel it is imperative first to understand precisely what constitutes a YSP.

YSPs can be defined as indirect compensation received from a lender to a broker in the form of a payment that represents the difference between the mortgage interest rate and the par interest rate. This difference can be fairly characterized as the lenders wholesale rate of funds. Virtually *all originators,* whether a bank, lender or mortgage broker, receive compensation upon the sale of the mortgage in terms of the spread above the wholesale rate of funds. The YSP represents a component of the broker or lender's compensation that is either not included, part of, or all of the compensation received.

Moreover, many lenders act as if they are brokers in the sense that prior to the mortgage loan closing, the lender knows the loan will be or has been committed to be purchased by an investor as most loans are rapidly sold into the secondary market to reduce the interest rate risk to the originator. As a result, most banks and other lenders not only receive compensation that is tantamount to YSPs, but also receive service release premiums, or

SRPs, upon sale of the loan into the secondary market. The key difference is that the mortgage broker YSP compensation is disclosed to the consumer but similar lender compensation, whether it is the YSP or SRP, is not. With this definition of YSPs in mind, we will first address the benefits of YSPs for consumers and then explain why YSPs should not be included in the points and fees triggers under HOEPA.

YSPs Benefit Consumers
Consumers of all income levels may find themselves in a situation that prevents them from qualifying for the lowest available mortgage rates and fees. Mortgage credit is the least expensive source of credit for those in need of money to purchase or improve their home, finance their children's education, or even start a business. They need to have the widest possible range of choices when they are buying a home or need a second mortgage. Congress must be careful to avoid measures that will prohibit consumers from selecting among the variety of finance choices that exist and using the tools they need to manage and improve their financial situation.

A YSP is a tool that allows a consumer with little or no-cash, and/or impaired credit the option of a low-cost or no-cost home loan because the closing costs and broker and lender compensation are included in the interest rate, which is paid by the consumer over time. Without low-cost or no-cost home loans, many consumers, many of them first-time homeowners, would be unable to purchase a home because of insufficient cash reserves to cover upfront closing costs.

YSPs Should Be Expressly Excluded From HOEPA Points and Fees Trigger
An issue that has surfaced when discussing proposals to address abusive lending is whether YSPs should be included in the points and fees threshold under the Home Ownership and Equity Protection Act of 1994 (HOEPA). NAMB believes it is imperative that any legislation directly and expressly exclude YSPs from the calculation of points and fees. There are two principal reasons for our stated position.

First, a loan under HOEPA is covered if one of two thresholds is met: 1) the APR exceeds the Treasury securities by 8% for first liens, and 10% for second liens; or 2) the total points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or a set dollar amount ($510 for 2005), adjusted annually for inflation. The YSP is *already captured* in the APR threshold. Including the YSP in the points and fees threshold, as some have proposed, will artificially cause loans originated by mortgage brokers to be considered high-cost, while excluding other identical loans that cost consumers the same in terms of points and fees. NAMB believes that all distribution channels should be treated in a uniform manner. Consumers should receive the same protections provided for in HOEPA regardless of who originates the loan.

Second, including YSPs in the HOEPA points and fees trigger will cause market reporting anomalies because it will appear that mortgage brokers are issuing more high-cost loans than lenders or banks when that is not the market reality. Regulators, particularly those responsible for interpreting data submitted in accordance with the Home Mortgage Disclosure Act (HMDA), will be misled by the reported data, as will consumers. Moreover, regulatory agencies that issue rules and opinions regarding high-cost loans will have inconsistencies resulting in both HMDA-reporting and audit implications. Mortgage loans with high YSPs that exceed the APR threshold are already covered under HOEPA and provide consumers the protections intended by and outlined in HOEPA. NAMB believes that YSPs should not be included in the HOEPA points and fees trigger so as to ensure that the option of low-cost or no-cost loans are not taken away from the consumer, either purposefully or inadvertently.

National, Uniform Licensing Standards and Nationwide Database of Mortgage Originators

NAMB seeks legislation that will implement uniform national lending standards to address abusive lending practices effectively, preserve access to affordable credit, and improve the overall expertise of the mortgage origination industry. As part of this effort, NAMB has been, and continues to be, a leader in advocating and participating actively in forums that will create strong, uniform national licensing and education standards and a nationwide registry for all mortgage originators. Specifically, NAMB supports measures that seek to protect consumers from abusive lending practices including formal licensing, pre-licensure education, and continuing education requirements. However, we believe that to be truly effective such measures should apply not just to mortgage brokers, but all mortgage originators. To this end, NAMB also supports a nationwide registry of all mortgage originators.

NAMB also is increasingly concerned about the proliferation of state and local initiatives that purport to address abusive lending. Mortgage lending has become largely a nationwide industry, with a number of lenders operating in all 50 states. It is incredibly burdensome and confusing to brokers and lenders to comply with 50 different state and local lending restrictions—a chaotic existence from which consumers ultimately suffer. Overreaching state and local laws will only disrupt the mortgage market, preventing lenders from offering borrowers legitimate nonprime products, and increasing loans costs for consumers.

We believe the record levels of homeownership in the United States can be attributed to the vibrant and competitive mortgage market we see today in both the prime and subprime arenas. The importance of preemption is demonstrated by the state law exemptions granted by federal financial regulators to federally chartered depository institutions and their operating subsidiaries. In addition, certain state-chartered depositories are exempt through states' parity laws. Proposed legislation should ensure that a level playing field exists where all market participants abide by the same set of rules. All consumers should receive equally effective protections regardless of where they live or who originates their loan. We believe that a national licensing standard helps to accomplish these objectives in addition to uniform national lending standards. Moreover, a level playing field for all participants is necessary to keep the flow of capital to the mortgage market, enabling competition to keep market players and rates in check and allowing consumers to have continued access to affordable credit regardless of whether consumers use a bank, lender or mortgage broker to obtain their mortgage.

NAMB supports a national, uniform licensing standard for all mortgage originators, in conjunction with a federal registry of all mortgage originators. We believe a nationwide registry will give mortgage industry professionals an avenue to report unscrupulous actions by other mortgage professionals, and help police itself and eliminate bad actors from its ranks. Some may argue that only brokers should be subject to a registry, along with national uniform lending standards. However, including one subset of mortgage originators does nothing more than confuse and mislead the consumer. The framework for debate here is not one of regulation, but rather one of consumer ability to make a well-informed decision. Consumers should be able to access and evaluate information about any mortgage originator—be it a mortgage broker or a loan officer operating for a large mortgage finance company—so as to make an informed decision about which one they will work with during the mortgage application process. The need for a nationwide registry of all mortgage originators who are all subject to the same national, uniform lending standard ensures that a consumer is able to evaluate each mortgage originator fairly.

Affordability and Availability of Mortgage Credit

Congress must create a balance to protect consumers from abusive lending practices, while at the same time, not restrict their choices of loan products and terms or reduce their access to affordable credit. Outright prohibitions of some practices intended to help consumers, such as financing of certain fees, could unduly limit credit availability and actually increase the cost of credit to the very same consumers that we are trying to protect.

For example, significantly lowering the HOEPA triggers to cover all loans, except for reverse mortgages, expands the universe of what is considered a high-cost mortgage and poses a serious threat to the availability of affordable credit. Today, many lenders already do not make or fund high-cost loans because of the attendant risks and legal liabilities associated with such loans. Also the financing of points and fees should not be completely constrained. It is critical to understand such a limitation means that higher cost borrowers will have restricted access to affordable mortgage credit and fewer options. Consumers may be forced to not get a loan, pay a higher interest rate on a loan, or secure a secondary loan to finance the costs, *i.e.* consumer finance loan. In practice, this prohibition would essentially eliminate the high cost mortgage market because the majority of high cost borrowers finance their points and fees. A limitation on financing points and fees, along with a reduction of the trigger threshold that will apply to more loans, could shrink the pool of lenders willing to offer these types of loans—less competition will result in higher cost loans. With fewer options available, higher risk borrowers will be driven to accept more costly consumer finance loans.

Restrictions on specific loan features do not necessarily advance the fight against abusive lending practices. On their own, these loan features are not abusive and in fact, can help consumers. For example, the prepayment penalty feature is a useful device that enables consumers to obtain a lower interest rate and hence, lower monthly payments that make affordable homeownership a real possibility. The same can be said for other loan terms or conditions. Rather, these loan features individually, or collectively, afford consumers the ability to purchase a home and provide options that fit with the consumers' own, unique circumstances.

Any efforts to legislate steering must be clear and not restrain a consumers' ability to shop for the loan product that best suits their financial situation. Steering proposals should not shift the burden of comparison shopping and the ability to choose the best product from the consumer to the lender or broker. A broad and vague steering provision will make compliance difficult, if not impossible, and carries with it too high a level of risk of penalty and increased litigation. Efforts to address steering should not have the effect of reducing the number of lenders willing to make high cost loans, which in turn will result in higher cost financing for the consumer.

Enforcement

We underscore the point that Congress should avoid draconian measures that ban or restrict viable loan products and features that do nothing to prevent abusive lending practices, but which limit consumer choice and prevent everyday consumers from becoming and remaining successful homeowners. Rather, NAMB strongly believes that in addition to a uniform national licensing framework, existing laws should be better enforced by state and federal regulators to eliminate abusive lending practices effectively. Federal fair lending and consumer protection laws, such as the Fair Housing Act, the Equal Credit Opportunity Act, the Truth in Lending Act, as amended by HOEPA, and the Real Estate Settlement Procedures Act all provide substantive protective measures to borrowers. These laws provide disclosure requirements, define high cost loans, and contain anti-discrimination provisions. Many of the abusive lending practices that are taking place often involve outright fraud, in addition to misleading and deceptive sales and marketing practices, which are already illegal. Although the mortgage lending industry is heavily regulated through these laws, perpetrators often ignore these laws and go unpunished for their violations. It is the serious lack of enforcement of these laws that allow an environment whereby abusive lenders continue to cultivate, and from which consumers will suffer the consequences.

Consumer Education and Financial Literacy

A key component in deterring the occurrence of abusive lending is through consumer education and financial literacy. Few, if any, could argue that a major tool to combat abusive lending practices is to improve consumer awareness through education. Informed consumers are in a better position to protect themselves from abusive lending practices and are not only more likely to become homeowners, but also remain successful homeowners. Certainly, it is important that the industry reach out to the people most frequently targeted by predatory lenders—low and moderate-income households, the elderly and underserved communities in urban and rural areas.

Mortgage brokers are in a unique position to educate consumers through the mortgage origination process – a role NAMB takes very seriously. NAMB works closely with the financial services industry as part of its on-going commitment to consumer education and has a long history of promoting consumer financial literacy. For example, last year, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently being managed by NAMB state affiliates in California, Florida and Texas. NAMB also partnered with United Guaranty to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low-to-moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more. NAMB has even taken its education efforts to your doorstep. Earlier this year, NAMB sponsored a Mortgage Broker 101 seminar where NAMB met with Hill staff to discuss the many facets of the mortgage process and the role of a mortgage broker in that process. NAMB also sponsored a Credit Scoring 101 seminar for Hill staff to explain the issues relative to credit scoring, including the major role a credit score has in determining mortgage eligibility.

Furthermore, in an effort to improve consumer financial literacy, NAMB has assembled a Consumer Protection Committee with the stated objective of preventing abusive lending practices through homebuyer education.

Because NAMB feels strongly that financial education is essential to protecting oneself against fraud or abusive lending tactics, NAMB believes that the education process should begin at a young age, with some target curriculum in our high schools. To this end, NAMB supported the bipartisan resolution passed by the U.S. House of Representatives designating April as "Financial Literacy Month." In particular, NAMB commends Representatives Judy Biggert (R-IL) and Rubén Hinojosa (D-TX) for introducing a resolution that calls for the federal government, states, local governments, schools, businesses and other groups to observe Financial Literacy Month and for their efforts towards consumer financial literacy.

Conclusion

NAMB believes that any legislation designed to curb abusive lending practices should create a uniform standard regardless of the distribution channel—broker, banker, lender—chosen by the consumer, and promote growth in homeownership by ensuring continued credit availability, competition and choice for consumers. This principle should guide this committee as it considers legislation to address abusive lending practices.

We appreciate the opportunity to offer our views. I am happy to answer any questions this committee may have.

CFAL Coalition for Fair and Affordable Lending

OPTION ONE

Testimony of Steve Nadon
Chairman of the Coalition for Fair and Affordable Lending (CFAL)
& Chief Operating Officer of Option One Mortgage

On

"Legislative Solutions to Abusive Mortgage Lending Practices"

Before the

Committee on Financial Services'
Subcommittees on Housing and Community Opportunity &
Financial Institutions and Consumer Credit
U.S. House of Representatives

May 24, 2005

Introduction & Overview

The Coalition for Fair and Affordable Lending[1] ("CFAL") appreciates the opportunity for me to testify on its behalf at today's hearing. I am Steve Nadon, CFAL's Chairman, and Chief Operating Officer of Option One Mortgage, which is a subsidiary of H&R Block, and which is one of the nation's largest nonprime mortgage lenders.

At the outset, I want to commend Chairman Ney and Chairman Bachus for scheduling today's hearing so that the Committee Members can hear suggestions on how to best refine pending legislation to prevent abusive lending practices without limiting borrowers' access to affordable mortgage credit and their ability to choose flexible mortgage financing options.

Much of my testimony will focus on provisions in Title I of H.R. 1295, the Ney-Kanjorski bill, and on H.R. 1182, the Miller-Watt bill, amending HOEPA's points and fees trigger, prepayment penalties, discount points, lender-paid broker compensation and the financing of loan closing costs. These issues, which greatly impact loan affordability, are at the heart of much of the debate surrounding these two bills. I believe it is essential for Committee Members to understand the practical----and potentially very harmful---- effects for borrowers if some of the proposed restrictions are adopted. Appendix "A" to this testimony provides a much more detailed analysis and commentary on most of the

[1] The Coalition for Fair and Affordable Lending (CFAL) was established in 2002 to advocate national uniform fair legislative standards for nonprime mortgage lending. CFAL's members include many of the nation's leading nonprime lenders.

CFAL Coalition for Fair and Affordable Lending

OPTION ONE

provisions in both bills. In addition, CFAL subsequently will be providing the Subcommittees with specific suggested legislative language for amendments in areas where CFAL believes this is needed and where we think the two bills can be brought together.

CFAL appreciates all Members' interest and involvement in this important legislative issue. We especially commend and thank the lead sponsors of H.R. 1295 and H.R. 1182, and their staffs, for the thought and hard work they have put into these bills. Both bills are well-intended and have a number of good concepts, but both have some problematic provisions. Having reviewed both bills, CFAL favors H.R. 1295 and believes that the Committee should use it as the base legislative vehicle for reporting out a Committee-approved measure, but should further refine it, including where appropriate, incorporating certain of the Miller-Watt bill's concepts.

- H.R. 1295, the Ney-Kanjorski bill, has broad bipartisan support. It significantly enhances current federal law, covering more loans, improving existing provisions and adding effective and workable new safeguards on other specific lending practices. Most of these provisions equal or exceed those of most state laws.
- Unlike the Miller-Watt bill, Ney-Kanjorski provides for uniform national mortgage lending standards, which CFAL strongly supports, and which is vitally important to ensuring both that all borrowers in this country, wherever they live, enjoy a high level of protection and that all communities have mortgage capital available on fair and affordable terms.
- H.R. 1295 also has very important additional provisions to greatly enhance financial counseling and education programs that are based on legislation developed earlier by Rep. David Scott, who we commend for making such a vital contribution to this comprehensive bill.
- Ney-Kanjorski has titles that would improve mortgage broker regulation, prevent appraisal fraud and help control "property flipping," and address mortgage servicing concerns.

However, H.R. 1295 is not perfect, and it needs a number of further technical and substantive refinements. For example, while we strongly support preemption, the provisions in Ney-Kanjorski need to be scaled back so that they do not sweep in almost all mortgage-related laws (e.g., foreclosure laws) and are instead targeted primarily to state and local laws aimed at regulating mortgage lending practices whether based on a "loan trigger rate" or some other mechanism. It also needs to be clarified to ensure that the Federal Reserve Board has authority to define and prohibit other abuses that may arise subsequently. Likewise, a number of more technical corrections are needed, such as making it clear, as we understand the lead sponsors intended, that the sale of single premium credit insurance and comparable products are prohibited in connection with all mortgage loans. Also, while CFAL believes that some of the Miller-Watt bill's provisions would adversely affect many borrowers, other concepts from that bill might be worked into H.R. 1295. We look forward to working with Committee Members and other interested parties to help ensure that the final Committee product will be the best bill possible for borrowers and will have strong bipartisan support.

Before moving to a discussion of how the two bills deal with key issues, I want to briefly comment on the importance of nonprime mortgage lending and the need for uniform national mortgage lending standards.

Nonprime Mortgage Lending & Uniform National Lending Standards

Nonprime Lending Is Critically Important For Homeownership - As Committee members know, housing is critically important to our nation. Not only is home ownership "the American dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. CFAL's members and other nonprime lenders play an increasingly vital role in meeting the housing credit needs of millions of Americans. In 2004, nonprime mortgage lending accounted for over 20% of the overall market and amounted to over $600 billion. Nonprime lending is especially important in helping people who have higher risk profiles, due to credit impairments or other factors, to purchase a home or to refinance an existing mortgage and obtain access to some of their equity to meet important personal financial needs.[2] Congress clearly must ensure that nonprime borrowers are not abused in the mortgage lending process, but you also must make certain that "protective" measures do not unintentionally and unnecessarily harm them by limiting their access to needed affordable mortgages and flexible financing choices.

Uniform Federal Standards Will Benefit Borrowers - Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. New federal statutory requirements are needed to remove gaps or weaknesses in HOEPA (the "Home Ownership and Equity Protection Act of 1994"), which is the primary federal law regulating mortgage lending practices with regard to high-cost loans. Moreover, legislation is needed to provide uniform national lending standards so that all mortgage lenders are governed by them and that every American borrower receives the same equal and effective protections regardless of which lender they choose or where they may live. CFAL believes that both federal and state regulators should actively enforce these nationwide standards.

The growing patchwork of arbitrary and confusing state and local laws intended to prevent mortgage lending abuses makes compliance burdensome, costly, and in some instances has disrupted local mortgage markets and reduced credit availability. More importantly, this hodgepodge of state regulation provides very unequal levels of

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[2] More detailed general information on nonprime lending is contained in the following earlier CFAL testimony before these Subcommittees at: http://financialservices.house.gov/media/pdf/110503sn.pdf (November 2003); and http://financialservices.house.gov/media/pdf/033004st.pdf (March 2004). In addition, considerable detail regarding the lending practices of my own company, Option One Mortgage, is attached as Appendix "B."

protection from borrowers. About half of the states have passed special anti-predatory lending statutes. None of these laws is the same. Some have provisions that go too far, while others do not provide adequate protections. The other states have not passed such comprehensive laws, and their residents for the most part must rely primarily on only the relatively weak current federal law. Furthermore, many borrowers in all states, including those that have special anti-predatory lending laws, can only rely on current HOEPA provisions because their lender is a depository institution that is exempted from compliance with stronger state lending laws. We believe that the states and even local governments have created this confusing patchwork of laws because Congress has not updated HOEPA. It is time for Congress to ensure that all Americans enjoy the same level of protection.

HOEPA and Proposed Amendments

In 1994, Congress recognized that the highest risk mortgage borrowers may be more likely to be subject to coercive or inappropriate lending practices. Accordingly, it passed HOEPA[3] to provide additional disclosures and some substantive protections for certain of the highest cost mortgage loans.[4] HOEPA applies only to "closed-end" refinance home loans (i.e., that amortize with set monthly payments over a specific time period) that "trigger" its provisions by having annual percentage rates ("APRs") above a set level or "points and fees" in excess of a specified percentage of the loan amount.[5] HOEPA currently does not apply to loans made to purchase a home, or to loans that are structured on an "open-end" basis (e.g., a typical home equity line-of-credit).[6]

Although HOEPA does provide some limited safeguards, it now is widely accepted that this federal law has serious defects in terms of coverage, how some of its provisions are either too weak or in some instances go too far, and how it fails to address some potentially abusive practices.

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[3] 15 U.S.C. §§ 1602(aa), 1639. Implementing HOEPA regulations issued by the Federal Reserve Board can be found at 12 C.F.R. § 226.32.

[4] In addition to special warning disclosures, loans subject to HOEPA and its implementing regulations have certain limitations or prohibitions on contract terms or sales practices, such as prohibiting the following: negative amortization which occurs when the payments made the principal balance; increased interest rates upon default; balloon payments on loans less than 5 years; payments made only to a home improvement contractor from loan proceeds; refinancing within 12 months unless it is in the borrower's "interest"; and making loans without regard to ability to repay on a "pattern and practice" basis. HOEPA also applies expanded assignee liability on covered loans for essentially ALL claims and defenses that the borrower could have raised against the loan originator, including those arising under other statutes and common law.

[5] HOEPA's APR triggers are 8% for first liens and 10% for junior liens over a comparable maturity Treasury rate. The law's points and fees trigger covers loans when the total points and fees (counting only certain specified items) exceeds the greater of 8% of the total loan amount, or an indexed base amount, which is $510 for 2005.

[6] Both the Ney-Kanjorski and Miller-Watt bills expand HOEPA's coverage to include purchase money loans and open-end loans, and CFAL supports this expanded coverage.

HOEPA's Practical Effect – Loans today are generally extended using risk-based pricing, with the highest-risk borrowers having the highest prices. In a number of cases, the borrowers' risks and reasonable costs associated with making the loans when fairly priced will cross one or both of HOEPA's high-cost trigger thresholds.

It is widely recognized that HOEPA has the practical effect in most cases of prohibiting the highest-risk borrowers from being able to obtain legitimate nonprime loans instead of simply, restricting inappropriate practices. Few lenders make loans that are subject to this statute and there are no secondary market purchasers of the relatively few that are made.[7] The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price *due not to the borrower's credit, but to the higher legal and reputational risks and reduced competition caused by the law itself.* Moreover, under even more restrictive state laws (e.g. North Carolina, Georgia, New Mexico, New Jersey), which all purport to "regulate" practices, virtually no legitimate lenders are making high-cost loans because key provisions in those laws have been crafted so as to have the practical effect of preventing any responsible lender from being able to offer loans above the high-cost thresholds. In reality, what we now have in many cases is a series of overly-restrictive provisions that are masquerading as regulations when they in fact are designed and function as usury limitations and prohibitions on making high-cost loans.

We believe that borrowers in all risk grades should be able to secure loans if they have adequate repayment ability with proper literacy programs, and that federal and state laws should be designed to impose reasonable regulation and not be crafted to unnecessarily deny credit to the highest-risk borrowers under the guise of "protecting" them. Therefore, as a threshold issue, we urge the Committee to consider first whether it believes that high-cost loans should be made with effective regulation, or whether high-cost loans should not be made but instead prohibited. The latter option is typically favored by parties who want to "protect borrowers from themselves" and think that many Americans should only rent and not own a home. We seriously question whether Congress intended to impose price controls or a *de facto* prohibition on most high-cost lending, and we recommend that, as the Committee restructures HOEPA, you do so in a

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[7] HOEPA poses two types of risk for legitimate lenders. The first is *reputational* (i.e., concerns whereby companies do not want to have their reputations hurt by being associated with loans that may be perceived as "high cost"). More frequently, however, the concern has to do with the *legal* risk that arises from HOEPA's provisions. The primary problem is that lenders sometimes inadvertently miscalculate whether or not certain loans cross HOEPA's thresholds. This puts them in a "got you" situation as they will not have given the required special HOEPA disclosure notice which has to be given before the loan is made. There is an inadequate provision for correction of this error or for most other mistakes. This means that the lender has violated the law. Penalties include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Lenders understandably consider this an extremely severe penalty, and many do not think it is worth the risk of making loans in these circumstances. Moreover, HOEPA's sweeping assignee liability provisions mean that secondary market purchasers would likewise be liable for such a miscalculation or other unintended violation about which they neither knew nor reasonably could have known. Not surprisingly, therefore, there is virtually no secondary market and no securitization of HOEPA loans.

way that reasonably regulates high-cost loans, but allows qualifying borrowers to obtain them and lenders to make and securitize them if they choose to do so.

Preserving Loan Affordability

Nonprime lenders offer their borrowers a wide array of loan products, most of which have certain basic flexible loan financing options that borrowers can choose from in order to make their loans more affordable. These financing options include:

- Accepting a prepayment penalty provision in exchange for a lower interest rate[8] (or in some cases, lower closing costs);
- Having the lender pay all or a part of the broker's compensation for them in exchange for a slightly higher interest rate[9];
- Allowing borrowers to "buy down" their interest rate by paying discount points at closing in exchange for a lower interest rate; and
- Voluntarily choosing to finance their closing costs as a part of the loan (i.e., they borrow enough to cover those costs) as this allows them to deploy their available cash resources elsewhere, or if they are cash-short, to avoid having to borrow elsewhere, often at more expensive rates, or in some cases not be able to get a loan.

The overwhelming majority of nonprime borrowers (like many prime borrowers) now voluntarily elect to use one or more of these financing options to make their loans more affordable by lowering their monthly payments or lowering their loan closing costs.

CFAL recognizes that unscrupulous lenders or brokers can apply any of these financing options in an abusive manner. Therefore, we support having reasonable safeguards to prevent abuse, while also preserving these important options for borrowers. In that regard, Ney-Kanjorski includes the following provisions:

- Prepayment Penalty Provisions - Substantially reduces HOEPA's current 5-year time limit on prepayment penalty provisions to 3 years, follows California's law limiting the maximum penalty to 6 months interest on 80% of the outstanding loan balance, and, perhaps most importantly, requires lenders to give borrowers a choice of a loan without a prepayment penalty as well as an explanation of the potential benefits and detriments of accepting a penalty, but appropriately does

[8] The Center for Responsible Lending (CRL) has issued a report that essentially claims borrowers generally not only do not get a lower rate in exchange for a prepay penalty but that they actually often pay a higher rate. http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.
Others have pointed out that this CRL study is fatally flawed:
http://www.msb.edu/prog/crc/Publications%20PDF%20files/Review%20of%20CRL%20Prepayment%20Penalty%20Studies.pdf. CFAL also considers this report to be very inaccurate. Our company data shows just the opposite of CRL's claims. CFAL is having an independent analysis done of available data to help demonstrate how prepayment penalty options do give borrowers lower rates.

[9] Some borrowers also elect to not pay any broker or lender points and fees and pay a higher interest rate instead, but most do not choose this option because the rate is generally much higher and makes their monthly payments higher.

not include the potential maximum prepay penalty (which may never be accessed) in the points and fees trigger calculation;[10]

- Lender-Paid Broker Compensation – Allows lenders to continue the widespread and accepted practice in both the prime and nonprime markets of paying all or a part of the broker's compensation for the borrower when the borrower elects to reduce his or her closing costs in exchange for a slightly higher rate, does not include such indirect broker compensation (e.g., yield spread premiums (YSP)) in the points and fees trigger calculation;
- Discount Points – Enables most nonprime borrowers (but not those with the most expensive high-cost loans) to use up to 2 bona fide discount points to buy down their interest rate without counting these in the points and fees trigger calculation provided several requirements are met (e.g., each point paid must result in at least ¼ % lower interest rate); and
- Financing of Points and Fees – Follows Massachusetts' law allowing high-cost loan borrowers to continue financing such closing costs, but caps this at a reasonable level of no more than 5% of the loan amount (6% if the loan is $40,000 or less).

We believe that the Ney-Kanjorski bill for the most part[11] strikes a good balance between adding protections against abuse of these financing options and allowing lenders

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[10] Critics often forget, or do not mention, the ongoing benefit and the potential longer term benefit that borrowers receive when they elect a prepayment penalty option. For example, assume a $150,000 loan with an 8% interest rate and a 1% savings on the rate by choosing the penalty option (i.e., otherwise the rate would be 9%). Under the California rule contained in Ney-Kanjorski, the maximum amount of the penalty would be 6 months' interest on 80% of the amount prepaid, which would be $4,800 ($150,000 x .8 = $120,000 subject to the penalty. 6 months' interest on that amount would be $120,000 x .08 divided by 2 = $4,800). The 1% reduction in rate would amount to a savings of $106.25 per month on the monthly payment. If a borrower decided to refinance after 26 months, the borrower would have to pay $4,800, but at that point would have received $2,763.28 in benefit by having the lower rate, so the net cost would really only be $2,036.72 ($4,800 - $2,763.28 = $2,036.72). On the other hand, if the borrower waited 4 years to refinance (which for many is increasingly likely in today's rising rate environment), the borrower would have saved $5,101.44 in mortgage payments, and not have to pay a penalty.

[11] CFAL believes that it would be appropriate to refine some of the Ney-Kanjorski provisions.

- For example, while we think that a 3-year prepayment penalty time limit is generally appropriate for a fixed rate loan, many loans today are adjustable rate mortgages (ARMs) with the interest rate adjusting after 2 years. We believe that it would be appropriate to strengthen Ney-Kanjorski by adding a provision that in the case of ARMs, the penalty period would terminate at the first rate adjustment date.
- Also, we recognize that some parties are concerned that there is no limitation on yield spread premiums (YSP) paid to brokers since YSP is not included in the points and fees trigger calculation as is done in the Miller-Watt bill. Concerns have also been raised as to whether there is always adequate up-front disclosure or transparency regarding the fact that a broker is receiving a YSP. This is another area where the Committee might consider refining Ney-Kanjorski so that it further addresses concerns covered by Miller-Watt by, for example, allowing 2 YSP points to be excluded (like 2 bona fide discount points) but including any over that level. Likewise, the Committee might consider requiring a clear early disclosure of the YSP payment. At Option One, we require the broker to obtain a signed acknowledgment from the borrower that the loan will have a specific interest rate and further that the broker will receive a specific amount of compensation as YSP from Option One. A copy of this disclosure form is attached as Appendix "C."

to continue offering these choices to borrowers so they can make their loans more affordable.

The Miller-Watt bill takes a fundamentally different approach on each of these issues, which has substantially negative impacts on loan affordability:

- Prepayment Penalty Provisions – Miller-Watt has several different restrictions on prepayment penalty provisions, including adding a new high-cost trigger that would make any loan (including a prime loan) with a penalty provision that is longer than 30 months or greater than 2% of the amount prepaid a high-cost loan; prohibiting prepayment penalties entirely on high-cost loans unless the amount of the loan exceeded the FHA insurance limits (which normally does not happen), and requiring the potential maximum amount of an otherwise allowable penalty to be counted in the points and fees trigger calculation---the net practical effect of these restrictions is that prepayment penalties, which allow borrowers the option of lowering their rates, simply could no longer be offered on virtually any nonprime loans, and this in turn would likely increase the interest rates for all nonprime borrowers by around 1%[12] (i.e., ALL nonprime borrowers monthly mortgage payments would increase significantly);
- Lender-Paid Broker Compensation – Miller-Watt includes indirect broker compensation (i.e., YSPs) in the points and fees trigger calculation, which, together with the inclusion of other items, would have the practical effect of pushing most into loans over the points and fees threshold into the highest cost category thereby forcing lenders to shift all or most costs into the interest rate, so rates will go up significantly, as will monthly payments;
- Discount Points – Miller-Watt on the one hand provides for the exclusion of 1 or 2 bona fide discount points, but on the other makes the exclusion apply only to loans that are close to the prime rate and then only if there was no exclusion of any prepayment penalty---here again the practical effect being that discount points could rarely be used on nonprime loans, thereby denying borrowers the option of lowering their monthly mortgage payments; and
- Financing Points and Fees – Miller-Watt imposes a total prohibition on any financing of points and fees on high-cost loans, which together with the *de facto* prohibition on prepayment penalties would essentially mean that few, if any, high-cost loans could even be made.[13]

[12] The Pentalpha Group study on prepayment penalties attached as Appendix "D" explains this marketplace impact.

[13] If the lender assumed that the average high-cost loan would refinance after 24 months, the interest rate in most cases probably would have to be set at a prohibitively high level to be able to recoup the closing costs before a refinancing occurred. For example, assume refinancing after 24 months on a $150,000 high-cost loan with 6% in points and fees amounting to $9,000. Shifting these costs into the loan rate would raise a borrower's monthly payment by another $375 in order for the lender to recoup these costs ($9,000 divided by 24 months = $375). Thus, in this type situation, the entire loan model basically falls apart and the loan probably would not be offered as the borrower could not afford the payments.

As explained earlier, virtually no reputable lenders are making high-cost loans under restrictive state statutes, like North Carolina's, and we do not believe that they could do so under the Miller-Watt bill. **However, the far greater problem Miller-Watt poses is the adverse impact it would have on many nonprime borrowers who would be seeking to obtain a loan below the new HOEPA trigger thresholds.** Let me explain this problem.

Under current HOEPA, the 8% points and fees trigger does not include either the potential maximum prepayment penalty or yield spread premiums. It does include discount points, but this typically has not presented a problem for borrowers as there has been ample room under the 8% trigger to accommodate several discount points without crossing the high-cost threshold.

Both Ney-Kanjorski and Miller-Watt lower the 8% trigger to 5%, but they take very different approaches in dealing with prepayment penalties, YSPs and discount points. As noted above, Miller-Watt includes both YSP and the potential maximum prepayment penalty in the calculation of points and fees and its exclusion of discount points essentially does not apply with respect to most nonprime loans. The result of this is that in real terms the 5% trigger is more like 2% or less. **This forces the lender to put more costs into the rate, significantly raising the rate, and therefore raising the borrower's monthly payment.** The borrower also is generally no longer able to use discount points to buy down his or her rate or a prepayment penalty to lower the rate, and the *de facto* prohibition on the use of prepayment penalties would further cause all nonprime loans to go up about 1%.

The bottom line here is unmistakable and inescapable: Most nonprime borrowers would have no flexible loan financing options that are so essential to meeting their needs and circumstances, and would find that loans would be much less affordable. Moreover, many borrowers who want to purchase homes would find that, with the much higher rates and monthly payments they could no longer qualify for a large enough loan so they would have to shift to a less expensive home and a smaller loan.

For example, under current federal law and under Ney-Kanjorski, a borrower who qualifies for a 30-year, $160,000 fixed rate loan at an annual interest rate of 8%, and who elects to use a prepayment penalty to lower the rate to 7% and to pay 2 discount points to lower the rate further to 6 ½%, and who elects to finance the points and fees, can lower his or her monthly principal and interest payment from $1,174.02 to $1051.76 a difference of $122.26 per month. On the other hand, under Miller-Watt, not only would this borrower not be able to choose the prepayment and discount point terms to make the loan more affordable, but mortgage rates generally for all nonprime borrowers would be raised around 1% (because prepay penalties are essentially prohibited), so the borrower would be paying a 9% rate, instead of a 6½% rate, making this monthly payment $1313.14 instead of $1051.76 as under Ney-Kanjorski, or 25% more per month.

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OPTION ONE MORTGAGE

Ney-Kanjorski vs. Miller-Watt
Loan Affordability Comparison

NEY-KANJORSKI		MILLER-WATT	
Home Price	$200,000	Home Price	$200,000
Mortgage Loan	$160,000	Mortgage Loan	$160,000
Mortgage Terms		Mortgage Terms	
	30 years		30 years
	8% Fixed Interest Rate		8% Fixed Interest Rate
	1% Broker's Fee		1% Broker's Fee
	2% Discount Points		No Discount Points
	1% Lender's Fee		1% Lender's Fee
	2 year Prepayment Provision		No Prepayment Provision
Payment Calculation		Payment Calculation	
Total Loan Amount (finance points & fees)	$166,400	Total Loan Amount (finance points & fees)	$163,200
Interest Rate	6 ½ % (8% - 1% for prepay provision – ½ % for 2 discount points = 6 ½ %)	Interest Rate	9% *(Miller-Watt essentially prevents nonprime loans from offering prepayment provisions; this is projected to raise ALL nonprime borrowers' rates approximately 1%; so instead of being able to reduce an 8% rate to 7% with a 2 year prepay provision, the 8% rate would increase to 9% and the bill also essentially prohibits discount points)*
Monthly Payment	$1051.76 (= 25% Less than Miller-Watt)	Monthly Payment	$1313.14 (= 25% More than Ney-Kanjorski)

Mr. Chairman, I suspect this is a classic case of unintended consequences and I do not believe that the Miller-Watt bill's sponsors ever intended such adverse consequences for borrowers. In any case, I sincerely hope that the Committee will not adopt the overly restrictive approach on these flexible loan financing options that is proposed in the Miller-Watt bill. CFAL believes that Ney-Kanjorski's provisions here generally provide reasonable protections that preserve borrowers' choices and their options for making their loans much more affordable than under Miller-Watt. As I noted earlier, some of these Ney-Kanjorski provisions can be tweaked or tightened somewhat, but they are basically sound and should be retained.

CFAL Coalition for Fair and Affordable Lending

OPTION ONE

Other Provisions in Miller-Watt and Title I of Ney-Kanjorski

The remainder of my testimony will highlight CFAL's views on a number of other significant provisions in these bills.[14]

Preventing "Loan Flipping" – Both bills apply similarly-worded tangible benefit tests, and both require that violations be knowing or intentional. Miller-Watt includes the word "net" presumably to require overall netting of the possible benefits and detriments. CFAL does not favor adding this term as it only makes even more unclear what is required for compliance. Frankly, unless one is intimately familiar with all the personal financial circumstances facing a borrower and his or her family and their own personal values and aspirations, how can anyone make a judgment about what is best for them? Miller-Watt also would apply this benefit test to all loans, not just high-cost mortgages. Only five states apply the test to all home loans as Miller-Watt proposes.[15] The Ney-Kanjorski bill, like most states, does not apply the test to all loans. Instead, it applies the anti-flipping test only if a borrower is refinanced to a high-cost loan from either a non-high-cost loan or from another high-cost loan. CFAL supports the Ney-Kanjorski approach.[16] The bill's 2-year time limit is a reasonable compromise given the varying limits in the states that have such provisions.[17]

Miller-Watt fails to give any definition or guidance as to what is deemed to be a tangible net benefit, but at least gives the Federal Reserve Board discretion to define this critical term if it elects to do so. Ney-Kanjorski seeks to provide more guidance on what Congress intends to be considered an adequate benefit by drawing on the concept in South Carolina's law of providing a list of safe harbor situations where a lender could safely assume a benefit existed. While we strongly favor having safe harbors, we believe that several of the Ney-Kanjorski provisions can be tightened further to prevent abuse, and we will be submitting suggested language subsequently for doing so. One option that the Committee should consider would be to combine having certain specified safe harbors while requiring the Federal Reserve Board to issue regulations to further define what the tangible benefit requirement means similar to what Miller-Watt proposes.

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[14] More detailed comments on various issues in both bills are contained in Appendix "A."

[15] Due to market disruptions caused in substantial part by the vagueness of their anti-flipping tests, two states (Georgia and New Jersey) that initially applied this restriction to more than high-cost loans subsequently amended their laws to limit restrictions to just high-cost loans. Georgia's flipping prohibition now applies to high-cost loans only. New Jersey no longer even has a tangible benefit anti-flipping test.

[16] Ney-Kanjorski also includes a provision modeled on the Massachusetts law, allowing a court the discretion to deny attorney's fees in flipping cases where a reasonable settlement offer is rejected. We support this provision as it will encourage reasonable settlements instead of costly and slow litigation.

[17] In five states the limit is 1 year (as is in current federal law) and in one state the limit is 18 months. Limits ranging from 42 to 60 months apply in three other states, while six states have no time limit on their flipping test. Four states restrict points and fees or prepayment penalties charged on refinancings.

Ensuring Repayment Ability - Current federal law provides that a "pattern or practice" of disregarding repayment ability must be shown for a violation to occur. Federal Reserve Board (FRB) regulations also provide that if the lender engages in a pattern or practice of making loans without verifying and documenting the borrower's repayment ability there is a presumption of such a violation having occurred. Both Miller-Watt and Ney-Kanjorski would provide for violations on a case-by-case basis instead of having to show a pattern or practice, which has proven very difficult to do. Thus, both bills substantially tighten the current federal standard. It is unclear why Miller-Watt also retains the pattern or practice restriction as a separate prohibition. Advocacy groups have long argued that the pattern or practice requirement is too difficult to prove and that the repayment ability test should apply on an individual case basis.

Both bills use a 50% debt-to-income (DTI) repayment ability test in order for a presumption of repayment ability to apply. The Ney-Kanjorski bill also requires borrowers to meet a separate residual income test, the precise requirements of which would be set by FRB regulations.

As to verification, Miller-Watt would require income verification "by tax returns, payroll receipts, or other third-party income verification." The precise meaning of what is considered third-party income verification is unclear. In any case, this provision goes well beyond what is required in the North Carolina statute upon which the bill is generally based.[18]

CFAL favors the Ney-Kanjorski verification provisions which follow a more balanced multi-tiered verification approach. First, the lender could not benefit from a repayment ability presumption if the lender knew or "has reason to know otherwise" that the borrower did not meet either the DTI or residual income test. Next, it requires verification "by the credit application, the borrower's financial statement, a credit report or any other reasonable means," similar to the North Carolina law's requirement. Then, because greater protections may be needed for persons living on fixed incomes (e.g., seniors on Social Security), Ney-Kanjorski also requires "reasonable documentation of such fixed income, in addition to any statement by the consumer" in order for the repayment ability presumption to apply.

Because many people, including small business owners and a great many recent immigrants, do not have earned income from regular wages that is easily verified, Ney-Kanjorski provides for verification by a signed financial statement or other documentation that shows the borrower's income and obligations, but only if the lender also "has a reasonable basis for believing that the income exists and will support

[18] The North Carolina statute provides: *"An obligor shall be presumed to be able to make the scheduled payments to repay the obligation if, at the time the loan is consummated, the obligor's total monthly debts, including amounts owed under the loan, do not exceed fifty percent (50%) of the obligor's monthly gross income as verified by the credit application, the obligor's financial statement, a credit report, financial information provided to the lender by or on behalf of the obligor, or any other reasonable means."*

repayment of the transaction." Lenders can evaluate repayment ability and confirm the borrower has adequate income by reviewing credit reports, mortgage payment history, and other data without always having to have "third-party income verification" (whatever that means) as Miller-Watt would require.

Preventing "Steering" – Steering unknowing borrowers to more expensive loans than they otherwise qualify for is perceived to be a significant problem by many parties. However, only one state, California, has a provision that prohibits steering. The Miller-Watt bill does not address this issue. Ney-Kanjorski includes an anti-steering provision based largely on the California statute. It essentially requires that: (1) lenders may not steer a borrower to a product not based on the lender's best credit grade that the borrower qualifies for; and (2) brokers may not steer customers to less favorable products than those offered by lenders with whom the broker regularly does business. This steering prohibition includes a safe harbor provision that allows borrowers to voluntarily choose to accept a somewhat more costly loan for their own personal reasons, even if they may be able to obtain a less expensive loan. For example, many borrowers have immediate needs for funds and voluntarily select the loan that closes fastest even if it is a bit more expensive.

CFAL supports prohibiting improper steering, but this is a very complex issue and it is important that the steering language be workable and that it accomplish its legitimate objective. We support the Ney-Kanjorski provision's concept, but are still reviewing the technical wording to determine if it needs further refinement.

Limiting Mandatory Arbitration – Miller-Watt would ban mandatory arbitration on all home loans, whereas Ney-Kanjorski prohibits it only on high-cost loans. Not a single state prohibits mandatory arbitration on all loans as Miller-Watt proposes. Arbitration is strictly prohibited on "high-cost" loans in only 8 states.[19]

Arbitration can often be an effective, quicker and less expensive dispute resolution process for the borrower.[20] Some mortgage lenders use it, others do not. Arbitration also is used in many other types of consumer credit, securities and employment cases. However, because high-cost mortgage loan borrowers may be more vulnerable and need extra protections, the Ney-Kanjorski bill, like all states that impose arbitration restrictions, prohibits mandatory arbitration only on high-cost loans. We support the targeted approach taken by Ney-Kanjorski and all states.[21]

[19] Five other states with arbitration limitations allow an arbitration clause if it complies with certain requirements (e.g., if it meets the standards of a nationally recognized arbitration association).
[20] The Committee may wish to review an informative study done on arbitration by Ernst & Young entitled "Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases."
[21] Both bills also contain similar provisions allowing for non-binding post controversy agreements that essentially amount to mediation, but Ney-Kanjorski adds several additional safeguards as to how such voluntary dispute resolution processes are to be conducted.

Meaningful Right to Cure - The federal statute's cure provisions have long been found to be inadequate by the mortgage lending industry, and lenders view enacting a workable cure procedure to be a critical part of reforming lending requirements. Borrowers, as well as lenders, will benefit from having a quick and inexpensive error resolution process instead of having to engage in lengthy and costly litigation.

Both bills have a two-track cure provision, but Miller-Watt proposes a more limited provision than Ney-Kanjorski.

- Essentially, Miller-Watt would first allow the lender to cure any violation, intentional or otherwise, within 30 days of loan closing provided the borrower had not filed suit over the violation. Miller-Watt also would allow a lender to correct an error within 60 days of learning of the error provided the borrower has not notified the lender of the violation or initiated a lawsuit and the lender could prove the violation was unintentional or a bona fide error.
- Ney-Kanjorski would allow 45 days after closing for the error to be corrected, and correction could be made even if a suit had been instituted. It also would allow a correction within 60 days of discovery, provided the lender not only made full restitution but also paid the borrower a $2,000 error penalty and the borrower's reasonable attorney's fees, if any.

The Ney-Kanjorski approach, which we strongly favor, would provide for borrowers to have errors corrected quickly, without slow and costly litigation, and the lender penalty would give lenders incentive to avoid errors. However, the Committee may wish to consider whether clarifications or modifications may be needed to address borrowers' rescission rights in connection with a new error correction procedure. Currently, a borrower has an extended 3-year right of rescission, in addition to TILA's basic 3-day rescission right, for material breaches of HOEPA. Consideration should be given as to how rescission should interface with the new cure provisions.

Limited Assignee Liability – Strict assignee liability generally does not apply with respect to prime loans or to nonprime loans, with the exception of high-cost loans under HOEPA and under the laws of around a dozen states. Miller-Watt makes no change in the current HOEPA assignee liability provisions.

Most legislators have rejected applying such strict liability for assignees because it is not fair to hold innocent purchasers strictly liable for violations that they had no reasonable way of knowing had occurred. Legislators also have recognized that assignee liability can easily upset the secondary market.[22] If assignee liability is extended beyond

[22] Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Securitization has let us bring in vast amounts of capital from the national and global markets. This has both enabled the nonprime lending industry to make far more credit available and to

high-cost loans as some advocates want, there is a real danger that mortgage capital for all covered loans could dry up in many markets. For example, broad assignee liability was one of the key reasons the nonprime market literally shut down in Georgia and legislators were forced to make significant changes to the law. A similar situation occurred in New Jersey.

The fact is that high-cost loans to which overreaching assignee liability restrictions in HOEPA and certain states' laws apply are virtually never sold in the secondary market. Because there is no secondary market for high-cost loans, and competition is therefore limited as the major wholesale lenders that sell all their loans into the secondary market do not offer such loans, borrowers who can only qualify for a high-cost loan have to obtain them from a lender that retains the loan in its own portfolio. The common result for the borrower is that the loan is priced significantly higher than it otherwise would be if there was a competitive secondary market for these loans. Alternatively, if they can not obtain a high-cost mortgage loan, they may go to more expensive sources of capital, such as credit card advances.

The Ney-Kanjorski bill therefore seeks to refine HOEPA's excessive and unworkable liability on assignees by substituting more balanced language so that high-cost loans could be sold in the secondary market, and so the thousands of borrowers in every state who only qualify for such loans would have far more opportunity to obtain them at less cost. It draws upon several states' language relating to due diligence requirements to avoid liability. The bill basically seeks to apply assignee liability only when the purchaser knew or reasonably should have known that violations of the statute had occurred in originating the loans. This approach would shift from having a *de facto* prohibition on selling HOEPA loans in the secondary market to letting such loans be securitized, provided the applicable special substantive safeguards are met. CFAL supports the Ney-Kanjorski provisions.[23]

Borrowers in foreclosure who claim to be victims of abusive practices can and do sue both the originating lender and broker. The mortgage servicer also is typically sued and borrowers raise lending violations---even technical, unintentional and immaterial ones----as foreclosure defenses. Generally, the originator is required by the purchaser to buy back the loan from the secondary market purchaser (in practice, it's usually sold back as soon as the allegations are raised by the borrower) and if liability attaches, it normally is satisfied by the lender, broker, and/or servicer.

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dramatically decrease the rates we charge borrowers. However, overreaching assignee liability provisions, regardless of how well-intended, can easily disrupt our capital markets, and have a horrendous adverse impact on both credit availability and borrowers' credit costs. Unbalanced legislation can also hurt not only those who it is primarily intended to protect (e.g., those perceived as being most vulnerable), but it can also injure the many other people who make up the larger part of the overall nonprime market.

[23] CFAL's views on assignee liability are discussed further in earlier testimony given to these Subcommittees at: http://financialservices.house.gov/media/pdf/062304cfal.pdf (June 2004).

CFAL COALITION FOR FAIR AND AFFORDABLE LENDING

OPTION ONE

Other Titles in Ney-Kanjorski

In closing, I want to note that we also want to work with Committee members and other interested parties on the issues covered by the other titles in Ney-Kanjorski concerning consumer financial education and counseling opportunities; mortgage broker licensing requirements; loan servicing; and preventing appraisal abuses and "property flipping."

In particular, CFAL is especially interested in the provisions in Title II relating to housing counseling and borrower financial education that were developed under Rep. David Scott's leadership. We share Rep. Scott's confidence that provisions in the bill that mandate establishing and widely publicizing the existence of both a toll-free telephone number and an internet website that the public can use for information about reputable credit counselors to assist them in making mortgage decisions will be practical, important tools for helping consumers navigate the mortgage process intelligently. We want to stress the significance of the toll-free number as it provides a human touch connecting consumers to a live certified advisor who can provide assistance. In addition, we support Rep. Scott's concept of having the 800-number program develop data that may provide an early warning system regarding problem areas based on the call volume and questions asked.

We strongly believe that enhanced borrower educational opportunities are critical for empowering people to make more informed financial choices and to avoid abusive practices. The ultimate answer to many of these problems is education as Rep. Scott has recognized, not restrictive legislation. We think that the Committee also should consider having lenders pay a modest $2 fee when loans are recorded after closing to help support state and community based education and counseling programs. A portion of this fee also could be used as a funding mechanism for enhanced state enforcement efforts.

* * * *

CFAL is confident that the Financial Services Committee can work together on a bipartisan basis to fairly resolve the various issues addressed in these legislative proposals, and can report out a balanced bill that provides effective national standards for fair lending that protect nonprime borrowers without unduly limiting their financing options and access to affordable mortgage credit. We look forward to continuing to work constructively with Committee members and all other interested parties to help enact such legislation.[24]

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[24] Please contact CFAL's Executive Director, Wright Andrews (202-742-4245, wandrews@butera-andrews.com), if you have questions or would like further information about CFAL's positions or have technical issues.

APPENDIX "A"

CFAL

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
DEFINITIONS			
Applicable Loan Types	• Higher-Cost Mortgage defined to include consumer credit transactions secured by the borrower's principal dwelling. • Refinance, purchase money, closed-end and open-end loans are included, but reverse mortgages are excluded.	• High-Cost Mortgage defined to include consumer credit transactions secured by the borrower's principal dwelling. • Refinance, purchase money, closed-end and open-end loans are included, but reverse mortgages are excluded.	• Both Ney-Kanjorski and Miller-Watt significantly expand HOEPA's coverage by including loans made for the purchase of a home and mortgages that are structured as open-end loans (e.g., home equity lines-of-credit).
Points and Fees Defined	• All finance charges as defined in TILA, except interest and the time-price differential; • All compensation paid directly to the mortgage broker by or on behalf of the borrower (excluding borrower credits); • All third party fees listed in section 106(e), except for escrow for future payments of taxes or insurance, unless: • The charge is bona fide, competitive, and reasonable; • The lender receives no direct compensation; and • The charge is paid to a 3rd party whether or not affiliated; • All prepayment fees or penalties incurred by the borrower if the loan refinances a previous loan currently held by the same lender or its affiliate; and	• All finance charges as defined in TILA, except interest and the time-price differential; • All compensation paid directly or indirectly to the mortgage broker; • All third party fees listed in section 106(e), except for escrow for future payments of taxes or insurance, unless: • The charge is reasonable; • The lender receives no direct compensation; and • The charge is paid to an unaffiliated 3rd party; • Premiums or other charges for single premium credit insurance (excluding fees or premiums paid on a monthly basis); • The maximum prepayment fees and penalties which may be charged or collected under the terms of the loan document (does	• As noted below, for most loans, both bills significantly lower current law's 8% points and fees trigger to 5%, thereby including potentially many more loans. However, the two bills take fundamentally different approaches in defining what charges are to be included in the definition of "points and fees" for purposes of calculating this trigger percentage. It is critical to understand the radically different marketplace effects that would result. o Miller-Watt dramatically further increases the potential coverage by counting both the potential maximum prepayment that might be charged on the new loan (*even if never accessed*) (the limited exception for "conventional" prepayment fees is drafted so that essentially no nonprime loans could qualify) penalty and lender-paid indirect broker compensation (i.e., yield spread premiums that allow borrowers to have part of their costs paid by the lender in exchange for a slightly higher rate). And, while Miller-Watt allows for the exclusion of up to 2 bona fide discount points, this exclusion is limited so that in reality relatively few no nonprime borrowers could use discount points to "buy down" their rate to obtain a lower monthly payment. o Ney-Kanjorski follows current law, and the law in most states, and does not include potential maximum prepayment fees and lender-paid broker compensation. Including these items would in effect be "double counting" because both of these items are already reflected in the loan interest rate, which is subject to a separate APR (annual percentage rate) trigger. Ney-Kanjorski also allows for the exclusion of up to 2 bona fide discount points

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	• Excludes 2 bona fide discount points if the undiscounted interest rate is not more than 4% above Treasury securities with comparable maturity (i.e., essentially the conventional or prime mortgage rate)	not apply to conventional prepay fee); and • All prepayment fees and penalties if the loan refinances a previous loan made or held by the same lender or its affiliate. • Excludes 2 bona fide discount points if undiscounted interest rate does not exceed more than 1% above Fannie/Freddie 90-day standard net yield; or one bona fide discount point if within 2%.	that are used by many nonprime borrowers to "buy down" their rate. (It does limit the use of discount points by the highest-risk borrowers whose loans are more than 4% above the conventional loan rate). • The key point to understand here is the practical effect of these different approaches. The Miller-Watt bill's inclusion in the points and fees trigger calculation on most loans of potential maximum prepayment penalties, discount points and lender-paid broker compensation, which in reality in most nonprime loan transactions would have the actual effect of further lowering the trigger percentage not just 3% (from 8% to 5%), but another 2%-6%, means almost all nonprime loans as currently structured would be deemed "high-cost". o Most lenders currently refuse to make high-cost loans because of the high legal and reputational risks, there is no secondary market for them, and even fewer would likely make them under the proposed additional restrictions in the Miller-Watt bill. o Lenders would be forced to restructure loan pricing so that the lender paid all, or at least a large part, of the loan closing costs, thereby avoiding crossing the "points and fees" trigger. (This would pose a problem for some loans as this could cause the rate to exceed the separate APR trigger, and lenders generally would not make those loans.) o This in turn would mean that in order to recover these costs, lenders would have to charge much higher loan rates, meaning much higher monthly payments, which would make loans much less affordable for nonprime borrowers. Many borrowers also could not even qualify for a loan as the new higher monthly payment would prevent them from meeting debt-to-income repayment ability tests. In order to qualify under the debt-to-income test many borrowers would have to purchase a less expensive home. • As explained further below, the Ney-Kanjorski bill would allow borrowers the choice of "loan affordability" financing options like: (1) accepting a prepayment penalty in exchange for a lower rate; or (2) having some of the compensation they would have to pay the broker paid by the lender in exchange for a slightly higher rate; or (3) using discount points to 'buy down" their rate so they can

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			have more affordable monthly payments. Miller-Watt's various direct and indirect limitations on such items have the opposite effect and make loans less affordable for many borrowers. • Both bills would require that the prepayment penalty on the prior loan be counted in the trigger calculation if the lender or its affiliate holds the prior loan. However, Miller-Watt would also require that the prepayment penalty on the prior loan be counted even if the lender or its affiliate no longer was the holder of the prior loan. • Ney-Kanjorski refines current law with respect to the treatment of fees paid to affiliates. o Current law generally excludes fees paid to third parties (e.g., appraisal fees, title search fees, etc.), but requires that lenders include these fees if paid to an affiliate. o Thus, even if an affiliate can provide a better service at a less expensive price, the lender must include it in the trigger calculation. o Recognizing the anti-competitive effect of an affiliate fee restriction in today's marketplace, and the fact that potential abuses can be controlled by adding other safeguards, Ney-Kanjorski allows affiliate fees to be excluded, provided certain requirements are met. o It provides that the fee can only be excluded like other third party fees if it actually is paid to the affiliated third party, if the lender receives no direct compensation for the service, and most importantly, if the fee paid for services to the affiliate is reasonable and competitive with prices offered by other non-affiliated service providers. • We understand that the intent of Ney-Kanjorski is to continue to exclude lender-paid broker compensation from the points and fees trigger calculation as HOEPA does currently. o Technical clarification should be made in the bill's language to clarify the sponsors' intent. o On the other hand, if the Committee ultimately determines that there should be a limit on such indirect compensation, we urge that it allow for

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Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			at least 2% yield spread premium. • We also understand that the sponsors intend to correct a drafting error and include single premium credit insurance and comparable products in the trigger calculation. Lenders generally no longer offer such products in connection with mortgage loans. CFAL supports making this technical correction to in essence prohibit offering such products in connection with mortgage transactions.
Bona Fide Discount Points	• Must be knowingly paid by the borrower for the express purpose of lowering the interest rate (IR); must reduce the loan IR from an IR which does not exceed the benchmark rate which is 4% over comparable Treasury securities; and must reduce the IR by a minimum of 25 basis points per discount point so long as other terms of the loan remain the same.	• Must be knowingly paid by the borrower for the purpose of reducing, and which in fact results in a bona fide reduction of, the interest rate or time-price differential applicable to the mortgage; the reduction must be reasonably consistent with established industry norms and practices for secondary market transactions.	• Both bills contain similar definitions of bona fide discount points. Ney-Kanjorski's approach is arguably more restrictive as it requires at least ¼ % discount per point paid. • Miller-Watt's "industry norms" approach may be more flexible as in reality industry norms and practices vary considerably and lenders in many cases might be reasonably consistent even if they gave less than ¼% discount. • Committee Members should keep in mind that while HOEPA's current points and fees trigger has included discount points in the trigger calculation, that has not presented a problem with respect to borrowers using them to buy down their rates as the 8% trigger level is high enough to accommodate up to 2 discount points in most cases if borrowers choose this option for lowering their monthly payments. • Under the new much lower 5% trigger level proposed in Ney-Kanjorski and Miller-Watt, it would be much more difficult to use discount points without crossing the higher-cost loan threshold unless the bills provide for some workable limited exception. • To deal with this concern, Ney-Kanjorski allows for the exclusion of up to 2 bona fide discount points, but only if (1) the specified safeguards---such as providing a minimum of ¼ % discount per point---are met; and (2) the loan's interest rate is within 4% of a comparable Treasury security. This would allow a limited use of discount points on most nonprime loans, but not on the more expensive loans with rates exceeding the 4% over Treasury level. • Miller-Watt provides for a far more restrictive exclusion for discount points, and its practical effect is to prevent any exclusion for most nonprime loans. Under Miller-Watt, if the loan rate is within 1%, or in some cases 2%, of the "required

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			net yield on a 90-day standard mandatory delivery commitment for a reasonably comparable loan" (i.e., basically a conventional, or 'prime' loan rate) from Fannie or Freddie (whichever is greater), 1 or 2 discount points could be excluded, provided there was no exclusion for prepayment penalties. In practice, this would prevent discount points from being used on most nonprime loans because their rates exceed these percentages due to the borrowers' higher risks.
THRESHOLDS (Triggers)			
APR Thresholds - High-Cost Loans	• Cannot exceed 8% over comparable T-Bill; 10% over comparable T-Bill for a junior lien.	• Cannot exceed 8% over comparable T-Bill; 10% over comparable T-Bill for a junior lien.	• Both bills retain the current APR triggers. • Retaining these trigger levels is important because lowering the points and fees trigger as is done elsewhere in both bills leads to shifting more fees into the rate which means that many more loans may come near or exceed the APR trigger.
Points and Fees Threshold – High-Cost Loans	• Higher-cost loan if points and fees as defined in the bill exceed 5% of the total loan amount, if the loan amount is greater than $40,000, or exceed 6% if the loan amount is less than or equal to $40,000.	• High-cost loan if points and fees as defined in the bill exceed 5% of the total loan amount, if the loan amount is greater than $20,000 (to be adjusted annually by FRB, but must stay within 6-10%), or the lesser of 8% or $1,000, if the loan amount is less than or equal to $20,000 (to be adjusted annually by FRB, but must stay within 8-12%).	• Both bills lower the HOEPA points and fees trigger percentage from 8% to 5%, but Ney-Kanjorski applies it to loans over $40,000 while Miller-Watt would apply it to loans starting at $20,000. • Ney-Kanjorski would use a 6% trigger for smaller loans of $40,000 or less, whereas Miller-Watt would use the lesser of 8% or $1,000 on loans of $20,000 or less. • Miller-Watt would allow for annual adjustment by the Federal Reserve Board, but limit the range to 6%-10% for loans over $20,000, and to 8%-12% for loans of $20,000 or less. • The Committee should consider whether either bill provides an adequate trigger level for smaller loans. For example, it typically takes about the same amount of work to do a smaller $50,000 second mortgage as a $150,000 first mortgage, yet the trigger amount may be very different----5% x $50,000 = $2,500 vs. 5% x $150,000 = $7,500. That being the case, it probably would be reasonable to have a somewhat higher % for smaller loans than either bill provides and to raise the amount to at least $50,000. • Having an unrealistically low trigger for smaller loans can be disadvantageous to the borrower. For example, if a broker can not make a reasonable commission on a small second mortgage, the loan might not be offered and the borrower would

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Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			have to obtain needed funds by refinancing the first mortgage, paying even higher costs.
Prepayment Penalties Threshold – High-Cost Loans		• Adds a new trigger making a loan high-cost if: (1) the loan documents permit the lender to charge or collect a prepayment penalty of more than 30 months after the loan closing, or (2) which exceeds, in the aggregate, 2% of the amount prepaid.	• If this new trigger provision applied, a substantial portion of today's nonprime loans---as well as many prime loans----would become "high cost" loans. • The effect of this Miller-Watt provision would be to force lenders to limit the few prepayment penalties that would be otherwise allowed to at most 30 months and 2% of the amount prepaid. • As will be discussed subsequently, other provisions in Miller-Watt have the effect of preventing prepayment penalties from even being offered on most nonprime loans, and further limiting prepayment penalties as here can only have adverse impacts on loan affordability.
PROHIBITED PRACTICES			
Financing Points and Fees	• Prohibited in excess of 5% of the total loan amount (or 6% for loans that do not exceed $40,000). • If any portion of the points and fees are financed, disclosure is required with a statement that such treatment of any such point, fee, or charge is not legally required.	• No financing of any points and fees on a high-cost loan. • Prohibits financing of any prepayment penalty payable by the borrower in a refinancing transaction if the lender or its affiliate is the holder of the note being refinanced.	• Only North Carolina and Indiana prohibit financing of points and fees as is done in Miller-Watt. Four other states limit financing to 3% or less of the loan amount, and four others impose financing limitations ranging from 5% to 8%.[1] The Ney-Kanjorski bill would establish a reasonable uniform standard, which is more restrictive than most states, at 5% (like Massachusetts) over which points and fees cannot be financed. • Ney-Kanjorski imposes a 5% financing limit on higher-cost loans instead of prohibiting the financing of points and fees on such loans as Miller-Watt does because Ney-Kanjorski seeks to follow the approach of reasonable and balanced regulation and offers borrowers pricing choices instead of imposing prohibitions that make loans far less affordable for them. • Current federal law imposes no limitation on financing closing costs and, as noted above, only two states prohibit financing such costs on higher-cost loans. This is not surprising because typically higher-cost loan borrowers, just like many prime borrowers, lack the cash to pay closing costs out-of-pocket. Most such borrowers, and in fact many prime borrowers, will voluntarily select the option of

[1] One state, Kentucky, has a 4% limitation on financing of prepayment charges and certain points and fees in cases where a lender is refinancing its own loan or that of an affiliate.

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis

			financing the costs as a part of the loan because this makes the loan much more affordable for them----in many cases it will mean the difference between fulfilling their dreams of home ownership or not being able to afford a home of their own.
			• Higher-cost borrowers, because of the increased risks they pose, already have to pay higher rates, and if they lack the available cash and can not finance a reasonable amount of closing costs, their options become much more limited or disappear.
			    o In some cases they may be able to borrow to pay the costs from even more expensive sources, such as a credit card cash advance, or an unsecured personal loan that may be undocumented (and its costs may not be taken into account when calculating repayment ability), or a pawnshop loan.
			    o Another approach would be for the lender to pay the costs and try to recoup them by charging an even higher interest rate. Obviously, a higher rate would mean higher monthly payments and would make the loan much less affordable as has been explained earlier.
			• However, the Miller-Watt prohibitions against both financing points and fees and having prepayment penalty options actually make it questionable whether in most cases higher-cost loans could even be offered at all.
			    o If the lender assumed that the average higher-cost loan with a high interest rate would refinance after 24 months, the rate in most cases probably would have to be set at a prohibitively high level to be able to recoup the closing costs before a refinancing occurred. For example, assume refinancing after 24 months on a $150,000 higher-cost loan with 6% in points and fees amounting to $9,000. Shifting these costs into the loan rate would raise a borrower's monthly payment by another $375 ($9,000 ÷24 = $375) in order for the lender to recoup these costs. Thus, in this type situation, the entire loan model basically falls apart and the loan probably would not be offered as the borrower could not afford the payments.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			• Miller-Watt also prohibits the financing of any prepayment penalty on a loan that is refinancing a loan made by the loan holder or an affiliate. (Elsewhere, Miller-Watt also requires that any such prepayment penalty, or one on a loan currently held by the lender or its affiliate, even if not made originally by the holder or its affiliate, must be counted in the points and fees when calculating the 5% trigger.)
Counseling	• When making a higher-cost loan, a lender must provide (as specified by regulation issued by the Federal Reserve Board) a written statement recommending counseling and a list containing the names, addresses, and phone numbers of HUD- or state-approved counselors. • Failure to provide a complete and updated list as reasonably possible constitutes a violation of this section. • The bill includes separate provisions expanding housing counseling and educational programs and related activities. Among other things, it would create a new HUD office to better administer such programs and improve program standards. The legislation authorizes additional funding through 2009 for such counseling. In addition, other provisions would allow borrowers to opt-in at the time of	• Before making a loan a lender must receive a certification from a HUD- or state housing authority-approved counselor. The counselor may not be employed by the lender or its affiliate. • The counselor must verify that the borrower has received all the disclosures as required by RESPA and Section 129 of HOEPA, prior to issuing a certification. • The FRB may prescribe regulations "requiring or encouraging" lenders to provide consumer mortgage education to prospective customers or to direct them to qualified education or counseling programs in there area. However, no FRB requirement is to be construed as affecting or superseding any state requirement regarding consumer mortgage counseling or education.	• Miller-Watt takes the approach of requiring mandatory counseling on higher-cost loans. • However, most state anti-predatory lending laws, which according to Ney-Kanjorski opponents are so effective, have no such counseling requirement. And, in North Carolina and the six other states that do require mandatory counseling on higher-cost loans, almost no such counseling occurs. Why? Because virtually no high-cost loans are being made under most such states' overly restrictive laws. No counseling is done when loans are not offered. • Ney-Kanjorski takes the approach of the large majority of states and does not force borrowers to undergo mandatory counseling. What it does require, however, is that lenders always recommend that borrowers who are getting higher-cost loans should consider having counseling and that lenders provide timely information to the borrowers on how to obtain such counseling. • Miller-Watt's provision granting the Federal Reserve Board unfettered discretion to require lenders to provide mortgage education to customers causes lenders concern as burdensome and costly requirements might be imposed. • Ney-Kanjorski's provisions reorganizing HUD's counseling and educational programs may provide more effective and efficient borrower education, but these provisions also merit further scrutiny by the Committee to determine if they offer the optimum approach for improving HUD's operations. • Enhancing counseling and educational programs and expanding the availability of such programs should be viewed as a priority issue as almost all parties agree that consumer financial education is critically important to empowering borrowers and helping prevent abusive lending practices. • Among other things, the Committee may want to give further consideration to what more might be done to ensure non-English speaking borrowers' special

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	loan closing to special foreclosure prevention counseling assistance, which would be available to them if they later have difficulty repaying their mortgage loans.		educational and counseling needs are adequately addressed.
Flipping	• Prohibited from knowingly or intentionally engaging in the unfair act or practice of loan flipping. • "Flipping" is defined as refinancing a home loan with a higher-cost mortgage within the next 24 months after closing without a "reasonable tangible benefit" considering all material circumstances known to the lender. • Ney-Kanjorski would provide guidance as to what would be considered an acceptable benefit by listing a number of safe harbors whereby the loan would be presumed to provide a benefit if the criteria listed in any of the safe harbors applies.[2]	• Prohibited from knowingly or intentionally engaging in the unfair act or practice of flipping. • "Flipping" is defined as refinancing an existing mortgage without a "reasonable tangible net benefit." • Benefit would be determined by "considering all of the circumstances, including the terms of both the new and the refinanced loans or credit, the cost of the new loan or credit, and the borrower's circumstances." • The net benefit test does not have a time limitation and it would apply to ALL loans, not just high-cost loans. • The Federal Reserve Board would	• Both bills apply relatively similarly worded tangible benefit tests, and both require that violations be knowing or intentional. Miller-Watt includes the word "net" presumably to require some degree of overall netting of the possible benefits and detriments. CFAL does not favor adding this term as it only makes even more unclear what is required for compliance. • Only five states apply the test to all home loans as Miller-Watt proposes.[4] • The Ney-Kanjorski bill, like most states, does not apply the test to all loans. Instead, it targets the anti-flipping test to apply if a borrower is refinanced to a higher-cost loan from either a non-higher-cost loan or from another higher-cost loan. The bill's 2-year time limit is a reasonable compromise given the varying limits in the states that have such provisions.[5] • Miller-Watt fails to give any definition or guidance as to what is deemed to be a tangible benefit, but at least gives the Federal Reserve Board discretion to define this critical term if it elects to do so. • Ney-Kanjorski seeks to provide more guidance on what Congress intends to be considered an adequate benefit by drawing on the concept in South Carolina's law of providing a list of safe harbor situations where a lender could know a benefit existed. • CFAL believes that several of the bill's safe harbor provisions should be

[2] The Ney-Kanjorski safe harbors are: (A) the purpose of the higher-cost mortgage is to finance a personal investment or a purchase or acquisition of real property that is not the principal dwelling of the borrower; (B) the interest rate on the new fixed-rate higher-cost mortgage is lower than the interest rate on the fixed-rate refinanced loan and it will take 4 years or less for the borrower to recoup the costs of the points and fees, and other closing costs that are required to be paid by the borrower on the new higher-cost mortgage through savings resulting from the lower interest rate; (C) the lender makes a good-faith determination that the borrower's monthly payment to pay the higher-cost mortgage is a minimum of 15 percent less than the total of all minimum monthly payments on the obligations being financed, based on a borrower credit report or other reasonable documentation utilized by the lender; (D) any cash

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	• If no safe harbor applies, "factors to be considered may include the terms and conditions of both the new and refinanced loan, the borrower's known economic and non-economic circumstances, the purpose of the loan, and the cost of the new loan." • Prohibits refinancing a special mortgage[3] (e.g., below-market interest rate or subsidized loan) made by any government agency, government-sponsored enterprise, or nonprofit corporation if it is apparent on the face of the security instrument for the existing loan that it is a special mortgage and if the borrower would lose one or more of the benefits of the	be allowed, but not required, to define the meaning of the term "tangible net benefit".	tightened and/or refined and we will be submitting technical language subsequently to the Committee suggesting how this can be done. • One option that the Committee might want to consider would be to agree upon having certain specified safe harbors, while requiring the Federal Reserve Board to issue regulations to further define what the tangible benefit requirement means similar to Miller-Watt would do. • Miller-Watt does not include a special provision relating to refinancing below-market type loans, such as a Habitat for Humanity loan, as is contained in Ney-Kanjorski and some state laws. Ney-Kanjorski addresses a serious concern lenders have raised to such provisions regarding knowing what loans are "special mortgages" by requiring that it must be apparent on the face of the security instrument that the existing loan is in fact a special mortgage. • Ney-Kanjorski also includes a provision modeled on the Massachusetts law, allowing a court the discretion to deny attorney's fees in flipping cases where a reasonable settlement offer is rejected.

proceeds paid either to the borrower, or on behalf of the borrower, above the payoff of the refinanced loan are in excess of twice the amount of total points and fees and closing costs that are required to be paid by the borrower; (E) the refinanced loan is changed from a loan that is not a fixed-rate fully-amortizing loan to a fixed-rate fully-amortizing loan; (F) the terms of repayment of the refinanced loan are changed from a longer full amortization term to a shorter full amortization term by at least 5 years; (G) the borrower presents a certificate, dated not more than 90 days prior to the date of the application for the new higher-cost mortgage, from an independent housing or credit counselor approved by the United States Department of Housing and Urban Development, or by any State regulatory agency, which states that the borrower has received counseling with regard to refinancing the existing loan; (H) the borrower provides the lender with a written, signed statement not prepared by the lender, at or before the consummation of the new higher-cost mortgage, that the new loan is needed to meet a bona fide personal or family financial, health or medical emergency, or to avoid a filed foreclosure action; or (I) the refinancing is necessary under, or in response to, any order or judgment of a court of competent jurisdiction.

[3] The loan would have to have, by at least 2 percentage points, a below-market interest rate as of the date of its consummation; or non-standard payment terms beneficial to the borrower, such as payments that vary with income or are limited to a percentage of income, or terms that permit the borrower to make no payments under specified conditions.

[4] Due to market disruptions caused in substantial part by the vagueness of their anti-flipping tests, two states (Georgia and New Jersey) that initially applied this restriction to more than high-cost loans subsequently amended their laws to limit restrictions to high-cost loans. Georgia's flipping prohibition now applies to high-cost loans only. New Jersey no longer even has a tangible benefit anti-flipping test.

[5] In five states the limit is 1 year (as is in current federal law) and in one state the limit is 18 months. Limits ranging from 36 to 60 months apply in four other states, while five states have no time limit on their flipping test.

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	special mortgage, without either express written consent of the holder of the loan or certification from a person or organization certified by HUD that the borrower obtained credit counseling. • A borrower may not recover the costs of the action and attorney's fees for violations of this section if the court determines that the borrower turned down a reasonable offer of remedy and compensation.		
Ability to Repay	• Deletes HOEPA's requirement that a "pattern or practice" of failure to consider repayment ability must be shown before a violation can be established and allows a violation to be shown on an individual case basis. • A lender may not extend credit without considering a borrower's ability to repay including his or her current and expected income, current obligations, and employment. • Presumption of ability to repay if (1) total monthly debt payments do not exceed 50% of the	• Retains HOEPA's pattern or practice prohibition as a separate violation, adding that a violation is presumed if the lender engages in a pattern or practice of making high-cost loans without verification. • Adds an additional violation for individual cases, providing that a lender may not make a high-cost loan if the lender does not reasonably believe that the borrower will be able to make the scheduled payments, based upon a consideration of current and expected income, current	• Current federal law provides that a "pattern or practice" of disregarding repayment ability must be shown for a violation to occur. Federal Reserve Board (FRB) regulations also provide that if the lender engages in a pattern or practice of making loans without verifying and documenting the borrower's repayment ability there is a presumption of such a violation having occurred. • Both Miller-Watt and Ney-Kanjorski would provide for violations on a case-by-case basis instead of having to prove a pattern or practice, which has proven very difficult to do. Thus, both bills substantially tighten the current federal standard. It is unclear why Miller-Watt also seems to retain the pattern or practice restriction as a separate prohibition. Advocacy groups have long argued that the pattern or practice requirement is too difficult to prove and that the repayment ability test should apply on an individual case basis. • Both bills use a 50% debt-to-income (DTI) repayment ability test in order for a presumption of repayment ability to apply. • The Ney-Kanjorski bill also requires borrowers to meet a separate residual income test, the precise requirements of which would be set by FRB regulations.

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	monthly gross income, as verified by the credit application, the borrower’s financial statement, a credit report, or any other reasonable means; and (2) the borrower has sufficient residual income to pay essential monthly expenses (as defined by FRB regulation).
	• If repayment ability is based primarily on fixed income (from a public or private source), then income verification must include reasonable documentation of such fixed income, in addition to any statement by the borrower.
	• In the case of a borrower without regular earned or fixed income, the borrower must sign a financial statement or provide other documentation showing the borrower’s income and debt obligations, and the lender must have a reasonable basis to believe that the income exists and will support the repayment.
	• The absence of any means of verification does not create a presumption of a violation.
		obligations, employment status, and other financial resources, other than equity in the residence.
		• A borrower is presumed to be able to repay if the borrower’s total monthly debts (including the amount owed under the loan) do not exceed 50% of the borrower’s monthly gross income, as verified by tax returns, payroll receipts, or other third-party income verification.
			The Committee should give consideration to making the residual income test an alternative, instead of a second test.
			• As to verification, Miller-Watt would require verification “by tax returns, payroll receipts, or other third-party income verification.” The precise meaning of what is considered third-party income verification is unclear. In any case, Miller-Watt goes beyond what the North Carolina law which provides: *“An obligor shall be presumed to be able to make the scheduled payments to repay the obligation if, at the time the loan is consummated, the obligor's total monthly debts, including amounts owed under the loan, do not exceed fifty percent (50%) of the obligor's monthly gross income* *<u>as verified by the credit application, the obligor's financial statement, a credit report, financial information provided to the lender by or on behalf of the obligor, or any other reasonable means</u>.”*
			
			• Ney-Kanjorski adopts a multi-tiered verification approach.
			  o First, the lender would not benefit from a repayment ability presumption if the lender knew or “has reason to know otherwise” that the borrower did not meet either the DTI or residual income test.
			  o Next, it requires verification “by the credit application, the borrower’s financial statement, a credit report or any other reasonable means.”
			  o Then, because greater protections may be needed for persons living on fixed incomes (e.g., seniors on Social Security), Ney-Kanjorski also requires “reasonable documentation of such fixed income, in addition to any statement by the consumer” in order for the repayment ability presumption to apply.
			  o Also, because many people, including business owners and a great many recent immigrants, do not have earned income from regular wages that is easily verified, it provides for verification by a signed financial statement or other documentation that shows the borrower’s income and obligations, but only if the lender also “has a reasonable basis for believing that the income exists and will support repayment of the transaction.” Lenders can evaluate repayment ability and confirm the borrower has adequate

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			income by reviewing credit reports, mortgage payment history, and other data without always having to have "third-party income verification" as Miller-Watt would require.
Prepayment Penalties	• Prepayment penalties are allowed on all loans, not just higher-cost, but only if (1) the penalty cannot be imposed due to debt acceleration from default or breach of loan terms; (2) the penalty period is limited to 36 months; (3) the borrower is given a choice of a similar loan without a penalty and informed of potential benefits and detriments of the penalty; and (4) the amount is limited to 6 months' interest on the amount prepaid in any 12 month period in excess of 20% of the original principal balance (i.e., 80% of 6 months' interest). • The Federal Reserve Board must prescribe regulations as needed to enforce this section's requirements.	• Prepayment penalties are allowed for high-cost loans only if: (1) the borrower's monthly debts do not exceed 50% of his or her monthly gross income; (2) the penalty applies only to prepayment made with funds obtained by other means than refinancing by a lender or its affiliate; (3) the penalty does not apply after the end of a 30-month period beginning at consummation and does not exceed 2% of the loan amount; (4) the principal of the mortgage exceeds the maximum under section 203(b)(2) of the National Housing Act for the same area; and (5) the penalty is not prohibited under other applicable law. • Also, any method of computing a refund of unearned scheduled interest is deemed to be a prepayment penalty if it is less favorable to the borrower than the actuarial method.	• Miller-Watt contains a series of restrictions on prepayment penalties that have the collective practical effect of prohibiting the use of such penalties on almost all nonprime loans. • If borrowers are in effect denied the choice of having a prepayment penalty clause in exchange for a lower interest rate, the interest rates on all nonprime loans would have to be significantly higher in order to recoup costs, resulting in a much higher monthly payment. This would mean that loans would become much less affordable for many borrowers, and many would not even be able to qualify for a loan because they would fail the debt-to-income test when the higher monthly payments were factored into the calculation. If they do not have this option, not only can they not lower their rate ½ % to 1%, but it is likely that rates on all borrower' loans would have to be increased by around 1% according to current economic analysis. • The Miller-Watt bill's limitation that a penalty could not be longer than 30 months or over 2% of the loan amount without the loan being deemed a high-cost loan also would mean in the relatively few cases where a penalty option could be offered that the value of the penalty in terms of reducing the borrower's rate (or in some cases, closing costs) would be relatively limited. • Ney-Kanjorski takes a fundamentally different approach of adopting reasonable and effective regulations regarding prepay penalties instead of restrictions that in effect prohibit penalties. o The Ney-Kanjorski 3-year limit, which is consistent with Freddie Mac's limitation, is quite reasonable as a maximum time period for all types of nonprime loan products. It is 2 years less than the current 5-year limit that applies under HOEPA and some state laws. o A 3-year limit is generally recognized as the industry best practices standard for fixed rate loan products. Lenders also limit penalties further on certain products. For example, one of today's popular products is the

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			so-called "2/28" 30-year adjustable rate mortgage (ARM) where the rate can adjust upward after an initial fixed rate period of 2 years. On this type product, lenders generally offer a 2-year prepayment penalty option so the borrower can more easily refinance if the rate adjustment turns out to be substantial. A shorter prepayment period, however, also typically means less of a rate reduction. o Quite importantly, Ney-Kanjorski requires that the borrower be given a choice of a loan without the penalty option and an explanation of the possible benefits and detriments of choosing a loan with the penalty option. o It also limits the amount of the penalty based on California's "6 months' interest" rule, under which borrowers may annually prepay up to 20% of the loan balance without penalty. • Critics often forget, or do not mention, the ongoing benefit and the potential longer term benefit that borrowers receive when they elect a prepayment penalty option. For example, assume a $150,000 loan with an 8% interest rate and a 1% savings on the rate by choosing the penalty option (i.e., otherwise the rate would be 9%). Under the California rule contained in Ney-Kanjorski, the maximum amount of the penalty would be 6 months' interest on 80% of the amount prepaid, which would be $4,800 ($150,000 x .8 = $120,000 subject to the penalty. 6 months' interest on that amount would be $120,000 x .08 divided by 2 = $4,800). The 1% reduction in rate would amount to a savings of $106.25 per month on the monthly payment. If a borrower decided to refinance after 26 months, the borrower would have to pay $4,800, but at that point would have received $2,763.28 in benefit by having the lower rate, so the net cost would really only be $2,036.72 ($4,800 - $2,763.28 = $2,036.72). On the other hand, if the borrower waited 4 years to refinance (which for many is increasingly likely in today's rising rate environment), the borrower would have saved $5,101.44 in mortgage payments, and not have to pay a penalty.
Single Premium Credit Insurance	• Prohibited from offering or selling of single premium credit	• No financing of any single premium credit life, credit	• Miller-Watt prohibits the financing of single premium credit insurance and comparable products on all loans and in another provision requires the cost of

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	insurance or any analogous non-insurance product. Expressly applies prohibition to debt cancellation or suspension agreements. • Exception for such products paid on a monthly basis.	disability, credit unemployment or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract. • Restriction applies to all home loans, not just higher-cost. • Exception for such products paid on a monthly basis.	such products to be included in the points and fees trigger calculation. The practical effect of these provisions is to prohibit the sale of such products. • Ney-Kanjorski takes the direct approach of prohibiting such products in connection with higher-cost loans. We understand that due to a drafting oversight, that bill failed to include the cost of such products in the trigger calculation as is currently done pursuant to HOEPA regulations, and that the sponsors intend to correct this during Committee consideration. • Lenders generally no longer even offer such products, and we support prohibiting the sale of such products in connection with all mortgage loans.
No Lending Without Specific Disclosures	• Adds 4 new disclosures: (1) "The interest rate and the amount of fees you pay on this loan are higher than most people pay for conventional or 'prime' rate loans. As a result, your monthly interest payments are higher than those on a comparable loan with a lower interest rate." (2) "The rate of interest and the amount of fees you pay on a loan may vary depending on which lender or broker you select. You may be able to get a loan with a lower interest rate. Your credit score can provide an indication of whether you may qualify for a lower-cost prime loan. If you have a relatively good credit risk score, such as a		• Ney-Kanjorski's addition disclosure provisions appear to be reasonable and may help borrowers better understand the loan transaction. • The bill also provides that the FRB can determine what is considered a prime rate loan for purposes of the disclosure statement.

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	FICO score in excess of 660, you may qualify for a 'prime' loan. In that event, you should consider shopping more for a lower-cost loan instead of simply accepting the higher-cost loan that has been offered to you." (3) "If you are taking out this loan to repay other loans, look to see how many months it will take to pay for this loan and what the total amount is that you will have to pay each month before this loan is repaid. Even though the total amount you will have to pay each month for this loan may be less than the total amount you are paying each month for those other loans, you may have to pay on this loan for a longer period than those other loans and that may cost you more overall." (4) "You may get into serious financial difficulties if you use this loan to pay off old debts and then replace them with other new debts." • Regulations for disclosures - The FRB may amend the definition and determination of a prime rate loan.		

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Late Fees	• Prohibits late charges for all consumer credit transactions secured by a house occupied as a principal dwelling (not just higher-cost) in excess of 5% of the amount of scheduled past due payments and requires that late fees may not be charged more than once with respect to single late payments and may only be assessed on payments past due for 15 days or more. • The Federal Reserve Board must prescribe regulations as needed to enforce this section's requirements.	• No late payment charge: (1) greater than 4% of the amount past due, (2) unless authorized by the loan documents; (3) before the end of the 15-day period beginning on the date when the payment is due (of the 30-day period in the case of a loan on which interest on each installment is paid in advance); or (4) more than once with respect to a single payment. • A provision also is included to require in essence that if a payment is paid in full within the allowed time, a late fee cannot be imposed on it relating to an earlier unpaid late fee.	• Both bills contain relatively similar late charge provisions, with Ney-Kanjorski using a 5% maximum and Miller-Watt using a 4% maximum, but Ney-Kanjorski applies the restriction to all loans, not just higher-cost loans.
Payoff Statement	• A payoff statement must be delivered within 7 business days of request and a payoff/demand fee is prohibited. • No fee is allowed for the first 2 payoff requests in any continuous 6-month period. After that, a fee must be reasonable. • Also, the lender may charge a "processing" fee for faxing or courier service delivering the payoff/demand statement. The	• A payoff statement must be delivered within 5 business days of request and a payoff/demand fee is prohibited. • The lender may charge a reasonable fee after 4 requests in any calendar year. • Also, the lender may charge a "processing" fee for faxing the payoff/demand statement. The fee must be comparable to other similar services. • The lender must disclose that	• Both bills contain relatively similar provisions. • Miller-Watt requires that 4 payoff balance statements be available without cost per year, whereas Ney-Kanjorski allows 2 no-cost statements within any continuous 6-month period. • Miller-Watt requires the payoff statement within 5 business days, whereas Ney-Kanjorski allows 7 business days.

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	fee must be comparable to that for other similar services.	payoff balances are available for free.	
Credit Reporting	• Lenders must furnish to a nationwide credit reporting agency on a monthly basis the complete payment history, favorable and unfavorable, of the obligor with respect to all higher-cost mortgages held or serviced by such lender, successor, assignee, or servicer. • Exception for those persons holding the loan for less than 90 days. • Exception for loan forbearances, work-outs, dispute or consumer complaint settlements.		• Most, but not all, lenders now report mortgage payment data to credit bureaus so that a more accurate credit history is available when credit inquiries are made. • Ney-Kanjorski adds a provision requiring reporting to credit bureaus on a monthly basis with regard to payment history on higher-cost mortgages. • The Committee should consider expanding this requirement to all home mortgages.
Arbitration	• Mandatory arbitration is prohibited for higher-cost loans. • Post-controversy voluntary arbitration is allowed as a method for resolving any controversy at any time after a dispute or claim arises, but cannot be interpreted as barring a borrower from subsequently bringing an action in court.	• No consumer credit transaction secured by the borrower's principal dwelling, not just high-cost loans, may include terms requiring arbitration or any other nonjudicial procedure. • A borrower and lender may agree to arbitration or any other non-judicial procedure at any time after a dispute or claim arises, but the	• Unlike any state or federal law, Miller-Watt would ban mandatory arbitration on all home loans, whereas Ney-Kanjorski applies the restriction only to higher-cost loans. • Arbitration is strictly prohibited on "high-cost" loans in only 9 states.[6] Arbitration can often be an effective, quicker and less expensive dispute resolution process for the borrower. Some mortgage lenders use it, others do not. Arbitration also is used in many other types of consumer credit, securities and employment cases. However, because higher-cost mortgage loan borrowers may be more vulnerable and need extra protections, the Ney-Kanjorski bill, like all states that impose arbitration restrictions, prohibits mandatory arbitration only on

[6] Five other states with arbitration limitations allow an arbitration clause if it complies with certain requirements (e.g., if it meets the standards of a nationally recognized arbitration association).

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	• A post-controversy voluntary arbitration agreement must: (1) establish the venue for the arbitration in the Federal judicial district or division in which the real property is located; (2) comply with the standards set forth by a nationally recognized arbitration organization; and (3) require the lender to bear the reasonable costs of all parties to the arbitration, including the production of witnesses and documents, during the first 2 days of such arbitration.	agreement cannot be interpreted as barring a borrower from bringing an action in court.	higher-cost loans. • Both bills contain similar provisions allowing for non-binding post controversy agreements that essentially amount to mediation, but Ney-Kanjorski adds several additional safeguards as to how such voluntary arbitrations are to be conducted.
Periodic Payments	• No higher-cost mortgage may include terms under which more than 2 scheduled payments of interest or principal may be paid in advance or otherwise deducted from the loan proceeds.		• Ney-Kanjorski seeks to clarify the current HOEPA restriction that no more than 2 scheduled mortgage payments may be paid in advance or otherwise deducted from the loan proceeds.
Modification and Deferral Fees	• Lenders are prohibited from charging modification or deferral fees in excess of the lesser of the amount of 1 monthly loan payment or $300. • This prohibition does not apply to loans in default or at least 60 days delinquent and part of a	• No fee is allowed to modify, renew, extend, or amend a high-cost loan, or to defer any payment due under the terms of a high-cost loan. • An exception is provided for such fees if the modification, renewal, extension or amendment results in	• Ney-Kanjorski allows for a limited fee for modifying a loan or deferring payment, whereas Miller-Watt allows for no such fee in most cases. • The Committee should consider how the two bills address this issue and determine the degree to which, if any, a limited fee might be allowed. • It would seem to be reasonable to allow lenders to charge a modest fee for their work when the borrower wants to modify a loan or defer a loan payment.

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Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	work-out process.	a lower APR and the amount of the fee is comparable to fees imposed on similar transactions that are not high-cost loans.	
No Call Provision	• Call provisions under which the indebtedness may be accelerated by the lender, in the lender's sole discretion, are prohibited. • This prohibition does not apply if the acceleration is due to: o A default or pursuant to a due-on-sale provision, or some other provision of the loan documents unrelated to the payment schedule; o Due to any action or omission by the borrower that adversely affects the lender's security interest in the house or any rights of the lender in such security.	• Call provisions under which the indebtedness may be accelerated by the lender, in the lender's sole discretion, are prohibited. • This prohibition does not apply if the acceleration is due to: o A default or pursuant to a due-on-sale provision, or some other provision of the loan documents unrelated to the payment schedule.	• Both bills contain relatively similar limitations on call provisions. • Ney-Kanjorski includes language based on the FRB regulations allowing an exception for acts of omissions by the borrower that adversely affects the lender's security for the loan or any right in the security.
Balloon Payments	• Balloon payments are prohibited. • An exception is provided for seasonal or irregular income or for a bridge loan (defined as having a maturity not to exceed 18 months and made in connection with the acquisition or construction of a home).	• Balloon payments are prohibited. • Exception for seasonal or irregular income.	• Both bills strengthen current law, which only prohibits balloon payment provisions of less than 5 years, by generally prohibiting balloon payment terms on higher-cost loans. • Both make exceptions for seasonal or irregular income. • Ney-Kanjorski also adds an exception for bridge loans not exceeding 18 months (6 months more than allowed under current FRB regulations), and requires an additional disclosure requirement when this exception applies.

CFAL

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	• When the exception applies specific disclosure of the balloon payment term is required.		
Negative Amortization	• Prohibited, except to allow for temporary forbearance plans.		• Ney-Kanjorski adds a technical amendment to address the fact that negative amortization might occur if the lender allowed a borrower the benefit of a temporary forbearance plan.
No Encouraging Default	• Prohibited.	• Prohibited.	• Both bills prohibit encouraging default.
Home Improvements	• Cannot use proceeds of a higher-cost mortgage to make the final payment or payment in full to a home improvement contractor without an independent inspection of any home improvement exceeding $10,000, and without proof the contractor has fully performed the obligation. • A completion certificate in compliance with state law or a signed statement from the borrower and home improvement contractor shall satisfy this requirement. • The lender must also provide certain disclosures to the borrower before making a final payment.		• Ney-Kanjorski would add new protections aimed at further limiting home improvement scams. It would prevent lenders from making a final payment or payment in full on larger home improvement contracts which exceed $10,000 without an independent inspection and without proof that the contractor has fully performed the contract obligation. • The basic concept of this provision seems sound and should reduce contractor fraud. However, the Committee should consider defining or requiring the Federal Reserve Board to define by regulation what is considered to be a final payment or payment in full. This provision should not be construed so that, for example, a final payment of only $1 could be withheld and no inspection certificate or proof of compliance would be required.

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Coalition for Fair and Affordable Lending

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
Increased Interest Rate Upon Default	• Current law's prohibition on increasing the interest rate on default would be retained but a narrow exception would be added providing the prohibition does not apply to changes in a variable interest rate based on an index due solely to a change in the index rate.	• Prohibited. • Exception when repayment has been accelerated by default, pursuant to a due-on-sale provision, or pursuant to a material violation of some other provision of the loan documents unrelated to the payment schedule.	• The Committee should consider adopting the limited exceptions contained in both bills.
Steering	• No lender shall knowingly or intentionally steer a borrower into a loan product not based on the lender's best credit grade that the borrower would qualify for. • No broker shall knowingly or intentionally steer a borrower to a less favorable product than one offered by lenders with whom the broker regularly does business and for which a borrower qualifies. • The lender must provide the borrower's credit score within 3 days of the later of the receipt of a higher-cost mortgage loan application, or the making of a determination that the borrower qualifies for a higher-cost mortgage. • If steering occurs, the loan must		• Although steering is perceived to be a problem by many parties, only one state, California, has a prohibition against steering borrowers to more expensive loans. • The newly available 2004 HMDA data is likely to increase concerns over steering. This data shows significant disparities in some cases between various racial and ethnic groups but does not and can not show the causes of such disparities, especially as it does not contain the basic risk-related factors lenders use to price loans. • Miller-Watt does not attempt to address the steering issue. • Ney-Kanjorski includes an anti-steering provision based largely on the California statute. • Ney-Kanjorski tackles this issue by essentially requiring that: (1) lenders may not steer a borrower to a product not based on the lender's best credit grade that the borrower qualifies for; and (2) brokers may not steer customers to less favorable products than those offered by lenders with whom the broker regularly does business. • This steering prohibition includes a safe harbor provision that allows borrowers to voluntarily choose to accept a somewhat more costly loan for their own personal reasons, even if they may be able to obtain a less expensive loan. For example, many borrowers have immediate needs for funds and want the loan that closes fastest even if it is a bit more expensive. • This is a very complex issue. It is very difficult in many cases, given the large

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	be, at the borrower's option, either rescinded or rewritten, and appropriate restitution made. o Restitution by the lender must include giving the borrower all fees, interest, or other charges paid by the borrower above those that would have been paid had the loan not been originated at the less favorable credit grade. • Penalty for knowing and intentional violation by a broker: $4,000 and the borrower's actual financial damages and reasonable attorney's fees and court costs. • SAFE HARBOR (for lender): lender must have a reasonable basis to believe that the credit grade determined by the lender's then-current underwriting guidelines and applied to the borrower was appropriate, based on the information available, including information provided by the borrower, or the borrower voluntarily, on an informed basis, agrees to a loan with a higher rate than that for which		variety of mortgage products available and the many differing considerations that may apply with respect to a particular borrower's personal circumstances, to determine what loan product is really "the best deal" for the borrower. • All interested parties should carefully study the Ney-Kanjorski prohibition on steering and recommend any needed refinements to the Committee so that the final version is workable and will accomplish its legitimate objective.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	the borrower would otherwise qualify. • SAFE HARBOR (for broker): broker must have a reasonable basis to believe that the applied risk grade was appropriate, based on the information available, including information provided by the borrower, or the borrower voluntarily, on an informed basis, agrees to a loan with a higher rate than that for which the borrower would otherwise qualify.		
No Bad Faith Avoidance of Restrictions	• Prohibited from seeking to evade the law's requirements by entering into a reciprocal arrangement, dividing any loan transaction into separate parts, or structuring or restructuring a loan as another form of loan. • Reciprocal arrangements are defined to essentially cover agreements or understandings where a lender or its affiliate agrees to engage in a transaction with or on behalf of another lender or its affiliate in exchange for the second lender or its affiliate agreeing to engage in a	• Prohibited from taking any action to structure a loan as an open-end credit plan or another form of loan, or to divide any loan into separate parts in order to evade the law's protections. • Does not specifically prohibit or define reciprocal arrangements.	• Lenders should not be allowed to avoid the statutory safeguards by dividing or restructuring the loan transaction. Therefore, it is appropriate to have a prohibition on bad faith avoidance of such restrictions. • Miller-Watt does not expressly prohibit or define reciprocal arrangements. • The Committee should review both bills' provisions on this issue and develop final language as it deems appropriate. In that regard, consideration should be given as to whether the non-attribution rule should be limited to purchase money transactions or might need further refinements to prevent possible abuse.

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Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	transaction with, or on behalf of, the first creditor or its affiliate for the purpose of evading any requirement or prohibition or other provision of federal law or regulation relating to higher-cost mortgages. • Non-attribution rule - If there are 2 contemporaneous credit transactions secured by the same property and the loan-to value ratio of one equals or exceeds 80%, the points and fees payable on this transaction may not be attributed to the other transaction.		
ENFORCEMENT, PENALTIES, ASSIGNEES, CURE, NATIONAL UNIFORMITY			
Right to Cure	• Allows a lender or assignee who fails to comply with the law's requirements to avoid liability: (1) within 45 days of loan closing, by notifying the borrower of the error and making appropriate restitution and necessary adjustments; or (2) within 60 days of discovering	• Allows a lender who fails to comply with the law's requirements to avoid liability: (1) within 30 days of loan closing and prior to the institution of any action, by notifying the borrower of the violation and making appropriate restitution and adjustment to the loan to make the	• The federal statute's cure provisions have long been found to be inadequate by the mortgage lending industry, and lenders view enacting a workable cure procedure to be a very important part of reforming lending requirements. • Borrowers, as well as lenders, will benefit from having a quick and inexpensive error resolution process instead of having to engage in lengthy and costly litigation. • Both bills have a two-track cure provision, but Miller-Watt proposes a more limited provision than Ney-Kanjorski. ○ Essentially, Miller-Watt would first allow the lender to cure any violation

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Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	an error, by notifying the borrower of the error and making appropriate restitution and necessary adjustments, and by paying the borrower an error penalty of $2,000 (if a lender or assignee did not discover the error through its own procedures) and reasonable attorney's fees. • Appropriate restitution may include modifying the transaction terms so it is no longer a higher-cost mortgage. • If a lender or assignee does not correct the error as provided for above, the borrower may file an action or proceed with an action already filed. • Document revisions made pursuant to this provision are deemed legally effective as of original date of the document that was revised.	loan satisfy the requirements or change the terms of the loan in a beneficial manner so that the loan is no longer a higher-cost loan; (2) within 60 days of the lender's discovery or receipt of notification of an unintentional violation or bona fide error and prior to institution of an action, by notifying the borrower of the compliance failure and making appropriate restitution and adjustment to the loan to make the loan satisfy the requirements or to change the terms of the loan in a beneficial manner so that the loan is no longer a high-cost loan.	within 30 days of loan closing provided the borrower had not filed suit over the violation. Miller-Watt also would allow a lender to correct an error within 60 days of learning of the error provided the lender has not notified the lender or initiated a lawsuit and the lender could prove the violation was unintentional or a bona fide error. o Ney-Kanjorski would allow 45 days after closing for the error to be corrected, and correction could be made even if a suit had been instituted. It also would allow a correction within 60 days of discovery, provided it not only made full restitution but also paid the borrower a $2,000 error penalty and the borrower's reasonable attorney's fees if any. o The Ney-Kanjorski approach, which we strongly favor, would provide for borrowers to have errors corrected quickly, without slow and costly litigation, and the lender penalty would give lenders further incentive to avoid errors. o The Committee may wish to consider whether clarifications or modifications may be needed to address borrowers' rescission rights in connection with any new error correction procedure. • Currently, a borrower has an extended 3-year right of rescission, in addition to TILA's basic 3-day rescission right, for material breaches of HOEPA. • Consideration should be given as to how this extended rescission right should interface with the new cure provisions.
Statute of Limitations	• 2 years from the date of the occurrence of the violation. • Appears to retain 1 year statute of limitations for steering violations.	• 3 years from the date of the occurrence of the violation.	• The general statute of limitations applicable here under current federal law is 1 year. Ney-Kanjorski would double the time, whereas Miller-Watt would triple it. • Lenders believe that it is quite adequate to double the period to 2 years. • CFAL believes the 2 year statute should include steering violations.

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Coalition for Fair and Affordable Lending

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
Right of Rescission	• Prohibits waiver of the borrower's rescission rights if a waiver was required by lender as condition of the loan or the lender advised or encouraged the borrower to waive this right.	• Can be asserted by a person in an action to collect the debt or as a defense to a judicial or nonjudicial foreclosure after the expiration of the 3-year time periods for affirmative actions.	• Ney-Kanjorski adds a reasonable safeguard prohibiting lenders from requiring the waiver of the borrower's rescission rights in order to obtain the loan or from encouraging the borrower to waive such rights. • Miller-Watt's provision allowing a borrower to assert a timeless right of rescission in debt collection or foreclosure proceedings appears to be unreasonably long and inconsistent with the concept of a statute of limitations and would encourage higher-cost borrowers who are in foreclosure to assert unmerited rescission claims.
Penalties	• Doubles the existing TILA/HOEPA maximum statutory civil penalty from $2,000 to $4,000 per violation and doubles maximum class action damages from $500,000 to $1,000,000. • Requires coordination of class action general damages with actual damages so general damages are reduced by aggregate amount of actual damages. • The court must consider whether a pattern or practice of violations existed and whether violations were willful.	• Doubles existing amount of total damages to twice the sum of actual damages, statutory damages, attorney's fees, and costs.	• Both bills increase penalties for violations. • Miller-Watt would double the sum of all damages, including actual damages. • Ney-Kanjorski, which we favor, would double the range of statutory damages.
Assignee Liability	• Allows limited liability for assignees of higher-cost mortgages. • A borrower may assert all affirmative claims and defenses		• Assignee liability generally does not apply with respect to prime loans or to nonprime loans, with the exception of higher-cost loans under HOEPA and under the laws of around a dozen states. • Most legislators have rejected applying such strict liability because it is not fair to hold innocent purchasers strictly liable for violations that they had no reasonable

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	against a purchaser or assignee that he/she could assert against the lender either: (1) as a defense to the enforcement of such mortgage based on a default if it is reasonably related to a violation of this section by a lender, unless the borrower demonstrates that the purchaser or assignee had actual knowledge of or reckless indifference to a violation (in which case a defensive claim may be raised without regard to whether such violation was related to the borrower's default); or (2) as an affirmative claim, unless the purchaser or assignee demonstrates by a preponderance of evidence that a reasonable person exercising ordinary due diligence could not determine based on required loan documentation, the itemization of the amount financed and other disclosure of disbursements that a violation had occurred. • This section does not apply if purchaser or assignee has exercised such due diligence by demonstrating that such		way of knowing had occurred. Legislators also have recognized that assignee liability can easily upset the secondary market. • If assignee liability is extended beyond higher-cost loans as some advocates want, there is a real danger that mortgage capital for all covered loans could dry up in many markets. For example, broad assignee liability was one of the key reasons the nonprime market literally shut down in Georgia and legislators were forced to make significant changes to the law. A similar situation occurred in New Jersey. • The fact is that higher-cost loans to which overreaching assignee liability restrictions in HOEPA and certain states' laws apply are virtually never sold in the secondary market. Because there is no secondary market for higher-cost loans, and competition is therefore limited as the major wholesale lenders that sell all their loans into the secondary market do not offer such loans, borrowers who can only qualify for a higher-cost loan have to obtain them from a lender that retains the loan in its own portfolio. The common result for the borrower is that the loan is priced significantly higher than it otherwise would be if there was a competitive secondary market for these loans. • The Ney-Kanjorski bill therefore seeks to refine HOEPA's excessive and unworkable liability on assignees by substituting more balanced language so that higher-cost loans could be sold in the secondary market and the thousands of borrowers in every state who only qualify for such loans would have far more opportunity to obtain less expensive loans. It draws upon several states' language relating to due diligence requirements to avoid liability. The bill basically seeks to apply assignee liability only when the purchaser knew or reasonably should have known that abuses actually had occurred. This approach would shift from having a *de facto* prohibition on selling HOEPA loans in the secondary market to letting such loans be securitized, provided the many applicable special substantive safeguards are met. • Borrowers in foreclosure who claim to be victims of abusive practices can and do sue both the originating lender and broker. The mortgage servicer also is typically sued and borrowers raise lending abuses as foreclosure defenses. Generally, the originator is required by the purchaser to buy back the loan from

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	purchaser or assignee (1) has policies in place expressly prohibiting the purchase or acceptance of assignment of higher-cost mortgages or such mortgages containing violations; (2) requires by contract that the seller or assignor represent and warrant that either (a) they would not sell or assign such mortgages; or (b) they had such a representation or warranty from a previous seller or assignor; and (3) exercises reasonable due diligence (may be met by employing a statistically robust sampling methodology – no loan-by-loan review is required) intended to prevent the purchase or assignment of such loans. • Damages for violations of TILA are limited to the amount specified in TILA/HOEPA civil liability section and for violations of other requirements to (1) the amount of all remaining indebtedness; and (2) the total amount the borrower paid. • In awarding damages, the court		the secondary market purchaser (in practice, it's usually sold back as soon as the allegations are raised by the borrower) and if liability attaches, it normally is satisfied by the lender, broker, and/or servicer and not the secondary market purchaser.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	must consider (1) the amount of actual economic damages and the extent to which the non-economic harm suffered should be compensable by general damages; (2) the lack of the purchaser or assignee's knowledge of or participation in the facts giving rise to the violations; (3) the materiality of the violation; and (4) the relative harm to the borrower. • Damages are limited to the amounts specified in TILA/HOEPA civil liability section, unless the borrower demonstrates that the purchaser or assignee had actual knowledge of or exhibited reckless indifference to a violation. • Clarification is added to indicate that purchasers and assignees do not include certain parties such as passive investors in securities based on a pool of mortgage loans.		

CFAL

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
Coordination with State Laws (Preemption)	• Ney-Kanjorski preempts any law of any State or political subdivision to the extent that such law attempts, directly or indirectly, to regulate mortgage lending activities by or through imposition of a high-cost limitation or any requirement, limitation, or prohibition without regard to whether the provisions are consistent with section 129 or 129A or whether the consumer credit transaction is a higher-cost mortgage. • The section provides definitions of mortgage lending activities, law of any State and high-cost limitations, and clarifies the scope of preemption. • Preemption is self-executing, but the Federal Reserve Board also is required upon request to promptly publish in the Federal Register notice of whether and the extent to which it determines that preemption applies. • Clarification is provided also that provisions of this title do not affect a State's authority to enforce this Act as the primary enforcement authority with		• The mortgage market is increasingly a nationwide market dominated by larger lenders who operate throughout the country, and even many "small" lenders offer products in several states. • A broad preemption is clearly needed to address the confusing patchwork of existing state and local laws that are intended to stop abusive lending practices. • However, the scope of some of the preemption provisions in Ney-Kanjorski need to be refined so that state laws that are mortgage related but not related to so-called predatory lending legislation are not affected. This is an issue, however, that can be addressed during Committee consideration after interested parties suggest appropriate modifications.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	regard to persons licensed in or chartered by such State.		
State Enforcement Authority	• Status quo maintained regarding States' enforcement authority against federal or state entities with respect to federal law. • Act also does not affect a State's authority to enforce this statute as the primary enforcement authority with regard to persons licensed in or chartered by such State.	• Status quo maintained regarding States' enforcement authority against federal or state entities with respect to federal law.	• HOEPA contains a special provision that allows the Attorney General of any state to sue any party, including otherwise exempt depository institutions, for violations. • Both bills retain the status quo regarding this provision and other enforcement authority available to state officials. • CFAL favors active state enforcement of any new federal law establishing uniform national standards for mortgage lenders.
Regulations	• The Federal Reserve Board is required to publish regulations implementing the Act and amendments in final form within 6 months of enactment.	• The Federal Reserve Board is required to publish regulations implementing the Act and amendments in final form within 6 months of enactment.	• Both bills have comparable provisions requiring the Federal Reserve Board to publish final regulations within 6 months of enactment.

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Comparison & Analysis of H.R. 1295 and H.R. 1182

OTHER TITLES	Please note the summary above includes provisions of H.R.1295 and H.R. 1182 related to prohibited mortgage lending practices with respect to higher-cost mortgages, but the summary below includes only selected provisions of separate titles of H.R. 1295 (not contained in H.R. 1182) related to mortgage brokers, appraisals, education and counseling.	
TITLE II	**Education and Counseling**	
Borrower Education and Counseling Opportunities	• Includes a separate title, based on earlier legislative initiatives by Rep. Scott and others expanding housing counseling and education programs and related activities. • Among other things, these education provisions would create a new HUD office to better administer such programs and improve program standards. • The bill also authorizes $75 million for each of fiscal years 2006-2009 for such activities.	• Miller-Watt has no comparable title dealing with borrower education and counseling; however, it does give the Federal Reserve Board discretion to prescribe regulations requiring or encouraging lenders to provide consumer mortgage education to prospective customers or to direct them to such programs in the vicinity of their residences. • During the last Congress, CFAL suggested that consideration be given to having a small fee on all mortgages (e.g., $2), half of which could be allocated to borrower financial education and counseling programs and half of which could be used for state enforcement programs. We again suggest that this education and enforcement fee approach be considered.
Title III	**Servicing**	
Mortgage Servicing Abuses	• Updates the Real Estate Settlement Procedures Act (RESPA) with regard to mortgage servicing practices. • Mortgage servicers are prohibited from: (1) force placing insurance unless there is a reasonable basis to believe that the borrower has failed to comply with the requirement to maintain property insurance, and from charging fees for responding to qualified written requests by the borrower; (2) failing to take timely action to respond to a borrower's requests to correct errors relating to the allocation of payments, final balances for purposes of paying off the loan or avoiding foreclosure, or other standard servicer duties; and (3) failing to respond within 10 days to a request from a borrower to provide the identity of and contact information for the owner assignee of the loan; and failing to comply with any other obligation to protect borrowers established by the HUD Secretary.	• The bill's servicing provisions in this Title, and provisions in the subsequent titles raise issues that CFAL's members are still evaluating. Only limited comments will be made at this time, but we will provide additional comments after the hearing if we deem it appropriate. • Mortgage servicing has definitely presented certain problems, and it is commendable that Ney-Kanjorski seeks to address a number of them (e.g., force placing insurance).

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Comparison & Analysis of H.R. 1295 and H.R. 1182

	• RESPA penalties would be increased by doubling existing monetary levels. • Mandates decreases in response times to certain borrower inquiries, establishes response times for obtaining pay-off amounts, and requires the prompt refund of escrow accounts upon the payoff of a loan. • HUD also would be required to prepare two studies relating to mortgage servicing fraud.	
Escrow and Impound Accounts	• Applies to all consumer credit transactions secured by the principal dwelling. • A lender must establish (at the time of consummation) an escrow or impound account (to remain in existence for a minimum of 5 years unless the underlying mortgage is terminated) for the payment of taxes and hazard insurance. o Such account may not be required as a condition of a sales contract or a loan, unless (1) it is required by federal laws; (2) a loan is guaranteed by a governmental lending or insurance agency; (3) the borrower's DTI exceeds 45%; (4) a borrower obtains a higher-cost mortgage; (5) the original principal amount of such loan is 90% or more of the sale price (in case of a sold property) or appraised value; (6) the combined principal amount of all loans securing the property exceeds 95% of the appraised value; or (7) it is required by the Federal Reserve Board pursuant to regulation. • A lender must make certain written disclosures to the borrower about the account within 3 business days before consummation. • Amounts paid for escrow or impound accounts are not included in points and fees.	• Many nonprime loans do not have escrow accounts for the payment of taxes and insurance. This means that nonprime borrowers, who often lack substantial cash reserves, frequently find it difficult to come up with the significant lump sum amounts needed when these expenses become due. • Requiring the establishment of escrow accounts for many nonprime loans would appear to be reasonable and beneficial to borrowers. • Further consideration should be given concerning whether these Ney-Kanjorski requirements are adequate and whether the group of borrowers for whom lenders would have to establish accounts should be adjusted to cover other borrowers. Also, clarification may be needed regarding under what conditions borrowers could terminate escrow accounts.
Title IV	**Appraisals**	
"Property Flipping" and Appraisals	• No higher-cost lending without a written appraisal of the property (the borrower is entitled to one free copy) performed by a qualified appraiser who conducts a physical inspection. • If the seller purchased or acquired the property within 180 days of the current transaction at a lower price, the lender must obtain a second qualified appraisal that supports the current sale price at no cost to the	• "Property flipping" has been a serious problem in a number of areas and has often involved a conspiracy between a number of parties, including for example, sellers, appraisers, brokers and real estate agents. One of the key elements has often been appraisal fraud. Therefore, Ney-Kanjorski seeks to strengthen the appraisal process and adds new appraisal requirements with respect to higher-cost loans.

	borrower. • If the lender willfully fails to obtain an appraisal, it is liable to the borrower for $2,000. • To enhance the independence of appraisers and help to ensure that they serve as an unbiased arbiter of a property's value, the bill prohibits the parties interested in a real estate transaction involving an appraisal from improperly influencing or attempting to improperly influence, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal. • Streamlines the process for obtaining appraisal practice permits, provides for reciprocity in State appraiser licensing, makes certain other changes relating to the appraisal process and requires the Comptroller General to conduct a comprehensive study within 18 months of enactment on possible improvements in the appraisal process and how to improve appraisals.	• Further consideration should be given to whether a second full physical inspection appraisal, which is relatively expensive, is needed or whether automated appraisals might be adequate. Also, the Committee might want to consider allowing for some price increase before the second appraisal is required because homes in so many areas are appreciating significantly every few months.
Title V	**Mortgage Brokers**	
New Mortgage Broker Licensing Standards & A National Broker Registry	• The bill would establish minimum uniform state broker licensing standards and create a national broker registry to help police rogue brokers.	• Brokers originate the majority of all mortgages and are play a vital role in delivering nonprime mortgage products to borrowers on a cost efficient basis. Most brokers are ethical and treat borrowers fairly, but a minority is not and those "bad apples" perpetrate many of the most serious lending abuses. • State licensing requirements vary widely and unethical brokers often will move to another state when they are sanctioned for improper actions. • State licensing requirements in some states need strengthening, and Ney-Kanjorski's broker licensing provisions appear to address many broker-related concerns. • Further input may be needed from state officials who regulate brokers with regard to how this Title could be refined and strengthened. • The concept of having some form of national broker registry has been discussed for several years, and this appears to be something that might be helpful in controlling bad actors.

APPENDIX "B"

Option One Mortgage Corporation

How We Make Homeownership Dreams Reality

May 2005

Homeownership in the United States is at an historic level. In 2004, the percentage of the population owning a home climbed to 69 percent. One of the important factors contributing to this expansion of homeownership is the growth of the nonprime (sometimes referred to as "subprime") mortgage market. By 2004, approximately 20 percent of the home mortgage lending in this country was nonprime. In essence, nonprime mortgage lending has created the opportunity for millions of Americans who do not qualify for prime loans to still have the ability to buy or refinance a home.

As one of the nation's largest nonprime home mortgage lenders, Option One Mortgage Corporation has been a leader in "doing nonprime right," with consumer-centric loan products and loan origination and servicing best practices that set the gold standard for the industry. While our goal has never been to be the biggest lender, our growth has been strong since we started our business a little over a decade ago. We believe our growth is a measure of having the right focus on quality and by being faithful to our values and culture. This is the starting point for all we do, and it has resulted in a work force of approximately 5,500 men and women across the country who are overwhelmingly proud to be part of our company and proud of how we help all kinds of Americans fulfill their homeownership dreams.

We want to share some information about the philosophy that guides us, as well as an overview of our business, including our commitments to lending in a nondiscriminatory, responsible manner; embracing diversity; supporting financial literacy; and giving back to society as a whole and the communities in which we do business, by improving housing, education, health, and human services. We have organized overviews of this information, as well as hard data and statistics to help dispel some of the misconceptions about the nonprime mortgage industry, including such hot-button issues as prepayment penalties, foreclosures, demographics, benefits-to-the-borrower, pricing, and fraud prevention. Also included in data summaries is important information about the profile of Option One's borrowers and the loans we make, including our underwriting philosophy, as well as information about how we service mortgage loans.

We hope this information will provide useful insight into the positive contributions our company is making to help people buy and retain their homes, increase their wealth and strengthen their communities through homeownership, and solve at least some of their financial challenges and goals.

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Appendices

COMPANY OVERVIEW

What We Do:	We are in the business of making, selling, and servicing nonprime residential mortgage loans.
Founded:	1992 – to increase opportunities for more Americans to realize the dream of homeownership, focusing on those borrowers who were not served by traditional mortgage lenders. Option One is a pioneer in the nonprime industry. Few companies have more experience in responsible nonprime lending.
Ownership:	Subsidiary of Block Financial, a subsidiary of H&R Block, Inc.
Lending channels:	Option One Mortgage – wholesale through brokers and other financial institutions
	H&R Block Mortgage Corporation – retail through mortgage offices
Industry Position:	Option One is consistently one of the nation's top 10 nonprime home loan originators based on volume
	Option One is consistently one of the nation's top 10 nonprime home loan servicers based on total servicing volume
Special programs:	Diversity Council dedicated to helping our company and associates embrace diversity in all forms
	Fraud Detection and Prevention Program considered a model for the mortgage industry (see Appendix D)
	Lending Hands community outreach program
	Option One University dedicated to broker training on fair, nondiscriminatory, responsible lending and other aspects of the mortgage industry
	TeamOne Associate Training Programs on ethics, fair lending, fraud detection as well as best practices and core processes
Awards:	Irvine Chamber of Commerce Business of the Year 2003
	OC Metro Best Places to Work 2004
	City of Irvine Family Friendly Award 2005

Reputation:	Option One is known for its unique culture of empowerment, generous benefits, and profit-sharing programs, and its commitment to uphold our ethical values. This translates into a committed and engaged associate workforce that provides our customers with a high level of service and satisfaction.
Geographic reach:	National (see Appendix H)
Headquarters:	Irvine, Orange County, California
Employees:	Approximately 5,500

COMPANY CULTURE

Option One's founders recognized the importance of developing and nurturing the right culture. That's why, before starting our company, they determined what kind of organization Option One would be. The foundation of the company's unique culture – its mission, vision and values – foster an environment of responsible lending.

Vision

To be widely recognized as the premier provider of innovative financial products and services.

Mission

To provide quality financial products and services that create value by achieving superior customer satisfaction and sustainable financial returns in a challenging and rewarding environment for our associates.

Values

- Do what is ethical, fair and makes good business sense.
- Do our best.
- Treat others as we want to be treated.
- Stimulate, anticipate and embrace change.

The key elements of this culture, in addition to the values above, are as follows:

- Recognizing that people are our most valuable asset.

- Empowering our associates to make decisions and recommendations that positively impact their jobs and our customers.

- Embracing change.

- Embracing diversity.

- Committing to continuous improvement of our products and services, with our focus on quality, not quantity.

- Basing our business on a customer-managed relationship; i.e., customizing our services to enable customers to have options on how, when, and where they conduct business with us.

The results of this commitment to the right culture are significant. Option One is widely recognized in the residential mortgage industry for its unique culture – a culture that sets it apart from other companies. According to research conducted by Mercer, 93 percent of associates say they are proud to work for Option One. And, of equal or even greater importance, Option One has built a high level of trust with our customers through our open and transparent communication with them. We continue to learn from them so we can serve their needs with the right products and practices.

OUR COMMITMENT TO BEING A GOOD CORPORATE CITIZEN

Commitment to Living Our Values

Each year Option One associates recommit to the company's values by signing the company's Code of Business Ethics & Conduct, which covers everything from privacy of customer information to abiding by all laws and regulations.

Training

The company has an extensive training program that includes online and classroom study in specific job skills by discipline as well as:

- Fair, nondiscriminatory lending
- Responsible (non-predatory) lending
- Fraud prevention and detection
- Professional conduct

Associate Compensation

Associates, with the exception of sales associates, participate in profit sharing, thus motivating everyone to serve their customers, internal or external, in the interest of continuing to generate a high-quality loan portfolio. Associates involved in loan sales receive commissions. Significantly, no overages are paid to either account executives (wholesale) or loan officers (retail) for originating loans that have a higher-than-par yield, nor is additional compensation paid to them for originating loans that have prepayment charge provisions.

Commitment to Responsible, Nondiscriminatory Lending

An inherent, well-engrained part of Option One's values and culture is doing what is right and ethical, and treating others how we want to be treated. As a result, fair and responsible lending comes naturally to Option One. But we don't just let our intuition guide us. Option One has fair lending training for all associates so people understand where inadvertent pitfalls may lie. We also have processes in place described in more detail in our Fair Lending Best Practices (see Appendix B) to reinforce responsible lending throughout our company.

Option One's commitment to fair lending includes, among other things, the following practices:

- We make loans only when there is a benefit to the borrower.
- We lend on a nondiscriminatory basis. We comply fully with the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, and the Equal Credit Opportunity Act.
- We offer customers the lowest interest rate and best product they qualify for in the channel in which they apply.
- We do not offer loans that contain mandatory arbitration, single premium credit insurance, or loans defined as high cost mortgages under applicable federal, state or local laws.
- We don't solicit customers in our servicing portfolio for refinances.
- We allow borrowers the choice of a loan with or without a prepayment penalty. Loans with prepayment penalties come with a lower rate or lower fees.
- We encourage our customers to apply for escrow accounts.
- We make every attempt to keep customers in their homes. Foreclosure is a last option when other alternatives have been exhausted.

Loans Option One Does Not Make

- Loans considered high-cost under federal, state or local law
- Stated income loans to fixed income borrowers
- Loans where the borrower does not have the ability to repay
- Loans with increasing interest rates after default

In addition, Option One does not disburse funds to contractors for home improvement loans. All funds are given directly to the homeowner.

Commitment to Embracing Diversity

The company formalized its long-standing commitment to diversity in 2003 by forming a Diversity Council, which has the goal of embracing diversity in all aspects of our business. At Option One diversity means inclusion – accepting and appreciating differences, while identifying those ways in which each of us is similar.

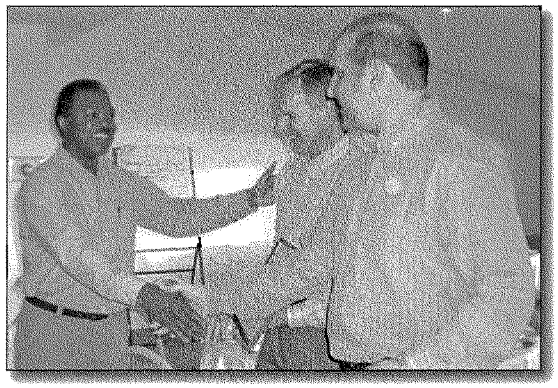
Not only is fostering diversity the right thing to do, it is also key to remaining competitive and making our organization an even more successful business. Embracing diversity:

- Helps attract and retain the most talented people.
- Enables better decisions and provides fresh perspectives for solving problems and responding creatively to customers' changing needs.
- Increases our ability to relate to, understand and, therefore, better serve our diverse borrowers.

Acting on our values impels us to appreciate diversity in its many forms, including differences in race, color, religion, national origin or ancestry, gender, marital status, sexual orientation, handicap status, familial status or age. Our appreciation of diversity guides how we recruit and develop associates, and how we work together to serve the needs of our customers for mortgage products and services.

Diversity Scholarships

The company's Diversity Council recently awarded 12 associates with diversity scholarships to MBA's School of Mortgage Banking to help them further their careers. Scholarships were awarded based on essays in which associates described their personal and professional commitment to fostering diversity. A similar program is in development for Option One's independent mortgage brokers.



Option One diversity scholar accepts congratulations from other associates.

Commitment to Supporting Financial Literacy

Option One wants customers to understand the loan process because it is in everyone's best interest that borrowers make informed decisions. That's why the company supports organizations that promote financial literacy, from kids in Junior Achievement programs to non-profits that help adults improve their credit scores. These include:

BorrowSmart

The BorrowSmart Education Foundation (www.borrowsmart.org) is a non-profit organization with particular focus on helping both consumers and credit counselors understand the risks, rights, and responsibilities involved in borrowing against the equity in one's home.

Jump$tart

The Jump$tart Coalition for Personal Financial Literacy (www.jumpstart.org) advocates on behalf of educating young adults about financial matters. The Jump$tart Coalition believes that all young adults need to have the financial literacy necessary to make informed financial decisions and urges the inclusion of such information in school curricula.

Don't Borrow Trouble

This Freddie Mac-sponsored program (www.dontborrowtrouble.com) teaches homeowners how to avoid predatory lending practices. At the invitation of Freddie Mac, Option One participates in forums throughout the country on the panel "The ABC's of Subprime Lending."

Stop Mortgage Fraud

Through its involvement with the Mortgage Banker's Association (MBA), Option One also supports Stop Mortgage Fraud (www.stopmortgagefraud.com), an educational Web site where borrowers can learn their rights and how to report abusive lending practices.

Commitment to Giving Back to Society

Lending Hands is the company's non-profit giving and volunteer program. It is a tangible expression of the company's culture and values. As a residential mortgage lender, Option One helps strengthen communities through homeownership. We view community involvement as another important way we can make a difference where we live and work. We do this by supporting local civic organizations, including fire and police, and through our work with non-profit organizations.

Empowerment is a core value of Option One, so we work with partners in our primary focus areas of housing, education, and health and human services that share our desire to strengthen the community by empowering others. These partners are:

Habitat for Humanity – where we continue our mission of helping hard-working, deserving people acquire homes of their own. We have built homes in communities across America including:

Huntington Beach, California
Stanton, California
Santa Ana, California
Fairfax, Virginia
Orlando, Florida
Westminster, California
Columbus, Ohio
Detroit, Michigan
Costa Mesa, California
Boston, Massachusetts
Charlotte, North Carolina
Jacksonville, Florida
Bellevue, Washington
Philadelphia, Pennsylvania
Dallas, Texas
Nashville, Tennessee
Cypress, California (building begins summer 2005)

We have also participated in and supported MBA builds of Habitat homes in San Diego and Daly City, California.

Option One associates and friends prepare to build a Habitat house.

Junior Achievement – where we help train America's future business leaders including early financial literacy education. Our activities include the following:

- Bowl-a-thon – In 2003, associates raised enough money at this annual event to support the participation of more than 1,700 students in JA for one year.
- Pinnacle Award – For three years in a row, Option One has received this JA award for the most funds raised in its business category.
- Job Shadow Day – Option One hosts students at the corporate office for this annual event in which kids learn about future career opportunities.
- JA in a Day – Option One associates provide financial sponsorship and staffing for this classroom-teaching day at a local school. Option One associates instruct students using JA's curriculum, which covers topics such as financial literacy, good citizenship, and business economics.

Volunteer Center of Orange County (California) – where we have a variety of opportunities for our associates to find causes that match their personal passions. Option One associates' participation in Health and Human Services endeavors includes, but is not limited to:

- The American Cancer Society's Daffodil Days campaign
- Susan G. Komen Breast Cancer Foundation
- United Way
- Red Cross
- Mentors for Youth
- AIDS Walk Washington, D.C.
- The Orange County Rescue Mission

- National Multiple Sclerosis Society
- Give Kids the World
- Orangewood Children's Foundation
- March of Dimes

HOW WE DO BUSINESS

Option One is in the business of making, servicing, and selling nonprime loans.

Nonprime Defined

Option One considers a residential mortgage loan to be nonprime if it does not meet the guidelines of a conforming lender – in essence, the guidelines of Fannie Mae and Freddie Mac for what constitutes a prime loan.

Making Loans

Option One's open and fair approach to lending helps people achieve homeownership or use their home equity to improve their lives.

Option One originates loans on a wholesale and correspondent[1] basis through a network of 34,000 approved brokers and through relationships with national financial institutions. The company originates retail loans through its subsidiary H&R Block Mortgage Corporation.

Loans funded since inception:	$96 billion as of April 30, 2005
Borrowers since inception:	706,000 as of April 30, 2005

Servicing Loans

Option One's expertise in servicing nonprime loans is one of its strengths. The company services its own loans as well as those of other national lenders.

Current Servicing Portfolio:	Approximately $67.7 billion assets under management comprised of more than 420,000 customers as of April 30, 2005 (including sub-served loans)
Ratings:	Highest rated nonprime loan servicer – Fitch's, Moody's and Standard & Poor's
Servicing offices:	Irvine, California, and Jacksonville, Florida

[1] A correspondent is a lender who closes loans with their own funding sources and sells the loan to Option One.

Selling Loans

Option One has a consistently strong portfolio of loans that has earned the trust of institutional and individual investors. With loan data going back to 1994, Option One continually improves its processes and is able to anticipate how its loans will perform over time. Selling loans provides additional capital to fund more loans, thus providing opportunities for more borrowers.

Loans are sold through:

- Securitizations, in which Option One retains a percentage of the ownership
- Whole loan sales

Servicing options on sold loans:

- Option One retains the servicing
- Servicing is released to the purchaser

Loans Originated by Option One in 2004

The following chart summarizes Option One's loan characteristics:

OPTION ONE'S 2004 LOAN PRODUCTION (Calendar Year)			
Loans Originated		**Average Loan Size**	
Number of Loans	159,949	First Mortgage	$169,867
Dollar Value of Loans	$24,735,094,529.86	Second Mortgage	$40,030
Product Types		**Averages for First Mortgages**	
Fixed Rate	34,945		
6-Mo. Adjustable*	124		
2-Yr. Adjustable**	99,398	Debt-to-Income Ratio	39.12%
3-Yr. Adjustable***	6,727	Loan to Value Ratio	77.85%
Seconds	18,755	FICO Score	608.73

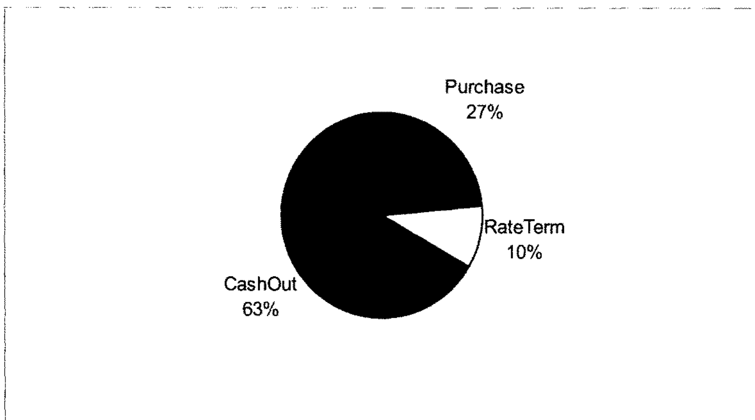
* fixed for 6 months then adjustable for the remaining 354 months
** fixed for 2 years then adjustable for the remaining 28 years
***fixed for 3 years then adjustable for the remaining 27 years

Purposes of Loans Made

Nonprime credit has helped many first-time home buyers take advantage of the burgeoning real estate market to begin building their wealth. More than one quarter of all Option One loans made in 2004 were for home purchase.

As in the prime market, 73 percent of Option One's borrowers have refinanced to take advantage of lower interest rates and to tap into some of the financial wealth in their homes.

PURPOSE OF LOAN
STATED BY OPTION ONE BORROWERS
IN 2004



Common reasons for nonprime borrowers to obtain cash out of their home include:

- Property improvements such as repairs and remodeling
- Sending their children to college
- Paying off higher-interest consumer debt
- Investing in a business
- Paying healthcare costs
- Buying a car
- Lifestyle purchases

Profile of Our Borrowers

Option One has made more than 706,000 loans since its founding in 1992. Our borrowers look much like your neighbors:

	2002 Fundings	2004 Fundings	Since Inception
Average Age	43.17	43.02	43.21
Annual Income	$60,999	$64,459	$60,591
Years in Home	6.34	6.59	6.19
Years in Job	7.48	7.27	7.32
Years in Profession	11.14	10.78	11.00
Property Type (SFR and PUD)*	85%	85%	85%
Year Home Built	1959	1963	1970
Average Square Feet	1693	1679	1679
Average Number of Bedrooms	3.3	3.3	3.3
Average Number of Bathrooms	1.8	1.9	1.8

* SFR = single family residence and PUD = planned unit development

Demographics

Our borrowers are diverse and have diversity characteristics similar to the general population as shown in the chart below. (For information about the general population, see Appendix A under Nonprime Borrower Demographic Profile.)

Option One Borrower Race & Ethnicity Statistics for 2004

Race	2004
American Indian or Alaskan Native	0.85%
Asian or Pacific Islander	2.00%
Black	14.20%
Native Hawaiian or Other Pacific Islander	0.52%
White	65.15%
Other	0.18%
Information Not Provided by Applicant	17.09%

Ethnicity	2004
Hispanic or Latino	12.80%
Not Hispanic or Latino	65.76%
Ethnicity Not Available/Not Provided	22.10%

Option One Borrower Age Statistics for 2004 Fundings

Age Range	% of Option One Borrowers
NA	1%
<20	0%
20-30	13%
31-40	31%
41-50	31%
51-60	17%
61+	7%

Our Lending Philosophy

Option One's overall lending philosophy is quality over quantity. This ranges from our underwriting and pricing policies to our customer service and loan servicing.

Conservative Underwriting

Our goal is to help people achieve the dreams made possible through homeownership. A borrower's ability to afford to pay back their loan is a key element of achieving this dream. To help facilitate this, Option One employs a conservative approach in our underwriting standards. In fact, 29.3 percent (based on 2004 submissions) of those who apply do not qualify for an Option One loan.

Underwriting considerations include:

- Credit – Option One offers the borrower the best loan program available in the loan channel in which they apply
- Capacity
    - The borrower must have the ability to repay
    - Fixed income borrowers are qualified at the fully indexed rate (The index plus the margin, rounded to the next highest eighth, equals the fully indexed rate.)
- Collateral – Determination if the collateral is accurately valued through appraisals
- Benefit – Determination that the loan will benefit the borrower

Borrower Benefit

All loans must benefit the borrower. There are a variety of factors that determine borrower benefit, but the most important is that we scrutinize loans carefully if there have been multiple refinances in the last 24 months to ensure the borrower is not eroding their equity.

To ensure our underwriters make decisions that are in the borrower's best interest, we have established a mandatory training on borrower benefit for all of our underwriters. While benefit is determined on a case-by-case basis, factors considered in determining benefit include:

- Rate
- Loan type
- Cash received
- Eliminating a financial hardship
- Net costs of the new loan recouped in 48 months
- Meaningful reduction in overall payment savings
- Multiple refinances in the last 24 months
- Amortization period
- Refinancing a land contract and putting the property in the borrowers' name

Also, Option One does not refinance special mortgages (usually a subordinate lien that has a provision where after a certain period of time the balance may be forgiven or there is a subsidized loan rate) unless there is a demonstrated overwhelming benefit to the borrower.

Decentralization

Option One has a unique position with respect to underwriting practices; it is largely decentralized. Regional underwriters report directly to corporate Lending Operations, so there is no untoward influence from branch managers or other local associates on underwriting decisions.

This has the following advantages:

- Provides better customer service because the underwriter is closer to the borrower
- Provides deeper knowledge of the local market to help facilitate decision making
- Enables decisions to be made at the local, customer level

Risk-Based Pricing

Risk

Option One categorizes prospective borrowers into risk grades based on several factors including the following:

- Credit score
- Mortgage or rental payment history
- Income documentation
- Loan-to-value ratio
- Debt-to-income ratio

The following chart shows 2004 mortgage loans originated by credit scores:

2004 Calendar Year Option One Mortgage Origination by Credit Score	
Credit Range	
No Score	1.39%
<500	0.06%
500-539	14.63%
540-579	16.17%
580-619	24.66%
620-659	24.44%
660-699	11.84%
700+	6.81%
Total	100.00%

More than 61 percent of Option One's borrowers rank in the least risky grades, AA+ and AA. Those in the top category are close to prime but they have other considerations that preclude them from getting a prime loan such as debt ratios, income documentation issues, or they request a higher loan-to-value than is allowed by prime lenders.

Borrowers in the lower grades such as C and CC typically have credit issues such as late mortgage or credit card payments. Many borrowers are able to use their Option One loan to improve their credit records and eventually move on to a prime loan. For this reason, Option One reports to all three credit bureaus monthly to help borrowers bolster their credit ratings.

The following chart provides a breakdown of Option One's 2004 borrowers by risk grade.

2004 Calendar Year Option One Mortgage Originations by Risk Grade	
Risk Grade	
AA+/AA	61.32%
A	25.92%
B	8.47%
C	2.84%
CC	1.45%
Total	100.00%

Pricing Considerations

Pricing, based on the risk categories above, is also influenced by a variety of other factors including the following:

Credit scores – used as a factor to determine the risk grade; however, there can be significant variability of credit scores within the risk grade. A borrower categorized as AA with a high credit score could receive a rate as low as 5.05 percent (as of May 2005).

Income documentation – AA borrowers who are able and willing to provide full documentation of their income can receive an interest rate as low as 5.05 percent (as of May 2005). Borrowers in limited or stated income documentation programs may pay rates that are 40 to 100 basis points higher, depending on their credit score and the loan-to-value ratio.

Loan program – Option One offers the borrower the best loan program available for their credit rating. Our most common product is a 2/28 adjustable rate mortgage (two years fixed, adjustable thereafter). The lowest rate for this loan is 5.05 percent. However, if a borrower prefers a 30-year fixed loan, the rate is 6.05 percent. (Rates cited as of May 2005.)

Loan size – Origination costs are fixed regardless of the size of the loan, however in some cases, Option One is able to offer a lower rate on larger loans.

Loan-to-value (LTV) ratio – The higher the LTV, the greater the risk; therefore, loans with lower LTVs are priced at lower rates.

Property type (single-family home, condominium, other) – Single-family homes and owner-occupied properties present lower risks; therefore, Option One rates may increase 0.4 to 1 percent if a property is not owner occupied, is a condominium, a rural property, or a three-to-four unit property.

Points – To help borrowers who do not have a lot of cash, Option One offers the option to pay a higher interest rate in exchange for lower points. When a broker offers this option to a borrower, it results in Option One paying the broker a yield-spread premium (see more about this on page 26 and in Appendix D).

Prepayment penalty – As described previously in this document, borrowers who agree to accept a prepayment penalty (no more than three years with the most common term being two years) may receive a lower interest rate. Also, we do not have prepay periods extend into the adjustment period on 2/28 adjustable rate mortgages.

The following chart summarizes Option One 2004 originations pricing by credit risk grade. More than 61 percent of Option One's borrowers rank in the highest two categories of AA+ and AA.

Option One 2004 Calendar Year Originations
Pricing by Risk Grade

Risk Grade	% of Originations	Weighted Avg Interest Rate	Weighted Avg APR	Weighted Avg FICO	Weighted Avg Points & Fees*
AA+/AA	61.32%	6.93	7.44	625.39	2.59%
A	34.29%	7.11	7.49	598.63	2.99%
B	8.47%	7.93	8.43	547.54	3.14%
C	2.84%	8.68	9.30	545.71	3.22%
CC	1.45%	9.72	10.37	549.57	3.32%

* Includes both Option One and broker points and fees paid by the borrower, but excludes third-party pass- through fees, such as appraisal, title insurance, and public official fees.

<u>Having the Right Relationship with Reputable Mortgage Brokers</u>

Option One works with more than 34,000 approved mortgage brokers. We expect the same values and ethical standards of these mortgage brokers as we do our own associates. We have several programs to maintain awareness of our standards and educate brokers about nondiscriminatory, responsible lending activities.

Broker Screening

Option One initially obtains a copy of the broker's license and verifies its validity. Licenses are again verified at the time of license renewal. Additionally, our Broker Approval Department runs background reports on all new broker applicants and their principals. We will not do business with a broker unless he or she has a valid license and passes our background check.

Although we believe that the vast majority of brokers are ethical, Option One maintains a strong fraud prevention and detection program to protect borrowers, as well as our company, against fraud. (For more information, see Appendix E)

Mortgage Broker's Pledge to Option One

Option One requires brokers to sign the *Broker's Commitment to Responsible Lending* (Appendix C). Some of the key commitments our brokers must make are as follows:

- *We affirm that our primary obligation is to act in the best interest of the borrower.*
- *We will always carefully analyze the Borrower's financial situation and true ability and willingness to repay the loan.*
- *We will not knowingly submit an application for a nonprime loan for a borrower who is eligible for, and whose needs are best met by, a prime loan.*
- *We will always operate in full compliance with all federal and state lending requirements – including disclosing all fees on the GFE and HUD-1.*
- *We will always comply with state and federal fair lending and non-discrimination laws. (We acknowledge and share Option One's commitment to abiding by both the spirit and letter of all fair lending laws and practices.)*
- *We will always, to the very best of our ability, ensure that each and every loan submission contains NO false or misleading information.*
- *We acknowledge and agree with Option One's Best Practices.*

Broker Watch List

All new brokers are automatically placed on a watch list for at least their first five loan submissions, ensuring their loans will be underwritten by a senior underwriter and specially scrutinized. In addition, established brokers who are suspected of fraud or whose loans are not performing as expected (e.g., high rate of default) are placed on a watch list and their loan applications are likewise scrutinized.

Fair Lending Education

Option One University is dedicated to training brokers in fair lending, fraud prevention and best practices in the mortgage industry. Courses are offered online and in person at locations throughout the nation. Some courses are certified for continuing education credit.

In addition, Option One partners with Campus MBA, part of the Mortgage Bankers Association, to sponsor additional ongoing educational opportunities for brokers. For example, last year Option One worked with the MBA on the "Creating New Customers" program, which provided brokers with a financial literacy education toolkit to host seminars in their communities. Broker training sessions and materials were offered in both English and Spanish.

Option One's *IQ Report* is a quarterly publication distributed to all of the company's brokers. Its mission is to educate brokers about fair lending practices as well as other industry issues.

Credit counselors and students attend an Option One-sponsored BorrowSmart program.

Broker Compensation

Option One's goal in broker compensation, as in all aspects of the loan transaction, is to make the process as transparent and understandable as possible to the borrower. Like the rest of the mortgage industry, one of the ways brokers doing business with Option One may be paid for the service they provide to borrowers is through yield spread premiums (YSP).

Option One makes YSPs available in a way that is faithful to our commitment to making the transaction transparent to the borrower. To educate our borrowers about all aspects of their loan, including YSPs, we have added full, plain-language, consumer-friendly disclosures about YSPs to our existing, strong initial disclosure process. We encourage borrowers to ask their broker or lender to show them how different combinations of rates and points might work in their favor. And the disclosure for loans that include a YSP clearly indicates the interest rate and the dollar amount paid to the broker for compensation. (See Appendix D for more information.)

Detecting and Preventing Fraud

Option One takes fraud prevention and detection very seriously and has a fraud program that is considered a model in the industry. Details of this program are in Appendix E, but highlights of the company's accomplishments are as follows:

- Created a Barred Individuals List to track individuals with whom Option One will no longer do business. This provides a control in case a bad loan officer moves to another company.

- Established a senior level Fraud Committee to provide oversight into fraud prevention and detection and also established a working committee to assist in operational issues pertaining to fraud management.

- Enhanced our broker approval process to include Lexis-Nexis reports on new brokers and their principals.

- Significantly increased staffing in Risk Mitigation, Option One's fraud investigation unit.

- Hired an Assistant Vice President, Portfolio Risk, who has a background in law enforcement and fraud investigations. The AVP has responsibility for the Risk Mitigation department and reports directly to the Chief Risk Officer.

- Instituted a corporate audit process whereby corporate auditors review files from brokers with high delinquency characteristics.

- Tested several front-end fraud detection systems and made a vendor selection (roll out will likely be mid-2005).

- Enhanced "red flags" training of branch and servicing associates.
- Enhanced the quality control program to incorporate lessons learned from fraud trends.
- Hired a Fraud Reporting Specialist to report fraud cases to state regulators and law enforcement agencies.
- Educate outside parties on fraud. For example, we are working with state regulators and law enforcement agencies to educate them on fraudulent schemes and methods of detecting fraud. Also, we have spoken at various industry conferences on fraud. And, we are in the process of developing a broker ethics course which will be offered through Option One University.

Servicing Loans with Borrower-Friendly Best Practices

Servicing Philosophy

As a residential mortgage servicer, we know that homeownership is the cornerstone of the American dream and we recognize its importance in building wealth and improving the lifestyles of families throughout our nation.

Option One plays a significant role in the housing market and we understand our obligation to make our services as easy to understand as possible for the consumer. Further, as an equal opportunity lender and servicer, we know how much our customers rely on us for honesty, fairness and a dedication to serving their best interests. We have made a commitment to serve our customers well.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive servicing practices, which harm not only consumers but also affect the reputations of all servicers. As responsible mortgage bankers, we comply fully with all mortgage-lending laws. These include the Fair Debt Practices Collection Act, the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, and the Equal Credit Opportunity Act.

When we created our Best Practices in Servicing (Appendix F), we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time and work to advance their understanding of the mortgage lending process.

As a top-rated residential mortgage servicer of non-prime loans, our role is to provide a high level of support and service offerings to our customers. All of our services are designed to service our customers when and how they need it. We offer a full array of services including a call center operation that is open 7 days a week, 24 hours a day; telephone automated services; and Internet self service. And, we take great care to work with customers who experience a challenge or are in trouble in meeting their mortgage financial obligations. To this end, we offer many options for borrowers including extended repayment plans, loan modifications, and reduced payoffs.

Reaching Out to Borrowers

Option One also invests in various outreach programs. For example, Option One is involved with the Home Ownership Preservation Initiative (HOPI) program in Chicago. This public-private partnership between lenders, the City of Chicago, and non-profit Neighborhood Housing Services of Chicago, Inc. (NHS) is destined to become a model of best practices throughout the nation. Among the program's activities is a direct mail campaign that targets high-foreclosure areas of the city for outreach about the city's 311 non-emergency hotline that will connect borrowers with free counseling services. Option One is involved in similar programs in Detroit and Dallas and is looking to bring such programs to Ohio and Philadelphia.

Recently Option One representatives went to Ohio to meet with troubled borrowers in person. This resulted in beneficial outcomes for both parties involved. In addition, Option One is working with Loan Cure, an organization that serves as a third-party to reach out to delinquent borrowers to bridge communication between the borrower and lender.

When all remedies to the customer have been exhausted, a foreclosure action may occur. A foreclosure typically results in a significant financial loss for both the customer and Option One.. For Option One loans, our experience is that the loss is over 40 cents on the dollar of the remaining principal amount of the loan when a foreclosure occurs.

In a recent benchmarking scorecard using January 2005 data, our foreclosure cure rate (comparing Option One results to multiple non-prime servicing competitors) was the top ranked. This means that Option One had more loans successfully cure than our peer's. The benchmark scorecard was completed by an independent third party (Loan Performance) and measured securitized loans.

Positive Recognition from the Rating Agencies and National Leaders

Our servicing platform is highly rated by all three major financial rating agencies and holds a reputation in the marketplace of being the best. Our success is driven by our strong commitment to doing it right. We track and measure a multitude of key performance metrics and benchmark our performance with the industry to strive for even better results and services for our customers.

In response to publishing our updated best practices last year, Option One received positive feedback from national leaders:

"We appreciate the steps Option One has taken to affirmatively prevent unfair lending practices and its commitment to ensuring its broadest possible compliance with local, state, and federal laws. The company's best practices for both the origination and servicing of loans set an example we hope the rest of the mortgage lending industry will follow."

– Shanna Smith, President and CEO of the National Fair Housing Alliance

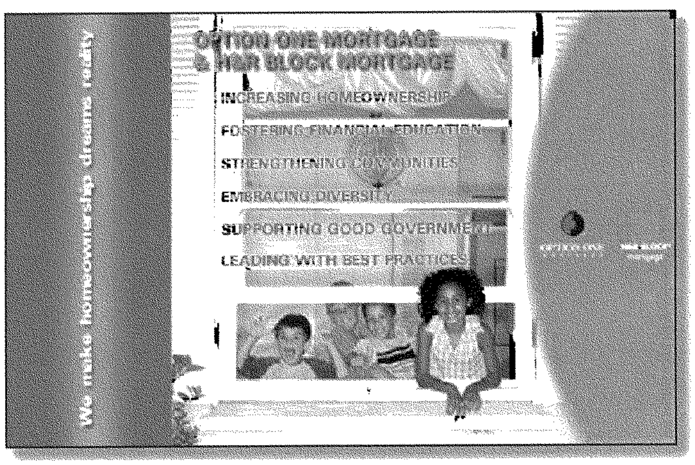
"Option One's best practices policy is clear, concise, and most importantly, consumer friendly. We are especially pleased with the company's significant emphasis on the importance of escrow accounts. Sub-prime borrowers need escrow accounts as much as, if not more than, any other borrower."

– Ricardo Byrd, Executive Director, National Association of Neighborhoods.

"Option One's enhanced set of best practices is a commendable step forward in fair lending and responsible servicing. In particular, the prohibition on mandatory arbitration serves as a model for where the whole industry needs to go. Regarding servicing practices, Option One's commitment to support post origination loan counseling and to use escrow accounts should be applauded. Escrow accounts help prevent loan delinquency for cash-strapped borrowers and avoid sometimes very expensive force-placed insurance."

– *John Taylor, President and CEO of the National Community Reinvestment Coalition*

Our commitment is to continuously improve how we make and service home loans.



APPENDIX A

A NONPRIME LENDING PRIMER
DISPELLING SOME COMMON MYTHS

Option One helps Americans achieve the dreams made possible through homeownership. This includes owning a home and building wealth and equity that enables people to:

- Send their children to college
- Refinance high-rate consumer debt to reduce their overall payment burden so they can manage their family budget
- Make home improvements to further increase the value of their property
- Start a business

There are many myths and misunderstandings about nonprime loans and borrowers. The following is designed to clarify some of the more common misconceptions and to indicate the positive contributions nonprime mortgage lending makes to our nation.

Fact: Homeownership builds strong communities.

According to a study conducted by the Hudson Institute[2]: "It has long been felt that the benefits of becoming a homeowner are not limited to the new owner, but also spill over to other members of society. Spillovers that are commonly cited include the fruits of greater participation in civic affairs, reductions in crime, and improved scholastic performance of children."

"These studies of investing in the local community provide rather strong evidence that homeownership generates external benefits for the community. In effect, the act of buying a home causes the homeowner's incentives to become more closely aligned with the community's, encouraging him to engage in activities (e.g., local memberships, local problem-solving) that benefit the community as well as the homeowner."

Fact: Homeownership is one of the best ways to build personal wealth.

Franklin D. Raines, former chairman and CEO of Fannie Mae stated this well in a 2002 speech titled Harnessing the Mystery of Capital; Closing the Wealth Gap: "Owning a home is the working man and woman's capital engine, the democratization of capital. Owning a home is the only investment – and the only leveraged investment – available to most Americans. It is a powerful way to transmit wealth from generation to generation."

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[2] "External Benefits of Homeownership" William Shew and Irwin M. Stelzer of Hudson Institute, February 2004.

According to a study at the University of Southern California[3]: "...[H]omeownership comprises a primary investment vehicle of American households; in that regard, elevated homeownership among minority households undoubtedly would serve to boost their wealth and economic status."

Thanks, in part, to nonprime lending, homeownership is at an all time high – 69 percent according to the National Association of Realtors. And minority homeownership is higher than ever also – 49 percent for African Americans, 47 percent for Hispanics, 58 percent for Asians, Pacific Islanders and Native Americans.

Fact: Nonprime loans offer individuals opportunities for homeownership and wealth building that the prime market does not. By expanding access to credit, you expand opportunities for individuals who do not qualify for traditional loans.

Fact: Many people have less-than-perfect credit records that disqualify them from a prime loan often due to a life event such as a job loss, divorce, disability or death in the family.

Fact: More women and minorities have difficulty qualifying for prime loans due to less wealth, life events described above as well as things like lack of an extensive credit record or limited employment history.

Fact: Many people use their nonprime loan to build a strong credit record and then move on to a prime loan after two or three years. In other words, nonprime mortgage loans can be the bridge for helping borrowers improve their credit worthiness.

Fact: Many nonprime borrowers have excellent credit records but are seeking loan terms that fall outside the guidelines of conforming lenders such as:

- They are self-employed
- They have multiple sources of income
- They have non-traditional sources of income
- They loan they seek has a high loan-to-value

Foreclosure

Misconception: Lenders foreclose on troubled borrowers at the first sign of a problem.

Fact: Lenders take great care to work with borrowers who are challenged to meet their financial obligations. There are many options for borrowers including extended repayment plans, loan modifications and reduced payoffs. Typically, a foreclosure proceeding will

[3] Stuart Gabriel and Gary Painter, Lusk Center for Real Estate, Marshall School of Business and School of Policy, Planning, and Development at the University of Southern California.

not begin until a borrower has no other means of catching up and is at least three payments behind.

Misconception: Lenders have a financial incentive to foreclosure on properties.

Fact: On the whole, lenders lose money on foreclosures. Generally, the losses amount to tens of thousands of dollars per loan (e.g., over 40 percent of the principal balance). Lenders want to keep borrowers in their home. It is in everyone's best interest.

Like many nonprime lenders, Option One has many programs to reach troubled borrowers. In fact, Option One pays for credit counseling for some borrowers and can directly connect the borrower to a third-party professional credit counselor. In some cases, Option One is able to revise loan terms to help a borrower get through a difficult period.

Option One also invests in various outreach programs as noted earlier.

Prepayment Penalties

Misconception: Loans that charge a prepayment penalty if the borrower repays the loan soon after it was made are a disadvantage to borrowers.

Fact: Many borrowers prefer a loan with a prepayment penalty because it reduces their interest rate or their points and fees associated with the loan, resulting in their paying significantly less for their loans overall.

Following are key points about prepayment penalties:

- For Option One borrowers opting for a loan with a prepayment penalty provision, the provision only lasts for the first two or three years of the loan.
- Option One offers loans with and without a prepayment provision so the borrower always has a choice.
- Option One provides a clear disclosure about prepayment penalties in plain-language, consumer-friendly documents.
- Many borrowers use these two-to-three years to build their credit record to qualify for a prime loan at a lower interest rate. In fact, Option One reports to credit agencies monthly to help borrowers build strong credit histories.
- Prepayment penalty provisions make the loan more attractive to investors because it gives more certainty to expectations of a loan staying on the books and ensuring the investor will receive their anticipated return. Investors therefore will pay a higher premium for loans with prepayment provisions and this allows the lender to offer the borrower a lower rate.

- This is very attractive for people who know they are going to stay in their homes for several years.

Nonprime Borrower Demographic Profile

Misconception: Nonprime borrowers are vulnerable populations such as the elderly, immigrants or minorities.

Fact: Nonprime borrowers reflect the general population.

Ethnicity

SMR Research,[4] one of the leading national third-party firms that collects and reviews industry data, found after analyzing year 2002 HMDA data and 2000 Census data that the ethnic breakdown of nonprime lending was the following:

Ethnic Breakdown of Nonprime Lending

Ethnicity	% of total population	% of nonprime borrowers
White	68.2	62.5
Hispanic	13.7	14.6
African American	11.9	13.2
Asian	3.7	3.9
Native American	0.7	0.6

Age

In an analysis of age and nonprime lending, SMR Research states that although, "the oldest homeowners have the lowest incomes of any homeowner group....The subprime share of the market is greatest by far where the elderly concentration is lowest."

"In summary, the subprime lender share of the market is highest in census tracts where elderly borrowers are least concentrated (0 to 1% of borrower). Subprime share is lowest where elderly borrowers are most concentrated (more than 50% of borrowers). Rather than 'targeting' the elderly, these data seem to prove the reverse."

Income

According to SMR Research 2002 data:
Prime borrowers' average annual income: $87,184
Nonprime borrowers' average annual income: $71,509

[4] SMR Research Corporation, "Predatory Lending: A New Study of Unfair Lending Accusations" (2004).

APPENDIX B

FAIR LENDING BEST PRACTICES

When we began our business in 1992, we started by creating a strong foundation. Even before developing a business plan, we established a set of values that we live each day. Our associates and our customers test everything we do against these values:

Do what is ethical, fair and makes good business sense.
Do our best.
Treat others as we want to be treated.

As residential mortgage lenders, we focus on helping our borrowers achieve the dream of homeownership or other important dreams, such as paying down high-interest credit-card debt, sending their children to college or remodeling their homes to increase their value for current enjoyment or future sale. We believe in homeownership as an important step in building wealth and improving the lifestyles of families throughout our nation.

Our commitment is to make our loans available to diverse communities and customers on an equal opportunity basis. We lend without regard to race, color, religion, national origin or ancestry, gender, marital status, handicap status, familial status, age (as long as the applicant is able to enter into a binding contract), receipt of public assistance, or the exercise of rights under the Consumer Credit Protection Act.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive lending practices, which harm not only consumers but also affect the reputations of all mortgage bankers. As responsible lenders, we comply fully with all mortgage-lending laws. These include the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act and the Equal Credit Opportunity Act.

When we created our Best Practices in Origination, we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time for mortgage products and services.

Serving You Right From The Start
At Option One and H&R Block Mortgage, our belief is that making good loans – loans that offer clear benefits -- to informed borrowers is the right thing to do.

Understanding How the Mortgage Process Works
We want you to be comfortable with the home-loan process and knowledgeable about your options so we start by providing educational information on various loan options before you even choose a loan. When you apply for a loan with us – whether through a mortgage broker or one of our loan officers – you receive a brochure that explains the lending process, definitions of key terms and information on contacting HUD-approved credit counseling agencies.

We are committed to financial literacy and support organizations such as:

- BorrowSmart (www.borrowsmart.org), a nonprofit educational foundation that specializes in helping consumers understand what to consider when refinancing a home loan.
- JumpStart (www.jumpstart.org), a nonprofit foundation that focuses on ways to increase the financial knowledge of young people.
- Don't Borrow Trouble (www.dontborrowtrouble.com), a program that is dedicated to increasing consumers' financial literacy, especially in understanding the risks, rights and responsibilities involved in taking out a home equity loan.
- Junior Achievement (www.ja.org), a nonprofit organization dedicated to educating young people about business, economics and free enterprise. Option One associates support Junior Achievement's programs for young people in the classroom.

In addition to our materials, we recommend you consult these sources for information.

Making Sure Loan Requirements Are Met
Based on the information you have provided on your application, we work hard to see that you are able to repay your loan and that the terms of the loan are appropriate for your particular situation.

This includes:

- Offering products that meet diverse credit profiles and incomes.
- Determining that you are able to repay the loan by:
    - Verifying sources of fixed income.
    - Verifying disposable income in cases where debt payment already exceeds 45 percent of the income you have disclosed on your application or you make less than $2,500 a month.
    - Only accepting appraisals performed by a licensed professional and completed in accordance with the Uniform Standards of

Professional Appraisal Practice. We trust the appraisal professional's local market knowledge and ability to place an appropriate value on the home. We never ask an appraiser to submit a report with a home value that we've pre-determined. When submitted, all appraisals are reviewed by Option One's trained underwriters and, at times, by licensed review appraisers.

Providing You With Options

Refinance Options That Benefit You
Refinancing may seem like a good deal, but there are many factors involved in determining if it is right for you. Using the information you have provided, Option One works hard to determine whether a refinance loan will benefit you. Factors considered in determining customer benefit include:

- Interest rates on the current and new loan.
- Amount of cash you would receive on the new loan.
- Points and fees on the new loan.
- Any prepayment charges that might apply on the current loan.
- Loan term comparison of current and new loan.
- Terms of any special loans or second mortgages that exist.
- Whether costs on a new loan could be recouped within 48 months.
- Whether it has been more than 24 months since the last refinance.
- Relieving a financial hardship.

In addition, we have a benefits review committee that looks at a sample of loans after funding. If a loan is brought to the committee's attention that did not clearly benefit the customer, the committee will take corrective action, which may include:

- Refunding points and fees.
- Creating more favorable loan terms at no cost to the borrower.
- Retraining or disciplining associates involved.

Prepayment Charge Options
Borrowers can choose a loan with or without a charge for repaying the loan early. Some borrowers may prefer to benefit from a lower annual percentage rate (APR) in exchange for choosing a loan with a prepayment charge. For example, some borrowers who plan to stay in their home for the length of the prepayment period could find the lower APR very beneficial. For other borrowers, a loan without a prepayment charge might be the best option for their situation. The choice is yours, and we explain this to you in a brochure you receive when you apply for a loan. Most of our loans that have prepayment options expire after two years and none are longer than three years.

Clear Loan Disclosures
Because we want borrowers to understand the terms of their loans, we have a strong disclosure process. After you submit a loan application, you can expect to receive our

disclosures within three days even if you've already received disclosures from a mortgage broker. When you apply for a loan, you'll receive a brochure that explains the lending process. When your loan closes, we also provide you with an easy-to-understand summary of the terms of the loan.

Option One also has an early re-disclosure process. As soon as we learn of any change in your loan terms, including points and fees, we will notify you promptly. To eliminate surprises, if key changes are found within 48 hours of closing, we will give you the option to reschedule the closing so you have enough time to review and fully understand the changes.

Protection for You

Protecting You Against Fraud
Because we have zero tolerance for fraud, we also have a process to help customers who may, in rare instances, be defrauded by parties not affiliated with Option One. To identify and address these unfortunate situations we:

- Train certain associates to recognize evidence of possible fraud.
- Maintain a dedicated fraud unit at our headquarters to investigate and respond effectively to activities by unfair or fraudulent parties.

We are also a financial supporter of Stop Mortgage Fraud, www.stopmortgagefraud.com, a Mortgage Bankers Association-sponsored effort to combat fraud in our business.

Your Identity
Option One has an identity-theft hotline for current customers, which is staffed by trained associates who can provide information on how to report identity theft to local law enforcement agencies and credit bureaus. You can reach our hotline at (800) 704-0800, ext. 30080.

Your Personal Information Is Kept Private
We do not sell your personal information. We use it only to conduct the business we have with you and we have strong internal controls to protect your personal information.

High-Cost Loans Are Not a Part of Our Product Line
Option One and H&R Block Mortgage do not offer loans defined as 'high cost' by federal, state or local laws.

Loans That Are a Benefit to You
There are some loans we don't think are usually in our customers' best interests, so we do not offer them. These include:

- Loans based purely on the equity in the property.
- Stated-income loans or loans that do not require income documentation if you are on a fixed income, such as Social Security or a pension.

- Loans with increasing interest rates in the event payments are missed.
- Loans that deduct initial principal and interest payments at closing.

Practices That Benefit You
We keep our customers' best interests in mind.

- We never disburse funds directly to home-improvement contractors. You choose your contractor, and you conduct all business dealings directly with them.
- To make certain there is no personal financial benefit for someone to charge you a higher rate, we:

    - Do not pay overages to our retail loan officers, which means the loan officer does not receive a financial incentive to charge a higher interest rate than our published rate.
    - If we service your loan, we do not solicit you to refinance unless you ask. If you request information on refinance options, we have a team of associates who can help.
    - We do not offer mandatory arbitration.

Behind the Scenes at Option One

Code of Business Ethics and Conduct
All associates annually re-commit themselves to the company's Code of Business Ethics and Conduct. By signing the code, associates promise to conduct business in accordance with the law, protect customers' privacy, and treat customers, other associates and business partners with fairness, respect and dignity.

Training
All associates involved in the lending process get training, including learning about fair lending practices and determining how a loan benefits the borrower.

Quality Control and Audits Are a Regular Part of Running our Business
There are a lot of things you'll never see or experience that are happening behind the scenes at Option One to help us serve you better, including:

- Our Compliance Department regularly reviews business processes and procedures for compliance with state and federal laws and regulations.
- Our Internal Audit Department regularly audits business processes and procedures and reports the results to Option One's management team.
- Our customer service and collections phone services are monitored to see that customer calls are handled professionally and accurately.
- Our due-diligence team audits a random sample of loans to make sure they are problem free.

- If a problem is suspected, another team takes over, checking for evidence of fraud.
- We have quality control measures in place to monitor and promote the best practices we've established to serve you well.

We Welcome Change
Our goal is to get better and better at what we do. We make a practice of evaluating our best practices on an ongoing basis so that we are always doing things better, finding solutions to your needs and working harder to serve you.

Working with our Brokers and Lenders to Serve You
Option One originates loans through a national network of brokers and lenders. To provide the highest quality experience for you, we've established the following practices:

Licensing Audits
A broker who wants to become an approved broker with Option One must apply to the company, providing information about his or her brokerage. We also verify that the mortgage broker has a current state license – and we check that license at renewal time, typically once a year. We also require that brokers comply with all federal, state and local laws.

A Commitment to Continuous Learning
We strive to give our brokers educational materials and experiences that will help them serve you better.

Established in 2002, Option One University provides our brokers and lenders with topical information on a variety of subjects, from responsible non-discriminatory lending practices to the appraisal process. These classes help mortgage professionals serve the borrowing public even better.

We also help keep our brokers current through a variety of other tools, including a quarterly publication specifically designed for them. And we have developed a Web site to keep them informed about legislation that impacts borrowers, including laws that could limit the ability of consumers to get credit when they need it.

We Require Factual Information
To become a broker with Option One, brokers must sign a broker agreement. That agreement specifies that all customer information submitted to us must be accurate and complete to the best of broker's knowledge.

We Hold Brokers Responsible
Option One has zero tolerance for fraud. We move quickly to terminate our relationship with brokers who have committed fraud and report them to the state licensing-agency and/or to federal, state or local law enforcement agencies.

APPENDIX C

BROKER'S COMMITMENT TO RESPONSIBLE LENDING

As a Broker and/or lender approved to submit loans to Option One,
and its employees and associates ("We") agree and acknowledge the following: (Company Name)

1. We affirm that our primary obligation is to act in the best interest of the Borrower. Therefore:
   a. We will always carefully analyze the Borrower's financial situation and true ability and willingness to repay the loan. We will only submit to Option One loans that are appropriate to this true ability.
   b. We will not knowingly submit an application for a non-prime loan for a borrower who is eligible for, and whose needs are best met by, a prime loan.

2. We will always operate in full compliance with all federal and state lending requirements -- including disclosing all fees on the GFE and HUD-1.

3. We will always comply with state and federal fair lending and non-discrimination laws. (We acknowledge and share Option One's commitment to abiding by both the spirit and letter of all fair lending laws and practices.)

4. We are properly licensed in the States where we do business.

5. We will always, to the very best of our ability, ensure that each and every loan submission contains NO false or misleading information. In particular (and without limitation) we will ensure that:
   a. The true source of the down payment is disclosed to Option One.
   b. The appraisal is a truly independent analysis of the value of the collateral.
   c. The borrower's true income is accurately calculated and disclosed.

   (We acknowledge and share Option One's commitment to preventing mortgage fraud. We understand that Option One views fraud as both a criminal and predatory practice. We understand that Option One reports all fraud to licensing and/or criminal authorities and may civilly sue brokers and agents that participate in fraudulent activities.)

6. We will not submit to Option One loans that refinance "Special" mortgages (such as reverse mortgages, mortgages from charitable organizations with discounted interest rates, specially subsidized loans, etc.).

7. We acknowledge that Option One will not fund "High Cost" loans as defined by applicable federal state or local ordinances.

8. We will always comply with the terms of our Broker Agreement with Option One.

9. We acknowledge and agree with Option One's Best Practices.

10. We will ensure that all of our employees and associates involved in submitting loans to Option One have read, understood and agree with this Broker Commitment to Responsible Lending.

Signature of Principal Officer Date

Printed Name of Principal Officer

APPENDIX D

BROKER COMPENSATION (YSP) AND THE FEES IN YOUR TRANSACTION DISCLOSURE

Loan Number: Servicing Number: Date:

In your loan transaction, you will have to pay fees to your broker, lender, and third parties (such as the appraiser, title company, closing agent, etc.). Some of these fees may be paid out of your pocket, others may be paid from the loan proceeds, and yet others may be paid by another party on your behalf (for instance, perhaps the seller of your property agreed to pay some of your costs). You should discuss with your broker the type of fees you will have to pay in your loan transaction, and the best way for you to handle the payment of those fees.

One of the ways that you can pay your broker is through something called a Yield Spread Premium, usually referred to as a YSP. When some or all of the broker's fee is paid by a YSP, it means that the lender is paying the broker on your behalf. The upside is you will be reducing the amount you have to pay out of pocket for the loan fees, or less money will be added on your loan balance to pay these fees. The benefit of a YSP is it leaves more money in your pocket. But in return for this benefit to you, you agree to pay a higher interest rate on the loan, allowing the lender to recoup the money it paid for you on this transaction.

THE YSP CHOICE IS YOURS TO MAKE

In your transaction, you are agreeing to pay a higher interest rate of ___________%. Your broker will directly receive compensation from Option One Mortgage Corporation ("OOMC") in the amount of $ ____________ _______. You understand that this compensation will appear as "broker compensation" or "yield spread premium" on certain disclosures (i.e. Good Faith Estimate of Closing Costs and HUD-1 Settlement Statement).

Borrower's Acknowledgment:

I acknowledge that I have a choice regarding loan terms. I have voluntarily agreed to the inclusion of the Yield Spread Premium in my loan terms.

Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date

APPENDIX E

FRAUD DETECTION & PREVENTION PROGRAM

OVERVIEW:

Option One is committed to building and maintaining a comprehensive, industry-leading fraud detection and prevention program. The Company has made the detection and prevention of fraud one of its highest priorities. This dedication to increasing awareness and halting the spread of fraud extends from Option One's senior management down to every employee at its branches.

Option One has long been committed to responsible lending and servicing practices. In addition, it has concentrated its efforts with respect to fraud detection and prevention program in response to the rise in the incidence of fraud. The enhancements that Option One has undertaken include (1) the reorganization of the corporate reporting structure and the addition of several new positions dedicated to the detection and prevention of fraud; (2) the revision of fraud-related policies and the creation of new policies aimed to prevent fraud and other misconduct; (3) the development of targeted reviews intended to identify instances of fraud and the responsible parties; (4) specialized training to increase fraud awareness; (5) the institution of regularized reports by the Chief Risk Officer to the Audit Committee of the parent company's Board of Directors; (6) the creation of an anonymous hotline for Option One employees to submit inquiries and concerns regarding potential misconduct; and (7) oversight of the hotline activity by the Chief Risk Officer. These and other measures that Option One has developed and implemented are described more fully below.

KEY ASPECTS OF THE PROGRAM:

- **Corporate Commitment.** Option One's commitment to fraud prevention extends from the top down throughout the Company, and Option One continually demonstrates to all of its employees that fraud cannot and will not be tolerated. For example, in January 2004, a memo from Option One's CEO expressed the need for heightened sensitivity to the growing problem of fraud. Continued training and fraud awareness presentations further emphasize the importance that Option One has placed on the detection and prevention of fraud.

- **Fraud Steering Committee.** Option One has a Fraud Steering Committee, which serves as the senior body for guiding corporate-wide anti-fraud policies. The Committee has the authority to order investigations, terminate employees or suspend brokers, and recommend policy revisions. Membership on the Committee comprises senior-level officers, including the Chief Risk Officer, General Counsel, Chief Appraiser, Chief Financial Officer, Senior Vice President for Credit Oversight and Senior Vice President for Wholesale Operations.

- **Fraud Committee.** Option One also has an inter-departmental Fraud Committee, which acts as a forum for the exchange of ideas, methods and recommendations for fraud detection and prevention. This Committee is chaired by the Company's Director of Portfolio Risk, and includes representatives from the Servicing, Wholesale, Appraisal, Training, Risk Management, Risk Mitigation, Asset Review, Broker Approval and Review, Closing Operations, Compliance, Underwriting, Human Resources and Secondary Marketing departments.

- **Independent Reporting Structure.** While all of Option One's departments prioritize the detection and prevention of fraud, primary responsibility rests with the Chief Risk Officer. Option One has reorganized its reporting structure to create a direct line from the Chief Risk Officer to the Company's Chief Executive Officer, independent from the Chief Operating Officer and the operational divisions of the Company. Personnel in departments including Portfolio Risk, Broker Approval and Review, Compliance and Risk Mitigation in turn report up to the Chief Risk Officer.

- **Risk Mitigation Department.** Option One has a dedicated Risk Mitigation Department, which investigates and takes action regarding fraud and improper conduct by employees and third parties. The department's responsibilities include assisting branch associates in responding to concerns regarding loan documentation and conducting independent reviews of loan files, brokers and other third parties who are involved in the application process.

- **Pre-Funding Reviews.** The Risk Mitigation Department conducts reviews of specific loan file documents, prior to loan funding, at the request of branch associates. These reviews may include calling to re-verify employment, confirming loan file information or taking other steps to ensure the accuracy and legitimacy of loan documents prior to funding.

- **Post-Funding Reviews.** The Risk Mitigation Department also conducts post-funding reviews, which typically involve the in-depth examination of multiple loans submitted by the same broker or Account Executive. These reviews may be triggered by delinquency reports, requests from the branches or the Appraisal, Servicing, Asset Management or Compliance departments. In addition, referrals for review are obtained from the Company's Consumer Complaints Task Force, Servicing High Risk Group and Legal Department. These reviews are supplemented by those performed by the Quality Control Department, some of whose analyses are directed toward the detection of mortgage fraud.

- **Corporate Appraisal Department.** The corporate Appraisal Department reviews appraisals on a sample basis. These reviews aid in the detection of property "flips," inflated appraisals and other forms of mortgage loan fraud. This department also tracks the performance of appraisers and maintains lists of "advised" (on-watch) and suspended appraisers.

- **Closing Department.** Option One's corporate Closing Department monitors closing agents, maintains a list of on-watch and suspended closing agents, and provides anti-fraud training to branch closers. In addition, Option One requires additional documentation for loans submitted by brokers who are affiliated with a closing agent.

- **Broker Approval.** Option One requires brokers to submit a detailed application, which is evaluated at both the branch and corporate levels prior to approval. This approval process includes verification of licenses, background searches and scrutiny of brokers' affiliations with other third parties, such as closing agents, involved in the mortgage lending business.

- **Broker Watch Lists.** All new brokers are automatically placed on a watch list for at least their first five loan submissions, ensuring that their loans will be underwritten by a senior underwriter and specially scrutinized. In addition, established brokers who are suspected of fraud or whose loans are not performing as expected (e.g., high rate of default) are placed on a watch list and their loan applications are likewise scrutinized.

- **Prompt and Decisive Action in the Event of Fraud.** Option One immediately takes action against those brokers found to have committed fraud and suspends them, where appropriate. Option One also may make referrals to appropriate law enforcement agencies and authorities. In addition, Option One maintains a Barred Individuals List of individuals whose conduct has warranted suspension or termination. This list includes brokers, loan officers, closing agents, appraisers, and others who have committed fraud against Option One. Option One will not originate a loan in which any individual on the Barred Individuals List is known to be involved in any capacity.

- **Specialized Training.** Option One conducts specialized "Red Flags" training at the start of the tenure of each employee involved in the loan origination process. This training includes a review of a specially developed Red Flags Guide that features examples and explanations of fraudulent schemes. Employees must certify that they have completed this training and must be re-certified annually to ensure that they remain aware and educated as to current industry trends. The Red Flags Guide is continually updated as new schemes are uncovered and information is learned by the Company.

- **Training of Third Parties.** In addition to training its own employees, Option One conducts training for its business partners that addresses the importance of detecting and preventing fraud. This education currently includes courses offered through Option One University and Campus MBA for brokers and other third parties, newsletters that address current issues in the industry, and speeches and classes conducted by Option One senior management at industry conferences.

- **Source and Seasoning Policy.** In order to combat down payment fraud, Option One instituted a source and seasoning of funds policy in April 2004 for all full documentation and stated income loans. This policy requires that the source of funds paid toward a borrower's down payment must be verified or must have been in the borrower's bank account for at least thirty days prior to the loan closing.

- **Anti-Flipping Policy.** The Company deters property "flipping" by placing significant restrictions on loans secured by properties that have been sold within the prior 12 months.

With respect to such applications, the Company requires a number of additional safeguards, such as additional documentation for home improvements and a technical review of the appraisal where the home value has increased by more than 10%.

- **Targeted Broker and Account Executive Reviews.** The Company has initiated comprehensive reviews of selected account executives and brokers. The account executives and brokers are targeted for review based on risk factors such as higher than expected delinquency rates, early payment default or loss severity, and unusual product mix. The results of these reviews are provided to the Fraud Steering Committee and may trigger an in-depth review of loan files for fraud.

- **Branch Investigations.** When Option One suspects instances of fraud at one of its branches or questions the possible involvement of branch employees in fraudulent activity, senior management directs in-depth branch investigations, which may lead to termination of employees and referrals for prosecution of third parties.

APPENDIX F

SERVICING BEST PRACTICES

When we began our business in 1992, we started by creating a strong foundation. Even before developing a business plan, we established a set of values that we live each day. Our associates test everything we do against these values:

Do what is ethical, fair and makes good business sense.
Do our best.
Treat others as we want to be treated.

As a residential mortgage servicer, we know that homeownership is the cornerstone of the American dream and we recognize its importance in building wealth and improving the lifestyles of families throughout our nation.

Option One plays a significant role in the housing market and we understand our obligation to make our services as easy to understand as possible for the consumer. Further, as an equal opportunity lender and servicer, we know how much our customers rely on us for honesty, fairness and a dedication to serving their best interests. We have made a commitment to serve our customers well.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive servicing practices, which harm not only consumers but also affect the reputations of all servicers. As responsible mortgage bankers, we comply fully with all mortgage-lending laws. These include the Fair Debt Practices Collection Act, the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act and the Equal Credit Opportunity Act.

When we created our Best Practices in Servicing, we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time and work to advance their understanding of the mortgage lending process.

Serving You Right from the Start

We Contact You

"Welcome to Option One!" These are the first words you'll hear from us as a new customer because you'll get a personal phone call from one of our customer service professionals. We call to thank you for your business, to make sure you understand key features of your loan and to answer any questions you might have. If your loan was transferred to Option One from another lender, we will send you a welcome letter with information about our services and how to get in touch with us if you have questions.

You Can Call Us, Too
We know when you're in the middle of a busy workday, you may not be thinking about your mortgage. That's why we have extended phone hours when you can speak to a customer service representative in English or Spanish, day or night. Additionally, our larger call centers maintain lists of Option One associates who speak other languages. If they are available when you call, we will be happy to transfer your call to these associates.

Our representatives are available:

Monday through Friday from 8 a.m. to midnight EST (5 a.m. to 9 p.m. PST)

Saturday from 9:30 a.m. to 6 p.m. EST (6:30 a.m. to 3 p.m. PST)
Before our customer service representatives start working with you, they receive more than 100 hours of training so that they can respond to your questions accurately and knowledgeably – and if they don't know the answer when you call, they'll find out and call you back. Our customer service phone number is (800) 648-9605.

Do It Yourself
We realize many homeowners prefer to do it themselves. Option One provides free 24-hour service through our automated phone system and our secure Web site at www.optiononemortgage.com, both of which provide information such as:

- Loan activity
- Online duplicates of billing statements
- Escrow
- How to obtain a loan payoff
- Verification of mortgage

Write to Us
Sometimes you just want to get things down on paper. That's why we have a Customer Resolution Department, a special unit dedicated exclusively to answering your letters promptly, completely and accurately. Typically, we respond faster than government-mandated guidelines.

Our mailing address is printed on the back of our monthly billing statements. In addition, this mailing address is listed under the "contact us" tab within our Servicing Web site at www.optiononeonline.com.

You can write us at:
Option One Mortgage Corporation
Attention: Servicing Unit
P.O. Box 57054
Irvine, CA 92619-7054

How Are We Doing?
Option One recently contracted with a national, independent polling organization to

complete a phone survey of several hundred servicing customers. In the spirit of ongoing improvement, we wanted to know what we are doing well, but more importantly, how we can improve. Our customers gave us many valuable suggestions and we plan to review and respond to them all.

We Treat You the Way We Want to Be Treated
From time to time, you may work with one of our vendors. We expect high standards of ethical professionalism from our vendors and ask that they comply with all record keeping, privacy and fairness laws and regulations.

We Welcome Change
Our goal is to get better and better at what we do. We have dedicated teams that regularly review our servicing practices to identify and implement the changes at Option One that keep us focused on finding solutions to your needs and working harder to serve you.

When It's Time to Make Your Payment

It's about Options
Option One has many convenient payment options that work for you.

- Automatic withdrawals from checking accounts with varied payment dates.
- An option to pay online – either via our Web site, or through your own bank's online bill payment service.
- East and West coast mail-in facilities, so your payment gets to us fast.
- We also provide phone payment and wiring options. Our fees for these types of payments made over the phone through our automated 800 number or directly with one of our representatives are among the lowest in the industry.

Sometimes you may have a question about your bill. If you do, please call us right away at (800) 648-9605, and we'll be happy to help.

Prompt and accurate payment posting is important to Option One. In order to process payments in a timely and accurate way, we do the following:

- Make every effort to process all payments on the business day they are received.
- If we are unable to credit your payment to your loan, a letter will be sent to you right away explaining why and providing you with a phone number to call in order for us to assist you.
- Write and call you if your bank returns your payment unpaid.
- Write and call you if your payment is late.
- Send an updated billing statement and letter if your payment is not received by the late charge date.
- Take a picture of your check upon processing in order to answer any payment questions you may have about your loan.

Sometimes, mortgage loans are sold or transferred from one company to another. We recognize that this can be confusing even though the company transferring your loan and the company receiving your loan both send letters with information on whom to call and where to send your payments. For that reason, when loans are transferred to Option One, we automatically block all late-charge assessments for a full 60 days so that you are not penalized in any way after the transfer. We also block all reporting to the credit bureaus for 60 days to make sure that you are fully protected during this time.

If You're Interested in Refinancing

As soon as you tell us you're ready to pay off your loan, we give you several options.

Refinancing with Us
If you originally got your loan through us and you tell us you are interested in refinancing, we have a unit that specializes in discussing refinance options available to you. This unit has access to the entire spectrum of mortgage programs, including prime, non-prime and government loans.

Paying Us Off
If you want to speed up the payoff of your loan, we:

- Promptly provide payoff statements, typically within 48 hours.
- Promptly return any funds escrowed for taxes or insurance, typically within 30 days.

Protecting You and Your Home

Hazard Insurance
Like all lenders, Option One requires you to have hazard insurance on your home, but we know it is sometimes difficult to keep it in place. Seven days prior to the expiration of your insurance, we make a call to your insurance agent and/or carrier. If your insurance lapses, we also notify you directly, in writing. These notices alert you that if you do not provide proof of insurance coverage as requested, the insurance we buy to cover your home may be more expensive and provide you with less coverage. Our written notices to you are as follows:

- First notice: After 14 days, we remind you to get new insurance.
- Second notice: This is sent 30 days after the first letter to remind you again.
- Third notice: 74 days after the day your insurance expires, we buy insurance for you and have our carrier mail you the policy document.
- Final notice: Approximately 90 days after we purchase the new insurance policy, we send you an additional letter advising you of the advance made to purchase the policy.
- **And:** Your billing statement will also reflect this transaction.

If we do have to buy insurance for you, we do not receive any commissions. Instead, we ask the insurance companies to reduce your premium by the amount of the commission they would have paid us. Once you have purchased a new insurance policy, we'll promptly cancel the policy we purchased and reimburse any amounts due you.

We have a master policy that covers the following, so we don't require you provide us with proof of insurance in these cases:

- Loan balances of less than $2,500.
- Second mortgages.
- Condominiums or town homes with master hazard policies.

Escrow Accounts
Putting aside money each month to pay real-estate tax and homeowner's insurance helps customers avoid large periodic lump-sum payments when bills are due. We provide these timesaving and convenient escrow accounts free of charge, and you can establish an escrow account with us before or anytime after your loan closes. There are no set-up or removal fees for an escrow account and because we take care of the required payments, you don't have to worry.

Option One encourages our customers to apply for escrow accounts. We include an escrow authorization form with your closing documents. You have the opportunity to complete the form, which authorizes us to set up an escrow account for your real-estate taxes and homeowners insurance.

Our Web site, www.optiononeonline.com, contains a link that describes escrow accounts. Start in the general information section and open the borrower knowledge tab. You may also call our customer service department at any time to ask for additional information and to apply for an escrow account. That phone number is (800) 648-9605.

Your Credit
We report to the three major national credit reporting agencies so that customers working to improve their credit standing have that information reported completely each month. A positive payment history can help you obtain a prime loan in the future.

Against Fraud
Option One has zero tolerance for fraud. We have developed a process to help customers who may, in rare instances, be defrauded by parties not affiliated with Option One. To identify and address these unfortunate situations, we:

- Train all associates involved in the lending process on ways to recognize red flags.
- Train certain loan counselors to recognize evidence of possible fraud based on customer comments and feedback.
- Maintain a dedicated fraud unit at our headquarters to investigate and respond effectively to activities of unfair or fraudulent actions by others.

We are also a financial supporter of Stop Mortgage Fraud (www.stopmortgagefraud.com), a Mortgage Bankers Association-sponsored effort to combat fraud in our business.

Your Identity
Option One has an identity theft hotline staffed by trained associates who can provide information on how to report identity theft to local law enforcement agencies and credit bureaus. You can reach our hotline at (800) 704-0800, ext. 30080.

Your Personal Information Is Kept Private
We do not sell your personal information. We use it only to conduct the business we have with you, and we have strong internal controls to protect you.

Information Available at No Cost to You
Many services are free at Option One:

- Free phone services, automated or live
- Free automatic payment withdrawals from your checking account
- Free online services
- Free escrow accounts for taxes and insurance
- Free copies of payment histories
- Free copies of loan documents
- Free payoff statements
- Free verifications of mortgages
- Free change of title/owner
- Free outbound faxing

We Want You to Keep Your Home
We know things can happen in life that lead to financial difficulties, but we do many things to help keep you in your home. In other words, if you have a problem, we do our best to find a solution.

Professionals on Staff
We believe in serving our customers only with qualified, committed and well-trained professionals, so we do not use temporary employees to make or receive calls from customers. When you call us, you'll always get us!

Comprehensive Reviews
We believe that it is in your and our best interests that you keep your home. Therefore, if your loan becomes delinquent, we will explore options with you, which may include developing an extended repayment plan, borrowing from other sources to resolve your short-term financial hardship, or refinancing or selling your home. We begin the foreclosure process only after we've completed a comprehensive review and determined that such action is reasonable and legitimate.

Extended Payment Plans
After we gather income and other financial information to determine that repaying past-due amounts over time will truly solve your financial difficulties, we offer plans that help you continue making house payments. There is never any charge for this service and we do not raise rates on past-due loans. Our goal is to help you stay in your house.

No Incentive Compensation
Our representatives do not get incentives based on the payments they collect. This helps ensure that our associates are not motivated by their own financial benefit.

Behind the Scenes at Option One
There are a lot of things you'll never see or experience that are happening behind the scenes at Option One to serve you better, including:

Quality Assurance Phone Monitoring
We monitor phone calls to make sure that customer calls are handled professionally and accurately. We strictly enforce compliance with the Fair Debt Collection Practices Act, a federal law designed to protect you from abusive and deceptive debt collectors. A single violation of the act may result in termination of that associate.

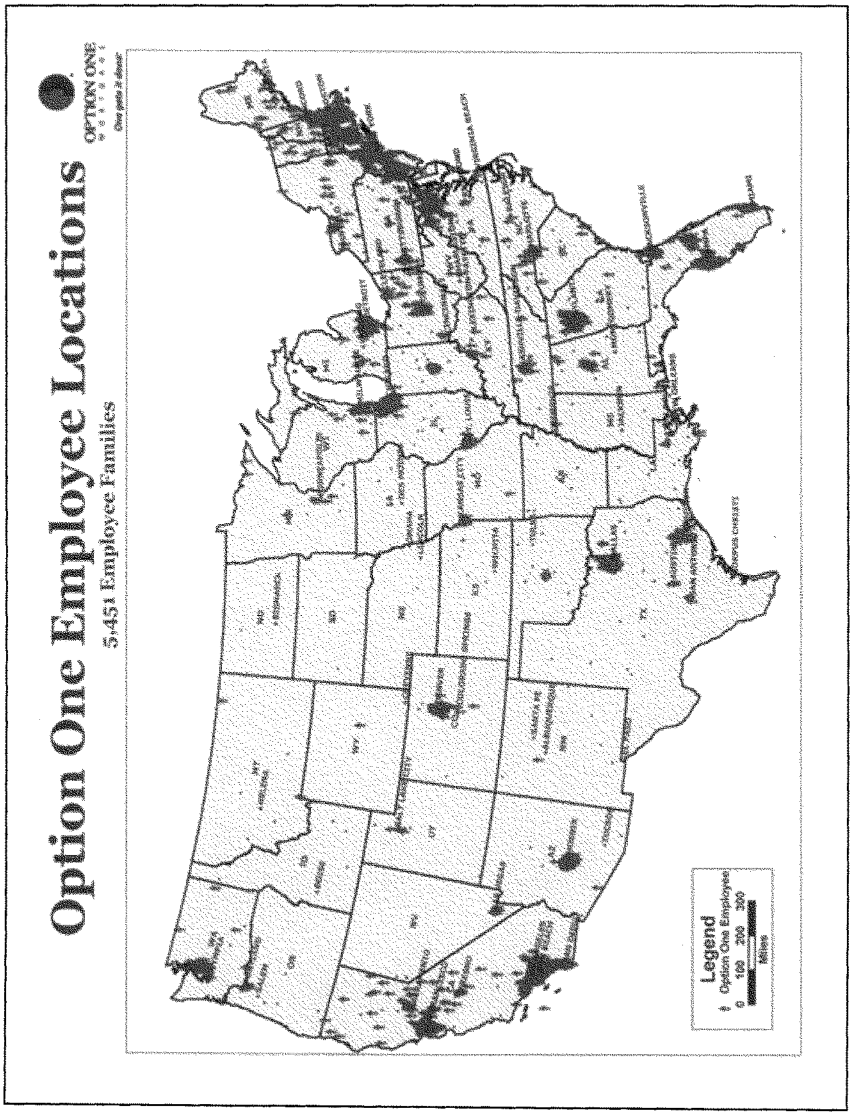
Process and Procedure Reviews

- Our Compliance Department regularly reviews business processes and procedures for compliance with state and federal laws and regulations.
- Our Internal Audit Department regularly audits business processes and procedures and reports the results to Option One's management team.

Our objective is to continue raising the bar in our servicing operations.

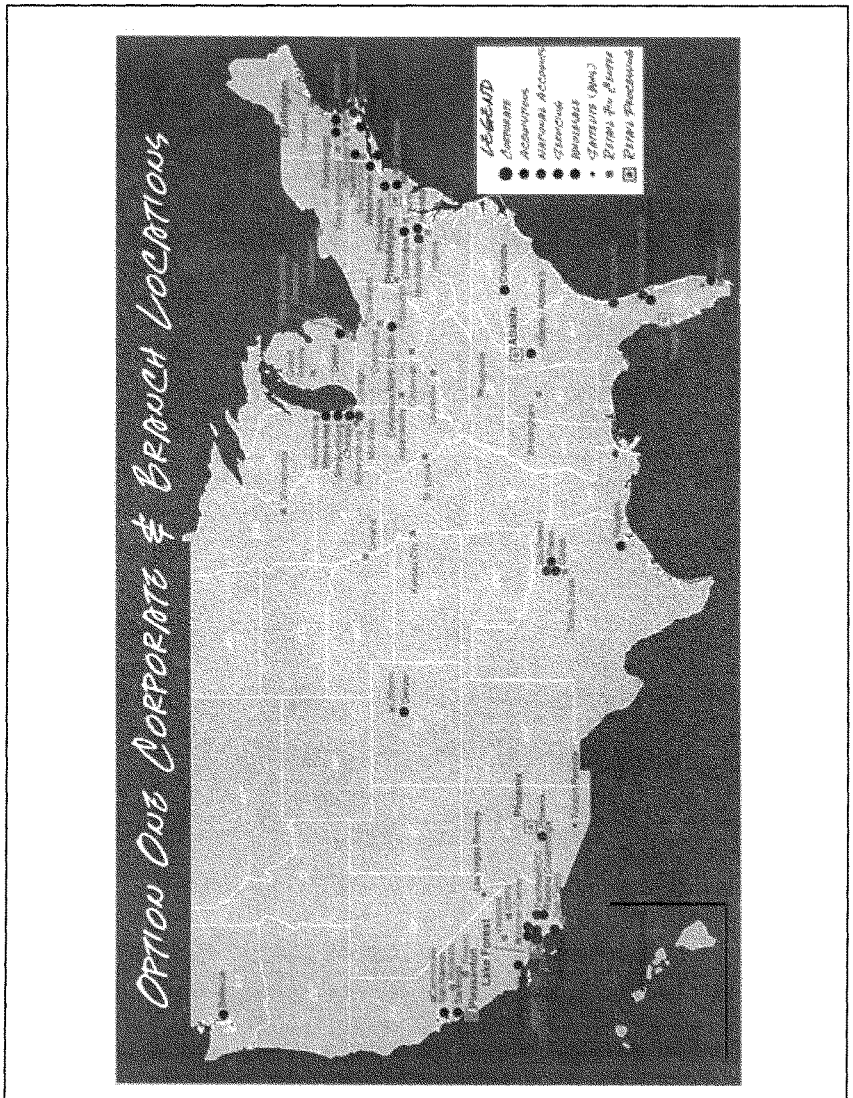
APPENDIX G

MAP OF OPTION ONE EMPLOYEES BY GEOGRAPHY



APPENDIX H

MAP OF OPTION ONE BRANCH OFFICE LOCATIONS



APPENDIX “C”

BROKER COMPENSATION (YSP) AND THE FEES IN YOUR TRANSACTION DISCLOSURE

Loan Number: Servicing Number: Date:

In your loan transaction, you will have to pay fees to your broker, lender, and third parties (such as the appraiser, title company, closing agent, etc.). Some of these fees may be paid out of your pocket, others may be paid from the loan proceeds, and yet others may be paid by another party on your behalf (for instance, perhaps the seller of your property agreed to pay some of your costs). You should discuss with your broker the type of fees you will have to pay in your loan transaction, and the best way for you to handle the payment of those fees.

One of the ways that you can pay your broker is through something called a Yield Spread Premium, usually referred to as a YSP. When some or all of the broker's fee is paid by a YSP, it means that the lender is paying the broker on your behalf. The upside is you will be reducing the amount you have to pay out of pocket for the loan fees, or less money will be added on your loan balance to pay these fees. The benefit of a YSP is it leaves more money in your pocket. But in return for this benefit to you, you agree to pay a higher interest rate on the loan, allowing the lender to recoup the money it paid for you on this transaction.

THE YSP CHOICE IS YOURS TO MAKE

In your transaction, you are agreeing to pay a higher interest rate of ___________%. Your broker will directly receive compensation from Option One Mortgage Corporation ("OOMC") in the amount of $ ______ ______________. You understand that this compensation will appear as "broker compensation" or "yield spread premium" on certain disclosures (i.e. Good Faith Estimate of Closing Costs and HUD-1 Settlement Statement).

Borrower's Acknowledgment:

I acknowledge that I have a choice regarding loan terms. I have voluntarily agreed to the inclusion of the Yield Spread Premium in my loan terms.

Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date

APPENDIX "D"

Analysis of
The Impact of Prepayment Penalties on
Residential Sub-prime Lending Coupons

May 12, 2004

Executive Summary:

For over 10 years, loan prepay penalties have been an instrumental cash flow in motivating fixed income bond investors to purchase bonds collateralized by sub-prime residential loans. If loan prepayment penalties were to be reduced in term, amount or eliminated completely, demand and/or pricing of the bonds backed by sub-prime loans could be adversely affected. We feel that in the absence of prepayment penalties:

1. Investors would want to be compensated for the heighten cash flow risk. They would either drop their bid in price or loan coupons would be forced higher to compensate for the added volatility. Higher coupons could also cause lending volumes to decline and lender profitability to erode as fixed expenses rose proportionally.

2. Additionally, securitization structures would likely be modified to reflect the rating agency's focus on the heightened cash flow volatility of the less-protected collateral pool. This adjustment would reduce sale proceeds for the lender.

Together, lower volume driven by higher coupons and higher costs (on a percentage basis) could have a significant negative impact on lenders margins. There are large lenders who, in this highly favorable interest rate and credit market, have lower overhead and benefit from scale. For some of the smaller lenders, the loss of prepayment penalties could mean the difference between small profits and losses. Borrowers seeking new loans would pay the consequences through higher coupons.

It is unreasonable to assume that the very favorable current interest rate environment and benign credit markets will remain unchanged in the future. If the markets were to revert back to more normalized environments (higher interest rates and defaults), even the large lenders could find their profitability impacted.

In this paper we seek to illustrate the impact that prepayment penalties have on the investor, the borrower and the lender. We provide this analysis based on the current market conditions which we consider to be very accommodating.

We have undertaken a quantitative analysis (outlined in the following sections) to estimate the rise in coupons necessary to compensate for the complete loss of prepay penalties. This projected increase, in the current environment given our assumptions, is 120 bps (i.e. - if current coupons were assumed to be 6.49%, this would project an increase to 7.69%). It should be noted that this increase is very sensitive to both the interest rate environment and underlying assumptions highlighted herein, and could be larger or smaller based on changes to these assumptions (i.e. - in faster prepay environments, the coupon increase would likely be greater and vice versa).

We have also used the scenarios in the above exercise to illustrate the impact to the sale proceeds of the originator. By removing the prepayment penalty income, increasing prepayment speeds assumptions and holding lending coupons constant, the impact would be a decrease of 1.98% in net sale proceeds (expressed in terms of par, see assumptions and illustration in Appendix B). This was enough to change a profitable issuance to a loss in today's environment. Similar to the coupon analysis discussed previously, this illustration is highly sensitive to the assumptions used to create it. This exercise is not intended to represent the actual margins realized by issuers; rather it attempts to quantify how margins could be affected given a change to a certain set of assumptions.

We have generated our opinions about this issue based on our direct and indirect research. Additionally, we have interviewed leading capital markets participants including but not limited to: loan and bond investors, research firms, loan originators, loan servicers, rating agencies and Wall Street dealers.

The Economics of Sub-Prime Lending:

A major shift has occurred since the sub-prime market started in the late 80's. The fixed income bond community has become the dominant provider of capital to the sub-prime borrower community. Previously, banks were the dominant capital provider. They had extensive loan origination networks and combined them with low cost deposits as their source of funding to generate attractive spread income. Currently, it is loan intermediaries such as loan brokers and conduit operators who originate, aggregate and sell the loans in bulk to the bond investment community. They use loan securitization to facilitate this process.

In the early days of the evolution from banks to bonds, the capital markets were unwilling to purchase the first loss and prepayment penalty cash flows at the offered prices. Intermediaries such as conduit managers retained a relatively large amount of credit and prepayment risk and retained the excess cash flow from prepayment penalties for taking the risk. These roles have largely changed. Now, the bond markets are more mature and the originators commit less capital in the risk because bond investors are willing to pay more. Their experience in understanding the product has improved, and capital markets have developed instruments (such as prepayment penalties) to give investors an added degree of comfort when committing capital to this volatile asset sector. The usefulness of these instruments, coupled with a benign credit environment and attractive interest rate environment, has dramatically improved the bid for sub-prime loans and the securities backed by them over the past several years.

The favorable market conditions have been a material component of the sub-prime markets success. For instance: house prices have risen materially, loan coupons have stayed low, investors have bought bonds and levered their purchase with low cost financing. Meaningful improvements have also been made to loan servicing practices. This has caused fewer loans to reach foreclosure. The result is that in more recent history, bonds investors have had a good experience and view the sector favorably.

Longer term, we feel the capital markets will continue to be the lead liquidity provider for the lenders, but the favorable current market environment should not be relied upon to support the sub-prime market to the same degree in the future. In other words, the market demand for bonds backed by sub-prime collateral may not be as robust in the future if a less desirable interest rate and/or credit environment were to occur. If prepayment penalties were to be eliminated in a period when the markets were more volatile lender liquidity could be reduced even more dramatically. Loan coupons could rise above the theoretical values calculated using today's market environment due to the combined effect.

Why are the capital markets a better bid than the banks and the loan originators?

1. A vast majority of the loans originated to date have exceeded initial credit projections.
2. The ratings for much of the previously issued debt have performed well.
3. Bond investors are generally comfortable with house prices and labor markets.
4. Investors, along with rating agencies, accept the inevitable variances associated with the "pool style" of lending. This approach involves looking at sub-prime risk in aggregate at the pool level (as opposed to the loan level), and using loan features such as prepayment penalties to stabilized cash flows even though the underlying loans are volatile.

Prepayment penalties are an important part of the proposition to invest in bonds collateralized by sub-prime loans:

Some market participants have argued that lenders could survive if prepayment penalties were eliminated in their entirety. We feel the elimination of prepay penalties could cause liquidity concerns to the sector as a whole. Eliminating prepayment penalties would impair the ability to securitize the risk by removing an important cash flow that provides diversification as well as cash flow stability. This would decrease lender's profitability which would, in turn, reduce capital available to the sector as a segment of these lenders exited the business.

Why prepayment penalties exist:

Many investors lost a lot of money in the early days of sub-prime bond investing. Most of them have said that it was a function of higher than expected losses and unpredictable prepays. Prepay penalties evolved as a partial solution to attract investors back to the sector.

Today, many loan and bond investors find sub-prime prepayment penalties particularly important. In addition to the prepay sensitivity created by interest rate volatility, the additional risk of prepayment due to credit curing is higher on sub-prime collateral. Credit curing occurs when borrowers make timely payments, improve their credit and qualify for a lower rate. Because of this additional uncertainty not found in prime loans, investors want to be paid more to take that un-hedgeable risk.

The capital markets generally prefer collateral and transaction structure consistency. History has shown that the markets can react to *small* changes in collateral and deal structures if necessary. Small is the operative word. Large changes in loan terms and securitization structure typically create unwanted market disruptions. These disruptions have historically affected liquidity and pricing in a negative fashion.

For instance - if a pool of mortgages contained 80% prepay penalties, and this percentage of loans was reduced to 70%, this change would be manageable and securitization pricing would not suffer materially. Loan coupons would likely remain unchanged. In a more dramatic example, if the number of penalty loans within a pool were dropped from 80% to 5%, investor demand would be impacted. As the percentage of loans in a pool with prepayment penalties declines, the impact to prepayment assumptions becomes more and more significant. A larger percentage decrease would force bidding assumptions and potentially securitization structure to change, causing a re-pricing of assets as well as a re-structuring of securitizations. We believe the market could adjust to less punitive penalties or shorter duration penalties, but their existence as an instrument remains fundamentally important to liquidity in the sub-prime sector.

From a lender's perspective, sub-prime loans have higher costs to originate. This makes this type of lending less profitable if a loan prepays after a short period. Investors are not willing to pay premium prices for loans that are likely to credit cure without some sort of protection to their return on the investment. The credit curing option that the borrower enjoys is un-hedgeable.

This relationship is best understood as a function of investor demand and loan supply:

The demand side: Bond Investors:

- Find that prepay penalties stabilize the cash flow pattern of the sub-prime collateral.
- Find that there is not a large derivative market in the sub prime sector (unlike the prime loan markets). As such, there are few, if any, hedging products that can offset rate speculation and credit curing exposure.

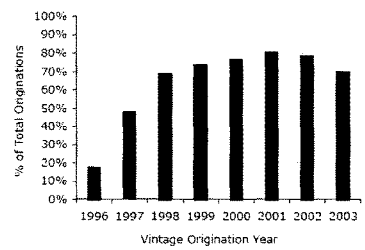
The supply side: Lenders:

- Have realized that without the bid from the capital markets, the liquidity of their loans would be significantly impaired. They also realize that these loans cannot be profitably produced given their cost to originate unless there are alternative sources of cash if the loans prepay.
- Use prepayment penalties to assist them during the period when they are aggregating new loans for sale in large bond deals. During that period,

they are exposed to prepayment risk which can be costly due to their high basis in the loans. Penalties mitigate this risk (by slowing speeds). It is important to note that a lender's all in cost for a sub prime loan is frequently higher than the penalty amount. As such, the penalty income may not be sufficient to cover the loss.

Homeowners have been a beneficiary of the bond markets strong bid for the loans. Many of the most distressed borrowers have been given loans because the markets will accept them in fractional percentages of a securitization. Others (less distressed but still sub-prime) simply enjoy a lower rate of interest than they would be offered without the same penalties.

Exhibit 2: Trends in Origination - Prepayment Penalties



Source: Banc One

The exhibit above shows the trend in the use of prepayment penalties. The percentage of loans originated with prepayment penalties has remained relatively stable since 1999, accounting for 70% to 80% of total annual originations.[1]

Definition and types of penalties:

Loan prepayment penalties are contractual features included in a mortgage that require a homeowner to pay a fee if they repay their mortgage in the early years of the loan's contracted life. The amount of the fee and the period the homeowner is required to pay this fee is disclosed in the original loan documentation.

A prepayment penalty is frequently found on different types of sub-prime mortgages (fixed rate, adjustable rate and hybrids). Usually, the penalty amount declines (to zero) with the passage of time and will not apply to repayment resulting from a home's sale.

Bond investors frequently have differing opinions about the value of prepay penalties on the three different loan types:

[1] Banc One, "ABS Yearbook 2004", pg.51

1. Prepayment penalties on fixed rate loans are heavily scrutinized by bond investors. As interest rates decline, investors want the bond cash flow to remain outstanding for the longest period. The put option of the borrower (prepayment) becomes more and more attractive to the borrower as rates continue to rally, making investors' focus on the prepayment penalty increasingly important on fixed rate loans.

2. For hybrid arms, most penalties expire no later than the first loan coupon reset date. Depending how far in the future the first reset date is, the impact can be very similar to the fixed loan example above or the ARM example below.

3. Prepayment penalties on ARMs are scrutinized the least because investors do not usually expect to have the price of their bonds deviate much from par. As such, a prepayment at par is not as costly.

There are two predominant types of prepay penalties. The first defines itself as a function of the loan coupon and the second defines itself as a function of the loan balance at the time of the repayment. Typical penalty types are are:

1. Six months interest (often on 80% of the loan balance)*
2. Flat percent of loan balance (5%, 3%, etc.)*

**Both types often have varied terms (2 yr, 3yr, 5 yr)*

Prepayment penalties effect on prepayment speeds:

Although historical loan prepayment data is available for sub-prime loans with prepayment penalties in general, prepayment data on loans sorted by prepayment penalty type is not available in a useful data set. It is our experience that most loan servicers do not keep accurate historical records in this regard. Although the data does exist with some servicers, the data that is available could be questioned as not being completely representative of all loans with these various types of penalties.

Loans with prepayment penalties are usually associated with lower rates, creating a two fold effect on projected and historical prepayment speeds. They prepay more slowly because:

1. There is an economic disincentive (penalty) in doing so, and;
2. The lower rate (than the no-penalty loan) decreases the refinancing incentive.

Figure 9a. **Prepayments on 2/28 Loans by Penalty Amount**

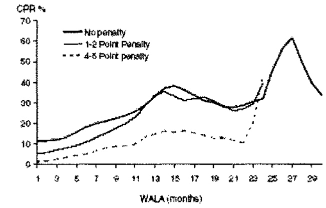
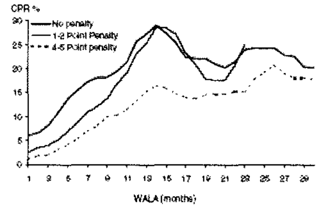


Figure 9b. **Prepayments on Fixed Rate Loans by Penalty Amount**



Source: Lehman Brothers

The rating agencies project the expected speed difference when they rate bond deals. Historically this decrease in prepayment speeds has been estimated to be approximately 10%[2] relative to loans without prepay penalties. In today's market, many investors estimate a decrease in prepay speeds due to the use of prepay penalties as high as 40-50%.

Concentration of prepayment penalties in sub-prime loans:

There is unquestionably a large disparity between the amounts of prime borrowers taking out loans with prepayment penalties versus the amount of sub-prime borrowers using penalties. Freddie Mac estimates that 80% of sub-prime loans carry prepayment penalties versus 2% in prime[3].

As stated earlier, prepay penalties on sub-prime loans became very popular in the mid 1990's to motivate investors to enter or return to the sub prime bond markets. Investors had inconsistent results and lenders used penalties to motivate them to buy bonds. Given the significant growth of sub-prime bond issuance since that time, it appears that this strategy was helpful. There are generally two perspectives of why there is a higher percentage of penalties on sub-prime versus prime:

1. **Opponents** to prepayment penalties would argue that many of these sub-prime borrowers are less sophisticated than prime borrowers, and often have these penalties included in their loan without fully understanding them or without understanding them at all.

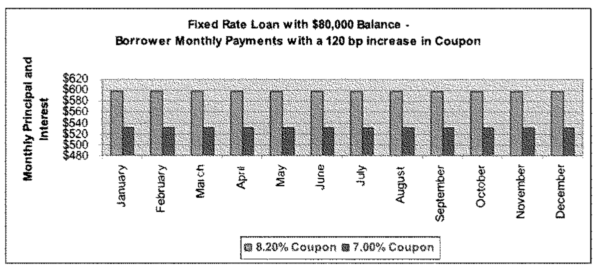
2. **Proponents** of penalties would argue that without these penalties, lenders would be forced to charge these borrowers significantly higher rates of interest, precluding many of them for qualifying for the requested loan amount. They take the perspective that borrowers freely enter this relationship because they have decided to accept the lower coupon and higher proceeds in exchange for temporary limitations.

[2] Standard & Poors, "NIM analysis: Valuing Prepayment Penalty Fee Income" January 3, 2001.
[3] Taken from "Frequently Asked Questions on Prepayment Penalties", www.freddiemac.com/singlefamily

Many borrowers are advantaged (via lower loan coupon) by the presence of prepayment penalties. Take, for instance, a prime borrower that is confident that he will be in his home for the next several years and does not wish to speculate on future lending coupons. By accepting a loan with a prepayment penalty, the borrower can enjoy a lower rate of interest (faster equity creation) over the term of the mortgage. The sub-prime borrower could be advantaged by a similar situation and/or be able to qualify for a mortgage that may have not been available without the presence of penalties due to the lower coupon.

The Borrowers Perspective – How will affordability be affected?

To illustrate the dollar impact of a lending coupon change to the sub-prime borrower, we look at a 7% fixed coupon loan with a balance of $80,000. A 120 bp increase in coupon would increase the annual payments on the loan from $6,386 to $7,178 for a difference of $792 (a significant sum for borrowers in this economic bracket, effectively putting this loan out of reach for a segment of them).



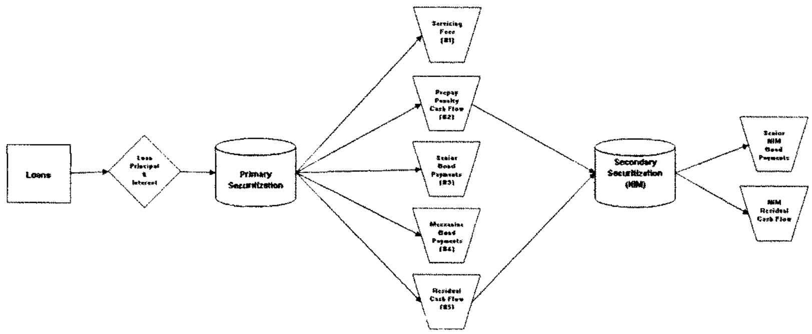
Source: Pentalpha

To look at it from another perspective, if the same borrower wanted to keep his monthly payment constant given a 120 bp rise in coupon, his loan size would have to be reduced from $80,000 to $71,250 (an over 10% decrease in the amount of money available to purchase the home).

The Investors Perspective – How will liquidity be affected?

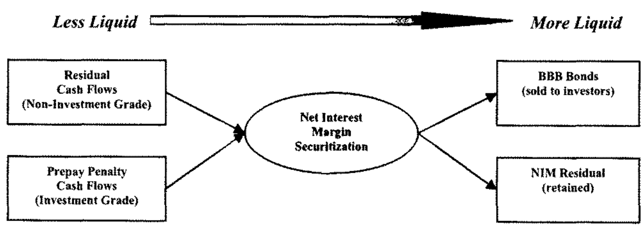
Although there are many bond transaction structures that are used in the market today, the over-collateralization structure is the most commonly used. As part of that structure, the following cash flows are created (all of the loans monthly cash flows are distributed into one of these five instruments):

1. Loan servicing cash flow
2. Prepayment penalty cash flow
3. Senior bond cash flow
4. Mezzanine bond cash flow
5. Residual cash flow



The cash flows found in #3 and #4 are commonly sold to investors in the form of bonds. The lender usually keeps cash flow #1 and applies an accounting value to that asset. An example of how the cash flows to #2 and #5 are monetized can be seen in a transaction structure called a net interest margin security ("NIM").

In a NIM securitization, an originator combines the junior residual cash flows (#5) with the senior prepayment penalty cash flows (#2) to create a new bond they can then sell to the investor community. The ability to sell these instruments to the capital markets on a combined basis creates liquidity for the lender.



It is estimated that prepayment penalties currently represent approximately 5%-15% of the projected gross cash flows in NIM transactions (depending on assumptions for prepayment rate and percent of penalties collected). The prepayment penalty cash flow is frequently considered a natural "hedge" for these transactions. If prepayment speeds were to increase (reducing cash flow to the residual), penalty income increases. Conversely, as prepayment speeds slow (increasing cash flow to the residual), penalty income decreases.

If prepayment penalties were reduced or eliminated completely, the rating agencies would likely reduce the amount of credit support and size of the senior bonds backed by NIM cash flows because of the loss of their diversification properties. Additionally, investors would also increase the yields demanded on these securities (decreasing proceeds) as the collateral would have lost this self-hedging characteristic and become inherently more risky.

The Originators Perspective - How is profitability affected?

In order to keep profitability unchanged, we estimated that the lender would need to raise loan coupons by 120 bps (our analysis is illustrated in a following section). The magnitude of this shift has been estimated by others at 100 bps[4]. It is important to note that our analysis illustrates the ***aggregate*** estimate of the move in loan coupon for an entire securitization. Individual loan coupons might have to be adjusted anywhere from 75 bps to 125 bps given the different types of penalties and credit risk that would have to be compensated for.

In order to understand the logic behind this estimated change in loan coupon, we outline here the basics of securitization economics and the steps originators take to lend profitably.

An originator will most often sell the loans it originates into the capital markets in the form of a securitization. In a securitization, the lender usually makes its money through:

1. Origination and underwriting fees associated with each loan.
2. The fee it charges to service the loans over time.
3. The collection and/or securitization of cash flow from the residual interest.
4. The collection and/or securitization of cash flow from the prepayment penalties.

[4] Chu & Kwan, Lehman Brothers "MBS&ABS Strategies" July 17, 2000.

By removing prepayment penalties as a source of cash flow, all four sources of profitability for the lender will be affected in the following ways:

Impact to issuance proceeds: Given faster prepayment speeds, securitization structures on the NIM transactions may have to be reduced in size to account for the change in cash flow characteristics. This will negatively affect the originators sale proceeds. The yield on the NIM transaction would also have to be increased as well to account for the increase in risk without the stabilizing effect of penalties. An example of the effect of faster prepayment speeds on securitization economics is illustrated in Appendix B.

Impact to residual cash flow income: Residual cash flows are often thought of as excess interest securities. Some describe residuals as paying the difference between the weighted average coupons of the collateral less the debt service on the securitization. As such, when you increase prepayment speeds (which would occur in the absence of prepayment penalties) there is less collateral to generate the excess interest and future cash flow will be reduced.

Impact to loan origination fee income: Given that many of the sub-prime borrowers will not be able to qualify/afford the higher rates necessitated by lack of penalties, there will be a smaller volume of borrowers to lend to. This results in a smaller volume of loans produced. Most lenders' profitability will likely decline as fixed expenses rise on a percentage basis.

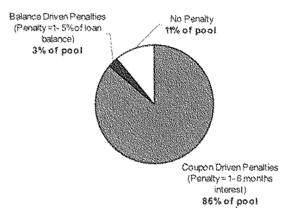
Impact to servicing fee income: Since the servicing fee is earned on the outstanding balance of the loan, and there is empirical evidence that non-prepayment penalty loans prepay faster, the cash flow to the servicing strip will be reduced as loans exit the pool at a faster rate and fee income is decreased over time. This is problematic due to the high fixed cost of sub-prime servicing.

Impact to prepayment penalty income: The direct impact of the elimination of penalties on this source of income for the originator is obvious (it will no longer exist). The indirect impact would be seen in net interest margin re-securitizations (a source of liquidity for originators).

Originator profitability impact – an example:

In order to better understand the impact of prepayment penalties on the lender's profitability, we analyzed the economics of a recent fixed rate sub-prime transaction. The intention of this analysis was to estimate how much loan coupons would have to be increased to compensate for the absence of prepayment penalties. In this recent transaction, the size of the sub-prime fixed rate collateral was \$960MM with a bond WAC[5] of 6.49%. Approximately 89% of these loans had prepayment penalties varying in term from 1 to 5 years:

Composition of Penalties on Original Pool



In order to replicate the effect of removing prepayment penalties, two variables were stressed:

1. Prepayment projections (CPR[6]) on the collateral and;
2. The associated coupons on that collateral.

The logic being that collateral originated without penalties would be originated with a higher coupon and prepay at a faster rate.

The bonds were offered on the transaction assuming a prepayment speed of 20 HEP[7]. For purposes of this analysis, we have estimated the loss of prepayment penalty protection would increase the projected prepayment speed assumption to 30 HEP. With this faster prepayment assumption and the penalty cash flow eliminated, the coupon on the collateral was increased until the aggregate pre-loss cash flow to the servicing strip and residual was equivalent to the original scenario.

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[5] WAC = Weighted Average Coupon

[6] CPR, (Constant Prepayment Rate) as defined by Bloomberg: CPR attempts to predict the percentage of principal that will prepay over the next 12 months based on historical principal paydowns.

[7] HEP, or (Home Equity Prepayment) Curve was developed by Prudential Securities and remains an actively used analytical tool. As Defined by Bloomberg: a prepayment measure scale with a 10 month seasoning ramp, as compared to the 30 month ramp for the PSA curve. The HEP scale ranges from 0% to 100%. A HEP value corresponds to the terminal 10th month CPR speed – having evenly stepped the preceding 9 months. For example, 20% HEP corresponds to 2% the 1st month, 4% the 2nd month, and 20% in the 10th month and thereafter. *A graphical example of 20 HEP and 30 HEP is provided as Appendix A.*

Outline of analysis:

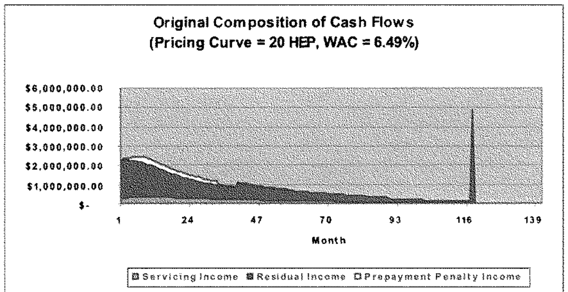
1. **Control Scenario** - The transaction was run at the securitization pricing assumptions of 20 HEP. This generated cash flows to the servicing strip, residual, and prepayment penalty class. The cash flows of the prepayment penalty and servicing classes were discounted at 8%, the residual cash flow was discounted at 18%. The net present value of the components was as follows: $15,180,397 of servicing income, $50,178,350 of residual income and $7,610,416 of prepayment penalty income. The cumulative Net Present Value (NPV) of the three cash flows was $72,969,164.

2. **Increased Prepayment Speed Scenario to Simulate Behavior of Non-Penalty Loans** - The prepayment penalty cash was removed, and the prepayment speed assumption on the associated collateral was increased to 30 HEP (from 20 HEP). The NPV of the cash flows (omitting the prepayment penalty class) in this scenario were as follows: $11,074,184 to the servicing class and $42,029,146 to the residual class. This aggregate NPV of $53,103,330 represents a loss of $72,969,164 - $53,103,330 = ($19,865,834)

3. **Increased Prepayment Speed with Lending Coupon Adjustment Scenario –** In the 30 HEP scenario, the coupon on the collateral was increased until the aggregate NPV cash flow in the adjusted scenario (#2) was equivalent to the control scenario (#1). The intention was to compensate for the loss of the penalty income (-$7,610,416), as well as the impairment to the cash flow to the residual (-$8,149,204) and servicing strip (-$4,106,214). To increase the NPV by this ($19,865,834) total, the loan coupon adjustment necessary was 115 bps. We believe there would have to be an additional 5 bps of coupon increase (estimate by Pentalpha) to compensate for the lower proceeds associated with the AAA bonds due to the likely change in assumptions used in the bidding process. This brings the total coupon increase to 120 bps.

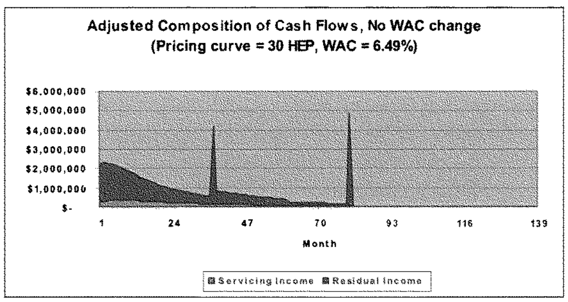
Summary Cash Flows:

Scenario #1: NPV of Cash Flows = $72,969,164



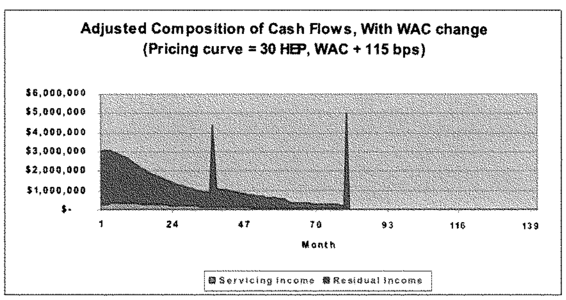
Source: Pentalpha, Wall Street Analytics

Scenario #2: NPV of Cash Flows = $53,103,330



Source: Pentalpha, Wall Street Analytics

Scenario #3: NPV of Cash Flows = $72,969,164



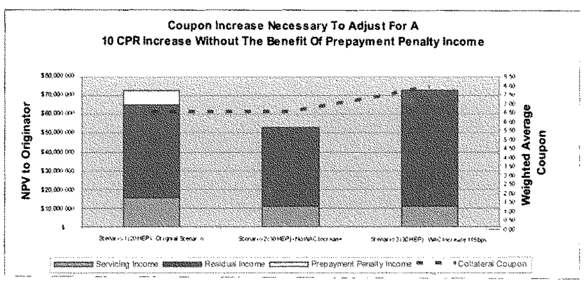
Source: Pentalpha, Wall Street Analytics

Results:

The components of the 120 bp estimated increase in loan coupon to compensate for the elimination of penalty income (given an increase in the pricing curve to 30 HEP) were as follows:

Impact of prepayment penalty income on loan coupon:			
Original WAC on Mortgage Pool	6.49%		
Increase necessary to compensate for the impairment to residual class due to faster prepay speeds	0.47%		
Increase necessary to compensate for the removal of prepayment penalty cash flows	0.44%	+115 bps	+120 bps
Increase necessary to compensate for impairment to servicing strip due to faster prepay speeds	0.24%		
Approximated increase due to loss of proceeds from wider execution on investment grade bonds	0.05%	+5 bps	
Estimated WAC on Mortgage Pool after adjustment	7.69%		

Source: Pentalpha



Source: Pentalpha

The graph shows that as the prepayment speed is increased from 20 HEP in scenario 1 (penalty income) to 30 HEP in scenario 2 (without prepayment penalty income), the net present value to the residual is decreased by ($8,149,203). The net present value of the servicing strip is also reduced by ($4,106,214) in scenario 2. The net present value of the prepayment penalties ($7,610,416) is eliminated. This ($19,865,834) total ($8,149,203+$4,106,214+$7,610,416) is then recouped in scenario 3 by increasing the loan coupon by 115 bps. In scenario 3, the net present value of the cash flow in scenario 1 is equal to that in scenario 3.

Looking at the "original composition of cash flows" on page # 15, there is a large distribution in residual cash flow at month 117. This is the release of the over-collateralization in the deal to the owner of the residual class assuming no losses or delinquencies. The over-collateralization (residual) can be thought of as the first loss piece. In our scenario # 2 - "adjusted composition of cash flows" on page # 15 we can see that the increase in coupon and faster prepayment speed has triggered the release of cash to the residual in months 35 and 79 based on step-down provisions in the deal structure. This illustrates the impact that faster prepayment speeds can have on some of the trigger mechanisms imbedded in these securitizations. The "adjusted composition of cash flows" shows a shorter, more volatile cash flow stream in both the loan coupon change and no loan coupon change scenarios.

Notes to Coupon Adjustment Exercise:

1. The analysis is highly sensitive to the assumptions tied to prepayment rates, as well as the discount rates used for the servicing income, prepayment penalty income, and residual income. The assumptions used are for illustration purposes only.

2. The increase in loan coupon due to the wider bond yields expected on the AAA classes (5 bps) is an estimate by Pentalpha.

3. This is a coupon sensitivity analysis. The interest rate environment will have a significant impact on this type of analysis. In a rising rate environment the speed differential between penalty and non-penalty loans will tighten significantly.

4. The collateral used in this analysis was originated with a fixed coupon, the impact to lending coupons could be significantly different with floating rate collateral.

5. This is a pre-loss analysis. The impact of losses could alter the results.

How will the margins of the originator be effected?

From the issuers perspective - Appendix B, shows the sources and uses of cash usually found in a whole loan execution as well as a typical securitization execution. It estimates the economic impact of removing prepayment penalties assuming faster prepayment speeds without a coupon adjustment. Dollar figures for the residual class, loan servicing strip, and prepayment penalty class are taken from our previous example. The figures are expressed as a percent of par (i.e.- in a $1 billion dollar transaction $50 million is 5% of par).

The impact in this example of moving the pricing curve from 20 HEP to 30 HEP and removing penalties (without increasing coupons) is significant. The profitability on the securitization decreases by 1.98% in sale proceeds (expressed as a percent of par). This amount exceeds lender margins and creates a loss in this example.

Notes to the securitization example (Exhibit B):

1. The estimates used for whole loan prices, underwriting fees, broker fees, costs to produce the loan, prepayment speed and discount rates are all assumptions used for illustration purposes only.

2. This analysis is not intended to be an illustration of the current realized net profit margins of the issuer, actual margins in the marketplace may differ. We are attempting here to illustrate the potential economic impact of changes to these cash flows.

3. This analysis utilizes pre loss cash flows. Residual class, loan servicing and prepayment penalty classes are highly sensitive to losses and could affect the economics of the analysis.

Conclusion:

Some market participants suggest that if prepayment penalties were eliminated in their entirety, the originators would simply make less money and continue to operate less profitably. We suggest here that the loss of prepay penalties without an increase in loan coupons could upset the originators liquidity as well as the economics of the securitization process.

In practice, we would expect borrowers to be highly sensitive to the theoretical change in coupon rates presented here. It is unlikely that originators could simply raise loan coupons to adjust for this loss to their profitability without significantly effecting lending volumes. While some of the larger originators might find it possible to continue to operate at reduced margins if prepayment penalties were to be eliminated (without being able to increase coupons as dramatically as presented here), we feel many of the smaller lenders would not. Should the capital environment change for the worse (higher defaults, faster prepayment speeds, flatter yield curve) without the benefit of prepayment penalties, even the larger firms could potentially find this type of lending unprofitable.

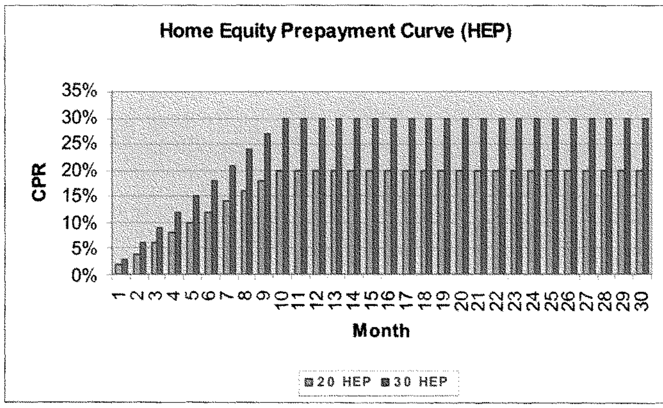
We attempt to illustrate here that there are many redeeming aspects of the prepay penalty feature that are beneficial to the borrower, originator and investor. These benefits are most commonly enjoyed as lower coupons and access to capital at the borrower level, greater liquidity at the investor level, and profitability at the originator level. Eliminating the use of prepay penalties would cause more repercussions than merely raising coupons while impairing lender liquidity and profitability. Without prepayment penalties some "challenged" borrowers could be priced out of the market and homeownership would be made unnecessarily more expensive for others. Many of the smaller lenders would experience significant financial stress given the reduced margins in the remaining volume. The decreased profitability to the sector would ultimately be paid for at the consumer level with fewer opportunities for the most distressed borrowers.

About Pentalpha Capital Group:

Pentalpha is an independent investment advisory and consulting firm founded in 1994. The firm specializes in complex loan and bond structures and is a consultant to leading investors, originators, servicers, and insurers of structured finance products. A more detailed description of Pentalpha can be found at www.pentalphaglobal.com.

Wall Street Analytics – an independent software development company specializing in the structured finance sector of the fixed income industry, was responsible for building the cash flow engine used in this report.

Appendix A


Home Equity Prepayment Curve (HEP)
35%
30%
25%
20%
15%
10%
5%
0%
CPR
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30
Month
20 HEP 30 HEP

Appendix B

Proceeds Analysis: Wholesale vs Securitization
Effect of Prepayment Speed and Prepayment Penalty Income on Securitization Economics

With Prepayment Penalties, Collateral Run at 20 HEP

Assumptions:	
WAC on Collateral:	6.49%
Collateral Type:	Fixed
Pricing Speed:	20 HEP

Discount Rates:	
Servicing:	8.00%
Prepayment Penalties:	8.00%
Residual:	18.00%

	Origination Costs	Proceeds from Loan Sale	Net Proceeds to Originator
Loan Originated	($100.00)		
Fees to Brokers	($1.00)		
Costs to Produce	($2.00)	$104.25	
	($103.00)	$104.25	$1.25

	Origination Costs		Direct Proceeds from Securitization	Indirect (retained) Proceeds from Securitization	Gross Proceeds from Securitization	Underwriting Costs on the Securitization	Net Proceeds to Originator
		Bond Proceeds	$98.00				
Loan originated at 6.5%	($100.00)	Residual		$5.01			
Fees to Brokers	($1.00)	Prepayment Class		$0.76			
Costs to Produce	($2.00)	Servicing Strip		$1.51		($1.00)	
	($103.00)		$98.00	$7.28	$105.28	($1.00)	$1.28

Without Prepayment Penalties, Collateral Run at 30 HEP

Assumptions:	
WAC on Collateral:	6.49%
Collateral Type:	Fixed
Pricing Speed:	30 HEP

Discount Rates:	
Servicing:	8.00%
Prepayment Penalties:	8.00%
Residual:	18.00%

	Origination Costs	Proceeds from Loan Sale	Net Proceeds to Originator
Loan Originated	($100.00)		
Fees to Brokers	($1.00)		
Costs to Produce	($2.00)	$102.30	
	($103.00)	$102.30	($0.70)

	Origination Costs		Direct Proceeds from Securitization	Indirect (retained) Proceeds from Securitization	Gross Proceeds from Securitization	Underwriting Costs on the Securitization	Net Proceeds to Originator
		Bond Proceeds	$98.00				
Loan originated at 6.5%	($100.00)	Residual		$4.20			
Fees to Brokers	($1.00)	Prepayment Class		$0.00			
Costs to Produce	($2.00)	Servicing Strip		$1.10		($1.00)	
	($103.00)		$99.00	$5.30	$103.30	($1.00)	($0.70)

*This example is for illustration purposes only and is not intended to accurately represent the margins actually realized by issuers.

*Cash flows were generated assuming no losses.

*If the retained classes were to be pledged to a Net Interest Margin securitization, additional costs (interest rate caps, securitization fees) would be borne that are not represented here

Disclaimer:

The materials contained in this report are not projections, predictions or forecasts. Past performance of securities, loans or other financial instruments is not indicative of future performance. All of the prices, discount rates, and assumptions used in this report should be considered for illustration purposes only. The opinions provided herein are subject to change without notice.

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Testimony of Joseph A. Smith, Jr., North Carolina Commissioner of Banks, to a Joint Hearing of the Subcommittees on Housing and Financial Institutions of the House Financial Services Committee

May 24, 2005

Rep. Ney, Rep. Bachus, Rep. Waters, Rep. Sanders, members of the Committee, I am Joseph A. Smith, Jr., North Carolina Commissioner of Banks. I appreciate this opportunity to testify today on the very important topic of "Legislative Ideas to Address Predatory Lending."

My duties as Commissioner of Banks include licensing and regulation of over 1,500 mortgage bankers and brokers and over 15,000 individual mortgage loan officers doing business in North Carolina. I also work with my friend and colleague Attorney General Roy Cooper to enforce North Carolina's consumer protection laws relating to mortgage lending, including our pioneering anti-predatory lending law. I will present to you today a few relevant lessons I have learned from this experience.

Let me begin with an obvious but important truth: residential mortgage lending is a local activity that is financed globally. Deregulation, advances in information technology and the growth and development of capital markets have revolutionized an activity that was at one time conducted primarily by locally-based institutions. Mortgage lending has been "deconstructed" so that origination, funding, and servicing are often conducted by different firms, often with no connection to local markets or the consumer. An activity that was based on relationships is now transactional.

This revolution has brought with it an array of outcomes for consumers: generally good, sometimes bad and occasionally ugly. The good news has been an increase in liquidity and availability of mortgage finance for consumers at virtually all levels of income and wealth; the bad news, an increase in foreclosures; the ugly, predatory lending and mortgage fraud.

The North Carolina General Assembly, by large and bipartisan majorities, has addressed predatory lending by enacting an anti-predatory lending law and a law regulating certain mortgage lenders and brokers. North Carolina is not alone in addressing predatory lending through legislation; a number of other states have taken similar actions. The reason for action at the state level is obvious: the damage done by predatory lending is local. It occurs where we live. States legislatures have acted with regard to predatory lending because federal laws and regulations did not protect their citizens from loan terms and lender conduct that they found to be unconscionable.

State anti-predatory lending laws have been criticized by a number of private and public sector sources. At the risk of over-simplifying, these criticisms are basically that such laws have created a patchwork of compliance issues for the industry that increases its costs, reduces its efficiency and restricts access to mortgage finance for low and moderate income borrowers. I would find the critiques of North Carolina's laws more convincing if they were accompanied by a single actual example of a low or moderate income person in the Tar Heel State who has been denied home mortgage credit because of our laws.

I will leave technical analysis of the impact of North Carolina's anti-predatory lending law to the experts. Let me suggest to you a few practical consequences of the law:

- The law appears to have substantially improved the conduct of lenders in our market. There have been very few instances where the borrower counseling required by the law has been sought. This fact, supported by our monitoring of the market, suggests that lenders have complied with the law by removing predatory loan terms from contracts and ceasing predatory conduct.

- I have seen no evidence whatsoever that credit availability has been reduced. If low and moderate income borrowers are being denied credit, that circumstance has not been brought to my attention or, to my knowledge, to the attention of any member of the North Carolina General Assembly.

- Of the roughly 1,500 consumer complaints received by my office each year, two-thirds involve mortgage lending. These complaints do not involve denials of credit; rather, they involve issues that arise when consumers do get credit.

- The foreclosure rate in North Carolina has doubled over the last five years. This does not strike me as evidence of the denial of credit. It does suggest issues to be addressed regarding the lending that is being done.

In sum, I would submit to you that the evidence from actual experience in North Carolina, as distinct from the "virtual" North Carolina created by our laws' critics, suggests that our approach to predatory lending has been successful.

The efforts by states to address predatory lending are examples of federalism at its best. The enactment of such laws has resulted in a debate on an important issue of public policy, including this consideration of the issue by the Congress. In light of the experience of the states, I would hope that Congress would consider the following issues in addressing predatory lending:

- Is federal action necessary at all? It is not clear to me that capital markets have been seriously affected by state laws; rather, they have adapted to them and have continued to operate. I would suggest that federal action is necessary only if the cost of compliance to mortgage bankers and secondary markets clearly outweighs the interest of states in protecting vulnerable borrowers and the markets themselves from predatory practices.

- If federal action is necessary, the experience of the states in setting standards for market activity should be the basis for federal standards.

- State authority to enforce federal standards should be included in any federal legislation. The effects of predatory conduct in the mortgage market are local and severe. Further, abuses that are immaterial from a global or national perspective are very material from a local one.

- Inclusion of the states in market oversight should be incorporated in federal legislation. The mortgage industry is a diverse one, including both large national and international organizations and small locally-owned firms. One size does not fit all in terms of regulation. The public interest is best served by a system the coordinates state and federal efforts.

- Federal legislation should incorporate the ongoing efforts of state regulators to create and implement a coordinated national licensing system for mortgage bankers and brokers and a centralized database with regard to market participants, both firms and individuals. Working through the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators, we have made significant progress on these important projects and expect the licensing system to be fully operational by the end of 2006.

The residential mortgage market is a vibrant and important national asset. Preserving its health is a matter of both state and national concern. I hope that this hearing and the debate that follows lead to action that enhances both the health and fairness of the market. I appreciate the opportunity to participate in this debate and would be happy to answer any questions you may have.

Thank you.

RESPRO®
Real Estate Services Providers Council, Inc.

June 3, 2005

The Honorable Robert Ney
Chairman of the Housing Opportunity Subcommittee
2438 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Ney:

On behalf of the Real Estate Services Providers Council, Inc. (RESPRO®), I would like to express our support for two key provisions in H.R. 1295, the Responsible Lending Act: (1) the creation of a level playing field between affiliated and unaffiliated mortgage companies under the Home Owners Equity Protection Act (HOEPA), and (2) the creation of a national standard for predatory lending practices.

Background of RESPRO®

RESPRO® is a national non-profit trade association of approximately 260 leading companies in the home buying and financing industry (see our membership list at http://www.respro.org/content.cfm?L1=1.0&L2=3.0). Our members represent a cross section of the industry, including real estate brokerage companies, mortgage lenders/brokers, title insurers/agencies, vendor management companies, and other settlement service providers.

Although RESPRO® represents providers across industry lines, the majority of our members offer mortgage loans, either directly, through wholly-owned subsidiaries, or through joint ventures with lender partners. The bond that unites RESPRO® members is their support of a fair and open competitive environment that allows all providers to offer diversified services or one-stop shopping, regardless of their industry or affiliation.

The Need for a Level Playing Field Under HOEPA

As you know, HOEPA currently places loan term restrictions and disclosure requirements on 'high cost' mortgages with an interest rate of more than 10% above the Treasury rate or mortgages with 'points and fees' of more than 8% of the loan amount. Unfortunately, however, HOEPA unnecessarily discriminates against affiliated businesses by requiring lenders to include 'points and fees' paid by the consumer to a lender's affiliate, but not 'points and fees' paid by the consumer to a third party, when calculating the 'points and fees' threshold.

H.R. 1295 correctly acknowledges that affiliated businesses in the mortgage marketplace have consistently been proven in economic studies and acknowledged by the Department of Housing and Urban Development (HUD) to potentially increase competition and lower costs for home-buyers and owners. It correctly recognizes that by unnecessarily restricting loans that potentially offer consumers lower cost loans, the current HOEPA law totally ignores whether the fees paid in any particular loan transaction are reasonable (e.g., a $1,000 charge for title insurance and $300 charge for an appraisal in a particular loan transaction by an unaffiliated settlement service provider would not be counted as 'points and fees', while a $750 charge for title insurance and a $250 charge for an appraisal would count as 'points and fees').

Rather than discriminate on the basis of corporate structure, H.R. 1295 requires that a 'point or fee' must be "bona fide, competitive, and reasonable;" to be excluded from the 'points and fees' threshold. This approach better ensures that fees consumers pay for settlement services will accurately reflect the cost of the transaction

RESPRO® vigorously supports the creation of this level playing for all providers. It is important as Congress continues to grapple with predatory lending legislation that, whatever legislation ultimately emerges, it corrects the discrimination under HOEPA and treats all providers equally.

A National Predatory Lending Standard

H.R. 1295 also would preempt contrary state laws regarding predatory lending in favor of a national standard. RESPRO® strongly supports this preemption provision, and we are glad to add our voice to the growing chorus who recognize the need for a uniform lending standard.

This metastasizing patchwork of various state and local predatory lending laws have significantly added to the compliance costs of mortgage providers and, in some cases, have led to a severe diminution in the availability of mortgage credit. We believe that only the establishment of a national lending standard will provide the requisite regulatory certainty to assure a stable flow of mortgage credit throughout the country.

We also note that the preemption language in H.R. 1295 is carefully drafted and narrowly tailored to accomplish its objective, which is to preempt only conflicting state laws on mortgage lending without reaching other state laws governing the real estate transaction. It reflects a carefully constructed compromise cognizant of the need for a uniform lending standard; while simultaneously respecting local prerogatives with respect to other aspects of real estate law.

Conclusion

Again, we thank you for your hard work in crafting a bi-partisan and balanced bill that creates (1) a level playing field between affiliated and unaffiliated businesses and (2) the a national predatory lending standard. We look forward to continuing to work with the Committee as it continues to debate this issue.

Mr. Ney insert

List of Co-sponsors of H.R. 1295

Current Co-Sponsors ~~(35)~~ 36:

Rep. Barrett, J. Gresham [R-SC-3]
Rep. Bishop, Sanford D., Jr. [D-GA-2]
Rep. Boyd, Allen [D-FL-2]
Rep. Brown-Waite, Ginny [R-FL-5]
Rep. Clay, Wm. Lacy [D-MO-1]
Rep. Cox, Christopher [R-CA-48]
Rep. Crowley, Joseph [D-NY-7]
Rep. Davis, Geoff [R-KY-4]
Rep. Doolittle, John [R-CA-4]
Rep. Feeney, Tom [R-FL-24]
Rep. Fitzpatrick, Michael G. [R-PA-8]
Rep. Ford, Harold E., Jr. [D-TN-9]
Rep. Boustany (R-LA-7)
Rep. Fossella, Vito [R-NY-13]
Rep. Gerlach, Jim [R-PA-6]
Rep. Gillmor, Paul E. [R-OH-5]
Rep. Harris, Katherine [R-FL-13]
Rep. Hensarling, Jeb [R-TX-5]
Rep. Hooley, Darlene [D-OR-5]
Rep. Israel, Steve [D-NY-2]
Rep. Kanjorski, Paul E. [D-PA-11]
Rep. King, Peter T. [R-NY-3]
Rep. LaHood, Ray [R-IL-18]
Rep. LaTourette, Steve C. [R-OH-14]
Rep. McHenry, Patrick T. [R-NC-10]
Rep. Meeks, Gregory W. [D-NY-6]
Rep. Miller, Gary G. [R-CA-42]
Rep. Owens, Major [D-NY-11]
Rep. Oxley, Michael G. [R-OH-4]
Rep. Peterson, Collin [D-MN-7]
Rep. Price, Tom [R-GA-6]
Rep. Renzi, Rick [R-AZ-1]
Rep. Scott, David [D-GA-13]
Rep. Sherman, Brad [D-CA-27]
Rep. Thompson, Bennie G. [D-MS-2]
Rep. Tiberi, Patrick J. [R-OH-12]

Mr. Bachus insert

Full discussion:

Mr. BACHUS. What about the North Carolina law? Do you all find that to be a fair law? I would ask you, Mr. Green.

Mr. GREEN. I guess we have found that the North Carolina law, specifically on predatory lending, has less vagueness in the assignee liability and frankly the body of their specific predatory lending stays away, as the previous witness said, from assignee liability specifically. *So it has been a law that most of the marketplace has perceived to be a more workable standard than what we found in other states.*

Mr. BACHUS. So you found that the North Carolina model at least does not inhibit the mortgage capital?

Mr. GREEN. I never say never.

Mr. BACHUS. It does not appear to be. I mean, we have experience with it now.

Mr. GREEN. Right. *But I think it would be a good standard as this committee furthers its look at potential legislation. It would be a good standard to look at.*

Mr. BACHUS. Okay.

....

Mr. BACHUS. Let me ask you this, my time has run out, I think what Mr. Green is saying is that the industry can live with the North Carolina law.

Mr. GREEN. I am saying it is a good starting place to look because their approach——

Mr. BACHUS. Has it limited liquidity to any great extent? I am not trying to put you on the spot.

Mr. GREEN. You are doing a good job.

[Laughter.]

I would say that the North Carolina law has examples in it that the industry does feel are more precise and objective than what we have experienced in other states.

Mr. BACHUS. Okay.

Mr. GREEN. The right place to be on a national standard is probably not going to be exactly where the North Carolina law is.

Mr. BACHUS. I understand. I am just saying it is workable. I think Mr. Calhoun is saying, at least what I hear, is that it is protecting consumers.

Mr. CALHOUN. That is correct, Mr. Chairman.

washingtonpost.com

Civil Rights Leaders To Fight Lending Bill

Consumers Unprotected, Groups Say

By Sandra Fleishman
Washington Post Staff Writer
Friday, March 25, 2005; Page E03

Consumer advocates are bringing out big names from the civil rights world to try to keep a lending industry-backed bill on predatory mortgage lending from rolling through Congress the way recent bankruptcy legislation did.

NAACP Chairman Julian Bond, the Rev. Jesse L. Jackson and Wade Henderson, executive director of the Leadership Conference on Civil Rights, and their groups are joining with consumer groups to oppose a bill introduced earlier this month by Rep. Robert W. Ney (R-Ohio), chairman of the House Financial Services housing subcommittee, and Rep. Paul E. Kanjorski (D-Pa.), the senior Democrat on the capital markets subcommittee.

The civil rights leaders and the head of the National Fair Housing Alliance are expected to issue a statement today urging Congress to reject the Ney-Kanjorski proposal. The Post obtained a copy of the statement yesterday.

"Representatives Ney and Kanjorski have failed to provide meaningful protections in their mis-named 'Responsible Lending Act,' " Bond said in the statement. "Their bill demonstrates a failure to address the real pain caused by predatory lending and the harm it is doing to African-American families."

The strong words seem to take the long-running debate over how to crack down on predatory lending back to where it has been for years, with a deadlock between lenders pushing for federal preemption of tougher state laws and consumer and civil rights groups arguing that proposed GOP fixes are too weak. The new twist this year, however, is that Democrat Kanjorski and three black Democrats on the committee have co-sponsored the bill with Ney.

Kanjorski yesterday said that he had expected criticism but that he hopes a bill can be crafted that meets the concerns of the groups and helps protect home buyers and lenders. But, he said, the current situation is driving lenders out of states with strict laws. "There has been a very long attempt to find something that's workable, and this is a start," he said in a phone interview. "But right now it's a disaster out there with every state having a different approach" to regulation.

The civil rights groups contend that the Ney-Kanjorski approach falls far short of what is needed to stop abusive lending targeted at minorities, the elderly and immigrants and instead removes protections in existing federal law and in state and local regulations. The states and local jurisdictions have been passing laws since about 1999 as lending to subprime, or higher-risk, borrowers has exploded. Although not all subprime lending is predatory, complaints about abusive lending, with hidden or excessive fees and deceptive practices, have skyrocketed as higher-cost, subprime loans have become available.

Subprime lending now accounts for about 20 percent of the mortgage market, with about $500 billion in new loans last year.

Consumer advocacy groups, including the Consumer Federation of America, the Center for Responsible Lending, the National Consumer Law Center, the National Association of Consumer Advocates and the

U.S. Public Interest Research Group, are backing a bill by House Financial Services ranking Democrat Barney Frank (Mass.) and North Carolina Democrats Brad Miller and Melvin Watt, who leads the Congressional Black Caucus. That bill is modeled on tough legislation passed by North Carolina in 1999. It does not preempt state laws.

Industry groups contend that preemption is required to eliminate what they say is a patchwork of state and local laws.

Among those supporting Ney-Kanjorski as a strong "first step" are the Mortgage Bankers Association, the National Association of Mortgage Brokers, the Bond Market Association, the American Securitization Forum and the National Home Equity Mortgage Association, which represents about 80 percent of what it terms the "non-prime" market.

Consumer groups have painted the Ney-Kanjorski bill as intolerable and an "evisceration" of state and federal protections.

Earlier this month, a coalition of those groups released an analysis saying that the legislation has too many loopholes and would hurt borrowers.

That analysis is "misleading," and the 126-page bill is not only strong but much tougher than the industry would like, said lending industry lobbyist Wright Andrews, executive director of the Coalition for Fair and Affordable Lending, which says it represents more than a third of the subprime industry. "It fails to recognize many of the strong provisions in the bill and overstates and grossly misstates what the laws around the country say."

Hearings are expected this spring, Kanjorski said yesterday.

Inside Mortgage Finance's

Inside B&C Lending

An In-Depth Report On The Dynamic Subprime Mortgage Business

Volume 6, Issue 5 March 5, 2001

Inside This Issue...

Household Tops Subprime Servicing Pack as Market Cracks $400 Billion

Consolidation was the watchword for the subprime servicing market in 2000, an exclusive new *Inside B&C Lending* ranking of the top players reveals. But even the mega-merger of Citigroup and Associates First Capital couldn't topple Household Finance from its perch atop the industry.

In fact, the Illinois-based finance company consolidated its hold on the second leg of the industry triple crown by finishing the year with a portfolio bulging at $36.64 billion, a level that would have been unthinkable as recently as two years ago.

Household's dominance of the market – it led its nearest competitor by more than $10 billion – highlights one of the realities of the new subprime market: more and more loans are concentrated in fewer and fewer hands. That trend gained momentum last year, when the demise of companies such as ContiMortgage, Firstplus Financial, United Companies and First Alliance Mortgage meant opportunities for companies looking to acquire large servicing portfolios.

The march toward consolidation shows little sign of abating in 2001. Only last week, in fact, J.P. Morgan Chase announced that it had completed its acquisition of Advanta, a move that is sure to add to the growing clout of banks in the servicing market. And with securitizers such as Delta Funding increasingly selling off the servicing rights to their loans, servicers should find ample opportunities to add to their books-of-business in the months ahead.

The extent to which consolidation has shaped the market is evident in the market share of the top servicers. As a group, the top 25 serviced 61 percent of the estimated $427.4 billion in subprime loans outstanding at the end of December. And while the servicing market as a whole grew an estimated 8.8 percent last year, the top 25 grew their collective portfolio at a blistering 26.9 percent rate.

(Continued on page 3)

Top Servicers...

Also worth watching as the year progresses is the ability of subprime servicers to cope with an anticipated refinance boom. If that boom develops, it could put pressure on companies trying to retain their portfolios. The increased use of prepayment penalties should help. But experts also pinpoint the ability to manage customer relationships as a key component of success.

Additionally, a slowing economy could result in increased delinquencies in the months ahead. How successful servicers are in managing that upswing will likely be one of the top stories of 2001.

Banks Gain Steam

While Household sat solidly atop the servicing market last year, CitiFinancial's acquisition of Associates First Capital helped bolt it into the second spot. While still a long way from catching Household, Citi's $25.09 billion subprime portfolio was up a hefty 136.5 percent from 1999.

Third-ranked Bank of America Home Equity, meanwhile, increased its subprime servicing business by 21.3 percent last year. The North Carolina banking giant, which closed its NationsCredit subprime unit, finished 2000 in command of a $25.96 billion portfolio and nipping at Citi's heels.

Fourth-ranked Option One Mortgage saw its servicing business grow 76 percent, to $17.47 billion, last year. The H&R Block subsidiary recently became one of the first subprime companies to garner an RPS1 primary servicer rating from rating agency Fitch.

Rounding out the top five, Advanta Corp. had the largest volume falloff of any top servicer. The Pennsylvania-based lender, which last week completed the sale of its mortgage unit to J.P.Morgan Chase, cut its servicing volume by 21.7 percent, to $15.82 billion, last year.

Acquisitions helped Countrywide Home Loans and Fairbank Mortgage leap into the top tier of the rankings last year.

Countrywide grabbed the sixth spot with a 147.7 percent expansion of its subprime portfolio. That rise, to a total of $15.22 billion, was fueled in part by the company's acquisition of Firstplus' book-of-business.

Similarly, Fairbank's jump to seventh in the rankings, from 16th in 1999, was partly a result of its purchase of ContiMortgage's servicing book. Fairbank's $12.50 billion year-end portfolio marked a 150 percent rise from 1999.

Eighth-ranked Conseco Finance grew its portfolio 9.1 percent, to $13.31 billion last year. Ocwen Financial claimed the ninth-spot with an $11.4 billion servicing portfolio.

Rounding out the top ten, Residential Funding Corp. closed the books on 2000 with a $10.6 billion portfolio, a 16.9 percent decrease from 1999.✦

Lenders Will Try to Pin Down Effects of NC Mortgage Law

Aiming to drum up support for their campaign against the rising tide of state predatory lending initiatives, lenders have set out to document what they say is a chilling of credit.

Spearheading that effort is the Mortgage Bankers Association of America and several multi-state lenders who are commissioning a study to gauge the impact of North Carolina's anti-predatory lending legislation on resident consumers and the state's subprime lending industry. The study will look into reports of lender flight and lending cutbacks as a result of the tough anti-predatory lending measure passed by the state legislature in 1999.

"We're trying to build some empirical evidence," Steve O'Connor, MBA's director of regulatory affairs, said. "We want to know the law's impact on consumers: Are they paying more for credit? Is there less credit available? Who is hurt the worst for not having the access [to credit] that they used to have?"

Such a study could give lenders a major boost in their fight against state predatory lending initiatives. While the industry has tried to paint the picture of a mass exodus from the market as a result of the predatory lending law, the evidence so far is largely anecdotal.

An *Inside B&C Lending* review of the rate sheets of several top subprime lenders found that, in general, those companies continue to offer a full array of products for borrowers in North Carolina – with little or no variation in rate.

And while some higher profile companies have opted to leave the market, it's not always clear what role the predatory lending law played in those decisions – or whether credit availability has been significantly curtailed.

New Century Financial, for instance, exited the North Carolina market "a little over a year ago," according to a spokesperson. But the official downplayed the role that the predatory lending law played in that decision. Instead, she noted, the pullout was part of a larger process of branch consolidation.

More recently, Countrywide's Full Spectrum announced that it is abandoning the market as well. But officials acknowledge that the unit was never much of a player in the Tar Heel state to begin with. "We really were just getting into the market," said Paul Abbamonto, Full Spectrum's president. "Unfortunately, it was a tough economic decision. A lot of people sharpened a lot of pencils over this, and they finally said 'we really can't do it.' There were just a lot of deal stoppers in it."

Officials at Option One Mortgage, a subsidiary of insurance giant H&R Block, revealed last week that they had also given "serious consideration" to a pull out from North Carolina. Among the company's concerns is a provision in the law that bars refinancing without a "net tangible benefit" to the borrower.

"We are putting a great deal of scrutiny to the loans we make there," said William Davis, head of compliance for Option One. "We'll maintain a very deliberate presence in North Carolina until we get a track record behind us."

On the issue of whether the law had restricted access to credit, Davis said, "my guess would be that there are people in North Carolina that no longer have access to the mortgage market."

One of the few companies that has so far been willing to put numbers to its North Carolina experience is Bank of America. In an interview last week, a spokesperson for the banking giant's Equicredit unit said that the company saw its subprime volume tumble by 42 percent, relative to the first half of the year, between July 1 of 2000, when the second phase of the law kicked in, and year-end. Meanwhile, Equicredit's volume nationally was down 11 percent during the same period, a fall-off that the official attributed to "general economic market conditions," including a falloff in consumer confidence.

Still, the falloff in North Carolina was smaller than the company anticipated, mainly because reduced competition meant that Equicredit was able to pick up some borrowers who otherwise might have gone to other lenders. The Equicredit official expressed concern that other borrowers have turned to hard money or payday lenders to meet their credit needs.

The MBA's O'Connor suggested that the flight of larger lenders from the state should provide a wake up call for regulators.

"The regulators may want certain entities to flee the state but I don't think they'd want a reputable major player like Countrywide to leave," he said. "Our purpose is to figure out the best response so that we will have a consistent message, a consistent set of rules across the board. What we don't want is a different response in every locality and state."

Activists have expressed a somewhat different view on the matter, however. While many acknowledge that more research into credit availability could be productive, no one seems to be apologizing for the legislation or the flight it may have caused. "Unfortunately, Associates [First Capital] didn't go with them," said Peter Skillern, executive director of the Community Reinvestment Association of North Carolina.

Preemptive Strike

Meanwhile, the state's major mortgage trade association is preparing a preemptive strike on another front: a broker and lender licensing bill.

"We're in the process of getting consensus from other industry groups," said Kate Crawford, legislative chair for the North Carolina Association of Mortgage Professionals.

Activists are expected to dust off their own version of a licensing measure that would place stiff new requirements on companies looking to originate loans in North Carolina. In its most recent incarnation, the bill, known as SB 866, would have required brokers to commit to a fiduciary relationship with borrowers. Described by one observer as the second fist in a "one-two punch" against predatory lending, the bill has drawn stiff opposition from the state's lending community.

Lenders were also expected to pursue legislation that would chip away at North Carolina's landmark predatory lending law. But, it now appears that such a bill won't appear in time for the Assembly's mid-April filing deadline. Crawford made it clear that the bill the NCAMP plans to put forward will have a narrow focus. "It's just a regulatory bill," she said. "No predatory lending issues are in our bill."

The timing of the bill might be advantageous: North Carolina's advocacy community has largely turned its attention to the issue of payday lending, and reports are that the fight over broker licensing might be on the backburner. That doesn't mean they won't be watching, however.

"I'd imagine that if any industry bill got legs, we'd marshal all of our people from the payday lending front," said CRA-NC's Skillern.

Some observers say the political climate in North Carolina has changed so much in the past few years that, as Skillern noted, "there's no way in hell that they are going to get any changes to the predatory lending law."✦

Countrywide, Option One Take Aim at 100 Percent

Two of the country's top subprime lenders are banking that new zero downpayment purchase-money mortgages will help reach more customers and open new markets.

"This program is ideal for home buyers who may not have perfect credit," said Paul Abbamonto, president of Countrywide's Full Spectrum, of the company's new zero downpayment mortgage. "Coming up with the cash for a downpayment is a major hurdle for many homebuyers."

The new zero-down mortgage combines an 80 percent fixed-rate first mortgage with a 15-year fixed-rate second. The mortgage can be used to finance the purchase of homes valued at up to $500,000.

Meanwhile, Option One Mortgage is touting its own hybrid zero-down loan. Dubbed the "80/20 Backpack," the new loan is being offered through the company's wholesale and retail branch networks.

The latest offering is one of a series of subprime mortgages aimed at borrowers with little wealth. Until recently, loan-to-value ratios have generally capped out at around 80 percent. But with the advent of automated underwriting systems and a better understanding of credit scoring, lenders have been able to push the envelope for borrowers in the upper tier of the subprime market with products aimed at low-wealth borrowers who have relatively good credit.

The companies are banking that borrowers will be attracted to the cost savings associated with the new hybrid loans. Abbamonto noted that Full Spectrum's customers would save money on things like appraisals and credit reports, while Option One is offering the piggyback portion of its loan with no fees and no prepayment penalties.

Both Full Spectrum and Option One's products are aimed at pretty much the same borrower base. Full Spectrum is making the product available to borrowers with a minimum FICO score of 620. The product does allow for debt-ratios of up to 50 percent, however, and borrowers with up to $500 in open collections are still eligible.

Option One is also targeting borrowers with scores of around 620, a category that Davis Townsend, the company's chief credit officer, describes as "a little lower than 'just miss.'" Townsend said the product will help Option One make a play for borrowers in the so-called "Alternative-A" market, who generally have FICOs higher than those of A-borrowers but lower than those of their counterparts in the agency market.

"This puts us into a market we haven't been in the past," said Townsend. "We've haven't really been able to crack into it before."

Since the move to higher LTV ratios began in earnest nearly two years ago, there have been questions about exactly how low down the credit scale lenders can safely go with such products. Some lenders have rolled out no-money down mortgages for borrowers with FICO scores as low as 585. Townsend made it clear that Option One isn't prepared to play in that segment of the market.

"[A FICO of] 600 is about low as we feel comfortable going because of performance issues," he said.

And while Abbamonto suggested that Full Spectrum would look for ways to serve low-wealth borrowers further down the credit scale, he noted that the challenges are fairly significant. "Everything can be done for a price. The question is 'what is that price and will the customers accept it and will

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A-	65%	50	N/A	N/A	8.000	7.875	7.750	7.625	4.500
	70%	50	N/A	N/A	8.250	8.125	8.000	7.875	4.500
	75%	50	N/A	N/A	8.625	8.500	8.375	8.250	4.500
	80%	50	N/A	N/A	9.250	9.125	9.000	8.875	5.000
	85%	50	N/A	N/A	10.000	9.750	9.625	9.500	5.500
	90%	50	N/A	N/A	10.500	10.500	10.125	10.000	5.750
B	65%	55	N/A	8.625	8.500	8.375	8.250	8.125	5.250
	70%	55	N/A	8.875	8.750	8.625	8.500	8.375	5.500
	75%	50	N/A	9.500	9.375	9.250	9.125	9.000	5.750
	80%	50	N/A	10.250	10.000	9.875	9.750	9.625	6.000
	85%	50	N/A	11.000	10.750	10.375	10.250	10.125	6.250
C	65%	50	9.500	9.375	9.250	9.125	9.000	8.875	6.000
	70%	50	10.000	9.875	9.750	9.625	9.500	9.375	6.250
	75%	50	10.750	10.500	10.375	10.125	10.000	9.875	6.500
D	65%	50	11.500	11.250	11.000	10.750	10.625	10.500	6.250
	70%	50	12.000	11.750	11.500	11.250	11.000	10.750	6.375
	75%	50	12.750	12.250	12.000	11.875	11.375	11.125	6.500
D-	65%	50	12.875	12.750	12.375	12.250	12.125	12.000	6.750
	70%	50	13.125	13.000	12.875	12.750	12.625	12.500	6.950

15 Yr. Fixed — FICO Score

	LTV	D/R	<501	501 to 540	541 to 580	581 to 620	621 to 660	>660
A-	65%	50	N/A	N/A	8.000	7.875	7.750	7.625
	70%	50	N/A	N/A	8.250	8.125	8.000	7.875
	75%	50	N/A	N/A	8.625	8.500	8.375	8.250
	80%	50	N/A	N/A	9.250	9.125	9.000	8.875
	85%	50	N/A	N/A	10.000	9.750	9.625	9.500
	90%	50	N/A	N/A	10.500	10.500	10.125	10.000
B	65%	55	N/A	8.625	8.500	8.375	8.250	8.125
	70%	55	N/A	8.875	8.750	8.625	8.500	8.375
	75%	50	N/A	9.500	9.375	9.250	9.125	9.000
	80%	50	N/A	10.250	10.000	9.875	9.750	9.625
	85%	50	N/A	11.000	10.750	10.375	10.250	10.125
C	65%	50	10.500	10.375	10.250	10.125	10.000	9.875
	70%	50	11.000	10.875	10.750	10.625	10.500	10.375
	75%	50	11.750	11.500	11.375	11.125	11.000	10.875
D	65%	50	12.250	12.000	11.750	11.500	11.375	11.250
	70%	50	12.750	12.500	12.250	12.000	11.750	11.500
	75%	50	13.500	13.000	12.750	12.625	12.125	11.875
D-	65%	50	13.625	13.500	13.125	13.000	12.875	12.750
	70%	50	13.875	13.750	13.625	13.500	13.375	13.250

Prepay Buy-Out
- Adjustment to Par Pricing only
- 1/2% discount to OFS for each one year of buy-out

Rate Buy-Down
- Reduce Rate ½% for each point paid
- Maximum Buy-Down 3 points or 150 bps in Rate

Broker Loan Payment (BLP)
- 1 BLP + 75 BPS to Rate
- 2 BLP + 150 BPS to Rate

Adjustments to Rates

Pre-Pay Adjustment
- 4 Yr. Pre-Pay reduce rate 25 BPS
- 5 Yr. Pre-Pay reduce rate 50 BPS

Product
- 30 Yr. Fixed + 25 BPS to 15 Yr. Fixed
- 2 Yr. ARM reduce rate 25 BPS from 3 Yr. ARM
- 5 Yr. ARM + 25 BPS to 3 Yr. ARM

Documentation Level
- Stated + 50 BPS
- Lite + 25 BPS

Property
- Non-Owner Occupied + 50 BPS
- 2nd homes > 70% LTV + 25 BPS
- Condominiums + 25 BPS
- 2-4 Units + 25 PBS
- Manufactured Homes + 50 BPS

Loan Size
- Loans < $40,000 + 25 BPS

ARM Program Notes
- Qualifying rate is the start rate
- 2 yr ARM: Max first adjustment 2%
- 3 yr ARM: Max first adjustment 3%
- All ARM's convert to 6 month LIBOR ARM after fixed rate period
- 1% max semi-annual adjustment, lifetime cap is 6.5%
- ARM's not permitted on non-owner occupied properties
- All non-owner occupied properties must be written on a Fixed Rate Program
- Maximum loan amount - $500,000
- 3 year Prepayment penalties required on all programs
- No BLP paid on loans with any prepay penalty buy-outs

Fixed Rate Program Notes
- 15 year Fixed Rate and 15 year Balloon (180/360) is shown
- All non-owner occupied properties must be written on a Fixed Rate Program
- Maximum loan amount - $500,000
- 3 year Prepayment penalties required on all programs
- No BLP paid on loans with any prepay penalty buy-outs

RATE WORKSHEET

Base		%
Buy-Down		%
BLP		%
Prepayment Adj.		%
Product Adj.		%
DOC Level Adj.		%
Property Adj.		%
Loan Size Adj.		%
FINAL		%

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OHIO

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Central Division Fulfillment Center

2550 West Golf Road
Rolling Meadows, IL 60008

un complicatetheratesheet

OHIO
Wholesale Mortgage Rate Sheet

ARGENT
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Effective: Feb. 19, 2005
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Credit: Mortgage Lates	Credit Score	Full and Limited Doc — Prime and Credit Advantage ARM* Product 65%	70%	75%	80%	85%	90%	95%	Stated Doc — Prime and Credit Advantage ARM* Product 65%	70%	75%	80%	85%	90%	95%
0 x 30 and No BK/NOD in the last 36 months	680	5.30	5.50	5.55	5.60	5.75	6.20	6.75	6.00	6.15	6.25	6.40	6.55	7.00	7.35
	650	5.45	5.55	5.60	5.75	5.85	6.30	6.85	6.10	6.20	6.45	6.65	6.80	7.30	7.80
	620	5.50	5.60	5.65	5.85	6.15	6.40	6.95	6.25	6.35	6.50	6.85	7.20	7.50	8.10
	600	5.55	5.65	5.75	5.90	6.25	6.50	7.15	6.30	6.45	6.60	7.05	7.45	7.75	8.45
	580	5.65	5.70	5.80	6.00	6.40	7.05	7.90	6.60	6.65	6.85	7.15	7.65	8.00	
	550	6.10	6.15	6.30	6.35	6.85	7.55		6.95	7.05	7.25	7.35	7.90	8.70	
	525	6.75	6.85	7.00	7.05	7.40			7.65	7.80	8.00	8.50			
	500	7.25	7.35	7.50	7.55										
3 x 30 and No BK/NOD in the last 24 months	680	5.40	5.60	5.65	5.70	6.10	6.30	7.00	6.15	6.30	6.45	6.70	6.90	7.20	7.60
	650	5.55	5.65	5.70	5.80	6.15	6.40	7.10	6.25	6.35	6.55	6.85	7.10	7.50	8.00
	620	5.65	5.70	5.85	5.90	6.25	6.50	7.20	6.50	6.60	6.85	7.00	7.30	7.60	8.50
	600	5.70	5.75	5.90	5.95	6.35	6.60	7.30	6.75	6.85	7.05	7.15	7.55	7.85	8.75
	580	6.00	6.10	6.20	6.40	6.85	7.30	8.70	7.00	7.15	7.30	7.55	7.95	8.40	
	550	6.45	6.60	6.75	6.90	7.30	7.75		7.45	7.60	7.85	8.10	8.70	9.45	
	525	7.05	7.20	7.40	7.50	7.75			8.60	8.85	9.15	9.65			
	500	7.45	7.60	7.80	7.90										
1 x 60 and No BK/NOD in the last 12 months	680	5.65	5.75	5.90	6.00	6.55	7.70		6.20	6.40	6.65	6.85	7.10	8.45	
	650	5.75	5.85	6.00	6.10	6.75	7.80		6.50	6.65	6.85	7.00	7.20	8.55	
	620	5.85	5.95	6.10	6.25	7.00	7.90		6.80	6.95	7.15	7.25	7.45	8.65	
	600	6.15	6.20	6.35	6.40	7.15	8.30		6.95	7.20	7.40	7.50	8.20		
	580	6.45	6.55	6.75	6.85	7.35	8.50		7.55	7.80	7.95	8.15	8.65		
	550	7.00	7.10	7.25	7.40	7.75	8.80		7.80	8.15	8.60	9.15			
	525	7.35	7.45	7.60	7.65				8.70	8.95	9.30				
	500	7.85	7.95	8.10	8.15										
1 x 90 and BK/NOD IN the last 12 months	680	6.25	6.35	6.45	6.65				6.75	7.05	7.45				
	650	6.40	6.50	6.60	6.80				6.90	7.20	7.60				
	620	6.60	6.70	6.80	7.00				7.10	7.40	7.80				
	600	6.75	6.85	6.95	7.15				7.25	7.55	7.95				
	580	6.95	7.05	7.15					7.65	7.95	8.35				
	550	7.25	7.35	7.50					8.25	8.55	9.00				
	525	7.60	7.75	7.90					9.10	9.40	9.85				
	500	8.20	8.45	8.95											
1 x 120	680	8.25	9.05	9.20					8.70						
	650	8.40	9.35	9.50					8.80						
	620	8.60	9.50						9.20						
	600	8.75	9.55						9.35						
	580	8.95	9.80						9.55						
	550	9.45	9.85						10.05						
	525	10.15	10.80						10.60						
	500	10.65	10.95												
MAX Debt Ratio ►		55%	55%	55%	50%	50%	50%	50%	55%	55%	55%	50%	50%	50%	50%

TRY OUR INTEREST ONLY OPTION!

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Send submissions to:
2550 West Golf Road
Rolling Meadows, IL 60008

Mortgagee Clause:
Argent Mortgage Co., LLC
It's Successors and/or Assigns
PO BOX 11056
Orange, CA 92856

ADJUSTMENTS

TYPE	CHARACTERISTICS	RATE	LTV
Purpose	Purchase	0 000	
Income Doc	Limited	0 250	
	Stated (Separate Matrix)		
Occupancy	Non-owner	0 750	-5
	Second home		5
Property	Condo(attached) and 2 units	0 250	
(no mobile)	3-4 units,manufactured,rural	0 500	-10
Prepayment	Add an additional year	-0 500	
	For each yr reduced	0 500	
	Waive (all products)	1 000	
Loan Amount	$50,000 to $69,999	0 250	
	$70,000 to $129,999	0 000	
	$130,000 to $189,999	-0 250	
	$190,000 to $500,000	0 000	
Program	Credit Adv - Stated Matrix	0 750	
	Credit Adv - Full/Limited Matrix	0 500	
Product	ARM	0 000	
	Fixed	0 750	
Product Option	ARM	0 000	
	Fixed	0 750	
Product Option	Interest Only	0 250	

NOTES AND LIMITATIONS

No PYA without prepay
Tri-merged credit report only
Minimum loan amount is $50k
*ARM represents 2/28 and 3/27; Terms Available: 30-, 20-, and 15-year

Par rates for 2/28 with 2 year prepay (max 3 years)
Par rates for 3/27 with 3 year prepay (max 3 years)
Par rates for Fixed with 3 year prepay (max 3 years)

BUY-UP AND BUY-DOWN (Max 2%)

Buy-Up:	Buy-Down:
1st 1% rebate 0.500 2nd 1% rebate 0.750	All Products 0.500 for 1% fee

PRIME ADVANTAGE

Max Loan Amount $750K
Max Cash Out $50K when open collections/charge offs > $5K
Disregard collections/charge offs that are over 24 months old

Full/Limited Doc Type	Stated Doc Type
Rural properties cannot exceed 80% LTV	Exclusions: mobile/manufactured home, rural properties Bankruptcy/Foreclosure - none in the last 36 months on LTV > 80%

Minimum rate for Full and Stated are 5.30 and 6.00 for ARM; 6.05 and 6.75 for Fixed

INTEREST ONLY OPTION - PRIME AND CREDIT ADVANTAGE

All program specific guidelines apply plus the following rules:
-Exclusions: Mobile/Manufactured, non-owner, fixed income borrowers
-Minimum middle FICO >=620
-Maximum delinquency 3x30 and No BK/NOD in last 24 months
-Max Debt Ratio 50%
-Initial interest only payment used for qualification

MAX LTV	PROGRAM
95%	Prime Advantage
90%	Credit Advantage - Full
80%	Credit Advantage - Stated

CREDIT ADVANTAGE (High score determines LTV)

Exclusions: non-owner, second homes, mobile/manufactured homes, rural properties and 1x120 or greater

Full/Limited Doc Type	Stated Doc Type
Max Loan Amount $400K Max LTV 90% Minimum middle FICO >= 500	Max Loan Amount $300K Max LTV 80% Minimum middle FICO >= 525

Minimum rate for Full and Stated are 5.80 and 6.75 for ARM; 6.55 and 7.50 for Fixed

MAXIMUM FEES

Misc Broker Fees	$1,000	Pts & Fees Combined	7.50%
AMC Fees	$550		

Argent Mortgage Company does not originate Section 32 loans

Call today for final program details. 800.563.7029

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OHIO — Effective: Feb. 19, 2005

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Full and Limited Doc

Mortgage Lates	Credit Score	100% Advantage ARM* Product 100%
0 x 30 and No BK/NOD in the last 36 months	680	7.40
	650	7.65
	620	8 40
	600	8 75
MAX Debt Ratio ►		50%

Stated Doc

Mortgage Lates	Credit Score	100% Advantage ARM* Product 100%
0 x 30 and No BK/NOD in the last 36 months	680	8.75
MAX Debt Ratio ►		50%

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Adjustments

TYPE	CHARACTERISTICS	RATE	LTV
Purpose	Purchase	0 000	
Income Doc	Limited	0 250	
	Stated (Separate Matrix)		
Occupancy	Non-owner	N/A	
	Second home	N/A	
Property	Condo(attached) and 2 units	0 250	
(no mobile)	3-4 units,manufactured,rural	N/A	
Prepayment	Add an additional year	-0 500	
	For each yr reduced	0 500	
	Waive (all products)	1 000	
Loan Amount			
	$75,000 to $129,999	0 000	
	$130,000 to $189,999	-0 250	
	$190,000 to $500,000	0 000	
Program	100% Advantage	0 000	
Product	ARM	0 000	
	Fixed	0.750	

Notes and Limitations

No PYA without prepay
Tri-merged credit report only
*ARM represents 2/28 and 3/27; Terms Available: 30-, 20-, and 15-year

Par rates for 2/28 with 2 year prepay (max 3 years)
Par rates for 3/27 with 3 year prepay (max 3 years)
Par rates for Fixed with 3 year prepay (max 3 years)

Buy-Up and Buy-Down (Max 2%)

Buy-Up
1st 1% rebate 0.500
2nd 1% rebate 0.750

Buy-Down
All Products 0.500 for 1% fee

Call today for final program details. 800.563.7029

100% Advantage

Exclusions: non-owner, second home, mobile/manu, rural, 3-4 units
2 months PITI
All delinquent credit should be brought current or paid off
Min Loan Amount $75K; Max Loan Amount $500K
Max Cash out $50K
LTV's > 95%
Interest Only Option not offered
Minimum rate for Full and Stated are 7.40 and 8.75 for ARM;8.15 and 9.50 for Fixed

Maximum Fees

AMC Fees	$550	Pts & Fees Combined	7.50%
Misc Broker Fees	$1,000		

Argent Mortgage Company does not originate Section 32 loans

Fedex: Call your rep

Send submissions to: 2550 West Golf Road Rolling Meadows, IL 60008

Mortgagee Clause: Argent Mortgage Company, LLC It's Successors and/or Assigns, PO Box 11058 Orange, CA 92856

EQUAL HOUSING LENDER

NCLR
NATIONAL COUNCIL OF LA RAZA

Legislative Solutions to Abusive Mortgage Lending Practices

Submitted to:

U.S. House of Representatives Committee on Financial Services
Subcommittee on Community and Housing Opportunity
Subcommittee on Financial Institutions and Consumer Credit

Submitted by:

National Council of La Raza
Janet Murguia, President and CEO

NATIONAL COUNCIL OF LA RAZA
The Raul Yzaguirre Building
1126 16th Street NW
Washington, DC 20036

May 24, 2005

Introduction
Predatory lending is an attack on national efforts to increase the wealth and financial stability of low-income and minority populations through homeownership. While the topic of predatory lending has been the subject of national conversation for some time, it is not clear that the experiences of Hispanic families are well-known. As a result, the Latino perspective is often left out of the dialogue. The National Council of La Raza (NCLR) is the largest national Hispanic constituency-based civil rights organization in the U.S., dedicated to improving life opportunities of the more than 40 million Hispanic Americans living in the U.S. As such, we have a deep interest in the extent to which Hispanic families are being served through the nation's financial services industry. Based on recent research NCLR has conducted, there is reason to be concerned that inadequacies in the market and in the level of consumer protections are leaving far too many hardworking Hispanic families vulnerable to abusive lending practices.

NCLR has a long history of working in the arenas of housing and homeownership:

- NCLR has developed the largest Latino-serving network of housing counseling agencies, known as the NCLR Homeownership Network (NHN), dedicated to providing low- and moderate-income Latino homebuyers individualized homeownership counseling. Since its inception in 1997, NHN agencies have helped more than 17,000 low-income families become new homeowners.
- NCLR conducts research and industry analyses, and actively engages relevant public policy issues such as preserving and strengthening the Community Reinvestment Act (CRA), supporting strong fair housing and fair lending laws, increasing access to financial services among low-income people, and promoting homeownership in the Latino community.

Predatory Lending in the Latino Community
Latino homebuyers are important stakeholders in the predatory lending debate. Since the findings of the 2000 Census established Latinos as the nation's largest minority, the Latino population has continued to grow rapidly and is expected to reach 15.5% of the population by 2010. With this growth come an increasing demand for homes and the accompanying financial services. While less than half (48%) of all Latino households own their own home, the number of Latinos entering the homebuying market continues to rise each year, making their needs and challenges significant to the mortgage market overall. As it is for most Americans, the home is the most significant wealth-building vehicle for Latinos, representing financial stability for the future. Predatory practices cut this process short, resulting in less home equity, lost investments, or possibly even foreclosure.

NCLR's soon-to-be-released issue brief, *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market*, identifies a number of elements systemic to the mortgage industry which make it a challenge for low-income Hispanic families to access the best-priced mortgage loan products. To pick just one example, financial institutions with the most competitive mortgage products are not reaching the Hispanic market and are being outperformed by their more expensive competitors. As a result, the range of products available to many Latino families, whether it is due to perception, market penetration, or geographic targeting, is more expensive than their risk may warrant.

As *Jeopardizing Hispanic Homeownership* explains in further detail, the experience of Latino families demands the attention of Congress and other stakeholders. Experiences unique to Hispanic and immigrant communities must become more prominent within the current dialogue on predatory lending. Specifically:

- **More than one in five Hispanic families does not use traditional mortgages to purchase their home.** Contract for Deed, also known as Land Contract, is used by 12.5% of Latino families, most of whom live in rural areas or are recent immigrants. This product works in a "rent-to-own" fashion where families make an initial downpayment and regular monthly payments that are not necessarily deducted from the principal. After several years, the family assumes title by acquiring a traditional mortgage to pay the balloon payment. Another 10% of Latino homeowners own a mobile or manufactured home. Because there are few, if any, traditional mortgage products for mobile and manufactured homes, buyers use dealer financing similar to an auto loan. Both products are fraught with danger for the consumer; they are locally regulated and are often used in communities where there is little infrastructure for investigation of fraud claims and enforcement.

- **Hispanic families rely heavily on mortgage brokers.** The advantage of mortgage brokers is the wide variety of loan products to which they have access. The disadvantage is that they have an economic interest in pushing the cost of a loan higher to produce a higher fee for themselves, called a Yield Spread Premium (YSP). In 2002, mortgage brokers originated approximately two-thirds of the nation's mortgages and between 65% and 80% of those mortgages not purchased by one of the Government Sponsored Enterprises (GSEs), also called "non-conforming" mortgages, which includes mortgages insured by the Federal Housing Administration (FHA) and subprime mortgages; approximately 45% of Hispanic purchase mortgages and 25% of Hispanic refinance mortgages are non-conforming. Inconsistent licensing requirements and limited federal oversight leave mortgage brokers unaccountable to consumers.

- **Hispanic families are likely to be steered into more expensive mortgage products while purchasing their home.** Barriers to the mainstream mortgage market, recent fair lending research, and analysis of recent data from the Home Mortgage Disclosure Act (HMDA) suggest that there is a high probability that many Hispanic families used mortgages to purchase their homes that are more expensive than warranted by their credit risk. For example, the rate at which Hispanic families are using the most expensive mortgage products is twice that of White families. Moreover, because Hispanic families do not refinance as often as other families, they may miss opportunities to save money by reducing their interest rate and increase their home equity.

Recommendations

Clearly, too many Hispanic families are falling between the cracks of the current system of consumer protection laws. Latinos, like all Americans, deserve a regulatory structure and consumer protections that ensure their every opportunity to get a fairly-priced home loan. While most stakeholders agree that something must be done to curb predatory lending, there are several points of disagreement about how to accomplish the task without interfering with the delivery of mortgages to consumers who need them. New federal legislation should guarantee families the most amount of protection possible, without reducing current safeguards. NCLR recommends the following:

- **Increase consumer protections and enforcement that target abusive practices.** Congress must increase protections that accurately target abusive practices in both the purchase and refinance markets. Remedies include: limiting excessive fees by incorporating all fees in the definition of a high-cost loan under HOEPA; prohibiting unnecessary add-ons that provide no added home value such as single premium credit insurance, especially in high-cost loans; and holding brokers and financial institutions accountable for their role in structuring a deceptive or abusive loan at various points in the purchase process.

- **Establish federal regulation and monitoring of mortgage brokers.** Congress has an obligation to create a regulatory body, or amend an existing agency's charter, to monitor mortgage brokers. In addition, mortgage brokers should be subject to HMDA data reporting requirements, including the type of institution for which their loans are packaged.

- **Increase access to the mainstream mortgage market.** Congress can improve access to the mainstream mortgage market by helping to standardize the subprime mortgage market, incorporate mortgage finance companies into the regulatory oversight systems, and increase enforcement of new and existing regulations. Subprime lenders can make their business more transparent by providing a public listing of terms and fees, as is done for prime products. In addition to the tightening of consumer protections, federal agencies must proactively investigate complaints, including claims of fraud at the local level.

- **Support housing counseling.** While housing counseling is by no means a cure to predatory lending, it is a critical means by which Hispanic and immigrant families become connected with fair-priced and affordable mortgages. Community-based organizations, often the first point of contact for families looking for information, are able to asses' families' financial situation individually and give them the information they need to make complex decisions.

The national debate around solutions to predatory lending cannot move forward without including the concerns of the Latino community. NCLR stands ready to work with all stakeholders to establish meaningful protections and plans for enforcement which will ensure that the right to equal access to mortgage lending is protected for all Americans.

CONSUMER MORTGAGE COALITION

TESTIMONY SUBMITTED TO:

United States House of Representatives

Committee on Financial Services

Subcommittees on Financial Services and Housing and Community Opportunity

"Legislative Solutions to Abusive Mortgage Lending Practices"

May 24, 2005

801 Pennsylvania Avenue, NW, Suite 625 Washington, DC 20004
PHONE: (202) 544-3550 FAX: (202) 543-1438

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit testimony regarding the Ney-Kanjorski "Responsible Lending Act," H.R. 1295.

About the CMC

The CMC was formed, in large part, to pursue reform of the mortgage origination process. From our perspective, one of the principal goals of mortgage reform is to promote fair lending while protecting the availability of credit to the largest number of consumers.

To this end, we have long supported uniform, national rules to ensure a level playing field for both industry participants and consumers. Mortgage lending is a national industry where it is routine for lenders to lend in multiple states, loans and loan servicing rights to be transferred across state lines, and pools of loans from around the country to be assembled and placed in securities which are sold on the national capital markets.[1] Consumers should have the same protections in the national market, whether they are in Maine or California, and lenders and servicers should operate under the same rules across the country. Moreover, the industry and consumers will benefit from uniform, national rules only if the rules are clear and easily understandable, compliance can be achieved through reasonable effort, and the rules strike the proper balance between preventing abusive lending practices and fostering competition and innovation in the marketplace.

Testimony

The CMC shares the Committee's concerns about responsible lending and, in particular, "higher-cost lending." As noted, we are in favor of uniform national rules to govern all mortgage lending, and applaud efforts to enact such uniform rules. We also believe that there is much in the Ney-Kanjorski bill that will benefit consumers and the residential mortgage market generally. In particular, we commend the sponsors for including in the Bill the following:

- ***The Modification of Assignee Liability Under the Truth in Lending Act ("TILA") and the Home Ownership and Equity Protection Act ("HOEPA").*** The current law creates near absolute liability for assignees, since assignees are liable for "all claims and defenses" unless the assignee can show that it could not have reasonably discovered that the loan was even subject to HOEPA. The result of this potential liability is that the secondary market – and, consequently, the primary market – for loans subject to HOEPA has shriveled to nothing. The Bill would reduce the liability of assignees that perform appropriate due diligence – a step we believe will go far toward reviving the primary and secondary markets for covered loans.

[1] Attachment A includes a description of the mortgage origination, servicing, and funding process, its participants and the compensation each receives.

- ***Preemption of State and Local Laws Applicable to "Higher-Cost Lending."*** Nationwide mortgage lenders have struggled to comply with the many different – and often conflicting – state and local high-cost home loan laws. Establishing uniform national rules that preempt the myriad state and local laws will greatly ease the compliance burden on lenders, and will ensure equal protections to all consumers of these loans.

- ***Additional Specific Disclosures.*** The CMC believes that helping consumers understand the mortgage process enables them to make more informed credit decisions. Better disclosures will help expose unscrupulous mortgage originators who try to cloak their fraudulent practices when preying on unsuspecting consumers.

- ***Equal Treatment of Affiliates.*** The Bill would appropriately remove from the definition of "points and fees" charges that are currently included only because the charges are imposed by a lender's affiliate. This disfavored treatment of affiliates has created obstacles to attempts to offer "bundled" services or "one stop shopping" which we believe is beneficial to consumers and reflects a distinction in the law that is not related to the function or activity of the service provider.

- ***Enhanced Cure Provisions.*** The Bill's revision of TILA's and HOEPA's limited cure provisions would allow lenders a reasonable opportunity to correct errors and make borrowers whole, thereby avoiding the need for expensive litigation.

- ***National Broker Registry***. The Bill's creation of a national broker registry will help consumers inform themselves about the brokers with whom they deal and increase regulator oversight.

- ***Optional Foreclosure Prevention Counseling.*** The Bill's creation of voluntary foreclosure prevention counseling would prove beneficial to consumers who encounter difficulties in paying a mortgage.

While we are in favor of a national uniform standard to govern "higher-cost lending," there are several provisions of the Ney-Kanjorski bill ("Bill") that we believe will not benefit consumers in any significant or meaningful way and will harm lenders and the residential mortgage market generally. Other provisions in the Bill that provide meaningful benefits to consumers do not go far enough. In particular, we want to highlight ten provisions we believe should be revised either because they pose the greatest dangers of harm and mischief, or because a revision will further benefit consumers. While this does not represent a comprehensive analysis of the entire Bill it reflects our general concerns about a number of the Bill's provisions.[2]

1. **Points and Fees Threshold.** Section 102(a)(1) would reduce the "points and fees" trigger for covered loans from 8% to 5% of the total loan amount. We believe that this new threshold will capture a large portion of loans that do not require the extra protections of HOEPA. Because many prime lenders will make

[2] Attachment B is a detailed analysis of the Ney-Kanjorski bill prepared by Buckley Kolar, LLP, the CMC's regulatory counsel.

the decision not to make any loans that cross the new HOEPA threshold, making this threshold too low will shrink the availability of credit. This will prove particularly injurious to consumers as interest rates rise. Because of the recent low interest rates, many consumers have low-cost first mortgages. When these consumers need credit, they will want to keep their first mortgage and will seek a second (and smaller) mortgage. It will be very difficult for lenders to make money on smaller second mortgages if they are limited to charging points less than 5%. Consequently, the availability of smaller secondary mortgages will decrease. And, as a result, many consumers will be forced to choose between high-cost credit card debt and refinancing their favorable first mortgage. To avoid placing consumers in this difficult scenario, the points and fees threshold should be raised.

This threshold problem is exacerbated by the inclusion of prepayment penalties (if the loan pays off a prior loan by the same lender or an affiliate) and the potential inclusion of yield spread premiums (see comment below).

This difficulty will not be mitigated in any meaningful way by the Bill's provisions permitting bona fide discount points to be excluded from the points and fees. Section 102(a)(2) permits exclusion of bona fide discount points only if the interest rate to be reduced does not exceed the "benchmark rate." Section 102(a)(3) provides that the "benchmark rate" may not exceed the sum of 4% and the yield of Treasury securities having comparable periods of maturity on the 15th day of the month immediately preceding the month in which the application of credit is received by the creditor. Thus, bona fide discount points are not excludable from the "points and fees" if the interest rate exceeds the benchmark rate – a threshold that is surprisingly low. We urge the removal of the benchmark rate restriction on excluding bona fide discount points.

2. **Limit on Financing Points and Fees.** Section 103(d) of the Bill prohibits the financing (directly or indirectly) of points or fees on a higher-cost mortgage that exceed 5% of the total loan amount (or, if the total loan amount is $40,000 or less, 6%). Because in practice most points on subprime loans are financed (many borrowers do not have ready access to cash to pay points or do not want to tap other illiquid assets), this restriction, if enacted, would effectively eliminate the high-cost mortgage market which the Bill would so carefully regulate. We urge that this prohibition either be removed or revised so that the cap is raised significantly.

3. **Treatment of Yield Spread Premiums.** The definition of "points and fees" in section 102(a)(2) of the Bill creates needless uncertainty regarding whether yield spread premiums are considered part of the points and fees. Yield spread premiums currently – and correctly – are not included in the calculation of "points and fees" under HOEPA. Two provisions of the Bill create uncertainty regarding whether this will remain the case. First, the Bill removes the requirement that "points and fees" be "payable by the consumer at or before closing." Not only does this potentially bring into the calculation amounts paid by the lender to various service providers, but it also potentially includes yield spread premiums in

this amount. Second, the Bill would include in "points and fees" "all compensation paid directly to mortgage brokers by or on behalf of consumers (other than borrower credits)." While it is unclear what is meant by "borrower credits," read broadly, this provision could also include yield spread premiums. The definition of "points and fees" should be revised to clarify that it does not include yield spread premiums.

4. **Anti-Steering Provision.** Section 103(r) includes an anti-steering provision, applicable to both lenders and brokers, that is extremely difficult to implement from a compliance standpoint, invites challenges because of the steep penalties involved, and will result in an endless stream of litigation. The provision requires the lender to place the consumer in the best credit grade for which the customer qualifies and requires the broker to place the borrower in a loan product with a lender that is not less favorable than the products of any other lender with whom the broker deals. Because there are many features to a mortgage loan, some of which are more important to individual borrowers than others, this provision, if enacted, will render virtually every lender or broker susceptible to a claim of second-guessing by a borrower in default. These claims would in essence require the parties to the litigation to re-underwrite the loan using the credit grades and program guides in effect at the time of origination and to evaluate the loan made against other potential loans that were not made that could have been more "favorable." We believe few such suits could be resolved on the pleadings or by motion; rather, each would require additional expensive litigation. While this type of provision may have found its way into one or more state laws, its negative effects have not yet been felt by the industry. Making it part of a federal law on high cost loans would be a mistake. We recommend that this prohibition be removed from the Bill.

5. **Appraisal Requirements.** Section 401 establishes various property appraisal requirements. These requirements appear intended to reduce the incidence of inflated appraisals. Unfortunately, they are unlikely to achieve this goal. On the contrary, these requirements may have the perverse effect of actually increasing risk by forcing lenders to misallocate resources on appraisals for lower-risk transactions instead of concentrating on transactions in which there is a substantial risk that the property is inadequate security for the loan. The requirements also create a disincentive to use automated valuation systems. Automated valuation systems have been demonstrated to be more effective than manual appraisals in preventing inflated valuations. The industry is moving more toward these systems. It would be a mistake for the Bill to hinder industry's progress toward better, fraud free appraisals.[3] (Attachment A includes a more detailed discussion of this issue.)

6. **Mandatory Arbitration Prohibition.** Section 104(a) would prohibit higher-cost mortgages from including pre-dispute arbitration agreements, but permits post-

[3] Attachment C provides a detailed discussion of the impact of the appraisal provisions included in the Ney-Kanjorski bill in a white paper prepared by the CMC entitled: "Residential Real Estate Appraisals in 2005: Are Appraisers Protecting Consumers, Lenders and Investors Against Property Flipping or Improvident Lending?" May 2005.

dispute arbitration agreements. The prohibition on pre-dispute arbitration agreements will do little more than increase the cost and duration of dispute resolution. Empirical studies of arbitration outcomes repeatedly have shown that consumers fare well in arbitration – and generally better than in litigation. *See, e.g.*, Ernst & Young, *Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases* (2004); Eric J. Mogilnicki and Kirk D. Jensen, *Arbitration and Unconscionability*, 19 GA. ST. U. L. REV. 761 (2003). In addition, arbitration is significantly faster than litigation. The greater speed in resolving disputes benefits many consumers, especially working families and the elderly, who cannot afford to wait months – and often years – for the resolution of a dispute in court.

We also believe the Bill's provision limiting arbitration agreements to post-dispute agreements is misguided. Once a dispute has arisen, one of the parties nearly always has a tactical advantage to increasing the cost or duration of a dispute. Consequently, it is unlikely the parties will agree to arbitration after a dispute has arisen. We recommend that the Bill permit borrowers and lenders to enter into voluntary arbitration agreements (i.e., agreements which the consumers can refuse and are informed they can refuse) at the time of closing, rather than only after a dispute has arisen.

7. **Assignee Liability.** Section 105(e), as we noted previously, is a significant improvement on the current law regarding assignee liability. Nevertheless, we believe the Bill does not go far enough in repairing the damage caused by the current law on assignee liability. The Bill does not fix the "all claims and defenses" language which HOEPA has applied to covered loans since its enactment and which has been the subject of significant litigation. We suggest revising the Bill to clarify whether "all claims and defenses" means all claims, or state law claims (such as fraud) that often may not be brought against assignees, or only claims that can be brought against assignees under state law.

8. **Prepayment Penalties as "Points and Fees."** Section 102(a)(2) includes certain prepayment penalties in the calculation of "points and fees." This is a not advisable for several reasons. First, because prepayment penalties are not paid at closing, they are fundamentally different than other "points and fees" and should not be grouped together with them. Second, the amount of a prepayment penalty often depends on when prepayment is made and the amount of prepayment. Any estimate of this amount at closing is likely to be incorrect and significantly higher than the amount the consumer may actually pay. As a result, the "points and fees" so calculated will exceed amounts actually paid in connection with the loan, thereby misclassifying some non-higher-cost loans as higher-cost. Third, prepayment penalties are contingent upon prepayment within a given time period. If the consumer does not prepay within this period, the consumer will not incur a prepayment penalty. Such contingent fees should not be included in the "points and fees." We urge that "points and fees" be limited to charges which are not

contingent, which are of a definite amount, and which are actually charged in connection with the origination of the loan.[4]

9. **Counseling.** The Bill contains various provisions intended to expand counseling and education programs. We applaud these efforts, but suggest that they do not go far enough. We recommend that the Bill be revised to increase the funding to such programs. The better educated and informed consumers are, the less likely they will be harmed by unscrupulous mortgage lenders.

10. **Increased Statutory Damages.** Section 105 would double the damages to which lenders may be subject under TILA and HOEPA. TILA and HOEPA, as well as their implementing regulation, Regulation Z, contain many hyper-technical provisions that can be difficult to understand. The statutory penalty for a TILA/HOEPA violation of even the most technical requirement would be increased from $2,000 to $4,000 for closed-end real estate loans, regardless of whether the consumer suffered any actual harm. The Bill would also double the potential class action liability for violations from $500,000 to $1,000,000 for any action – again, regardless of whether any consumer suffered any actual harm. This increase in potential class action liability applies to any loan, not just closed-end real estate loans. We would recommend that Section 105 of the Bill be revised to eliminate these dramatic increases in liability for what may be mere technical violations, or to limit the increases specifically to high-cost loans.

* * *

The CMC appreciates the opportunity to submit its views concerning the Ney-Kanjorksi bill. We look forward to continuing to work with both the Subcomittees and the full Committee in its efforts to protect consumers from abusive lending practices without reducing the availability of credit or harming lenders.

[4] Attachment D includes a study prepared by the Pentalpha Group LLC entitled: "Analysis of The Impact of Prepayment Penalties on Residential Sub-prime Lending Coupons," May 12, 2004. We are submitting this study as an attachment to the CMC's testimony because some market participants have suggested that if prepayment penalties were eliminated, originators would simply make less money and continue to operate less profitably. The loss of prepayment penalties, without an increase in loan coupons, could upset the economics of the securitization process to the detriment of consumers and industry partners alike. The benefits of prepayment penalties include lower coupons and access to capital at the borrower level and greater liquidity at the investor level.

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MORTGAGE LENDING AND SERVICING PROCESS

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, a real estate broker or home improvement contractor refers the borrower. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).

- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

  The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.

- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.

- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

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Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in

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the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

<u>Compensation to Brokers and Correspondent Lenders</u>

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[1] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid

[1] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

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by the lender reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[2] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[3] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will

[2] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[3] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

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receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

Compensation to Investors (Portfolio Lenders or Secondary Market Investors)

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

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MEMORANDUM

To	**Consumer Mortgage Coalition**
From	Buckley Kolar LLP
Re	Summary of H.R. 1295, the Ney-Kanjorski "Responsible Lending Act"
Date	April 1, 2005

This memorandum provides a summary of key provisions of H.R. 1295, introduced by Congressmen Bob Ney (R-OH) and Paul E. Kanjorski (D-PA) on March 15, 2005 (the "Bill"). If enacted, it would be called the Responsible Lending Act.

BILL SUMMARY

The Bill largely concerns "higher cost" mortgage loans and would amend: (i) the Home Ownership and Equity Protection Act ("HOEPA"), the Truth in Lending Act ("TILA"), the Real Estate Settlement Procedures Act ("RESPA"), federal housing statutes to improve housing counseling assistance, and national laws governing appraisals. The Bill also establishes uniform mortgage broker licensing standards and sets up a national registry to monitor the mortgage broker industry.

The primary legislative compromise represented by the Bill is its broad preemption of state and local so-called "anti-predatory lending" laws in favor of HOEPA being greatly expanded, both in the loans that it covers and the many new limitations the Bill would put on those loans. The Bill would also alter the HOEPA/TILA liability regime, doubling the potential statutory damages in civil cases both for individual and class actions, but reducing the potential liability of assignees which had performed appropriate due diligence. One crucial provision that limits financing fees to the levels set as the points and fees threshold would appear to effectively eliminate the market for higher cost mortgage loans regulated by the Bill.

The Bill most likely represents a starting point rather than a final compromise. In introducing the Bill, Congressman Ney noted in a press release that "he hopes that his colleagues in the House and Senate, industry leaders, consumer groups, and regulators will continue to offer constructive comments about and ideas for the new legislation in the weeks and months ahead.... 'I am flexible and willing to refine the bill. That's exactly what Congressman Kanjorski and I did

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after gathering additional input and discussing the issues. I hope that everyone will continue to offer their ideas so that we can further improve this bill going forward.'"

The crucial amendments relating to high cost mortgages become effective for applications received on or after the date that is three months following enactment, with regulations to be promulgated by the Board of Governors of the Federal Reserve System (the "Board") within twelve months following enactment.

ANALYSIS

I. Higher-Cost Mortgages

A. Expanded Coverage

a. *All Major Loan Types* (section 102(a)(1), p. 4)[1]

The Bill would include HELOCs and purchase money loans – loan types currently excluded from HOEPA. Only reverse mortgages would be excluded from coverage. Claiming that creditors were falsely structuring loans as open-end transactions to avoid HOEPA status, consumer groups have long pushed to expand HOEPA to include HELOCs.

b. *Lower Thresholds* (section 102(a)(1), p. 4)

The Bill would change the existing HOEPA "points and fees" trigger from 8% to 5% (for loans with a total loan amount exceeding $40,000) and 6% (for loans with a total loan amount of $40,000 or less). The points and fees trigger would no longer be adjusted annually based on the consumer price index. While the Bill does not prohibit loans that exceed the threshold, as discussed below, the Bill would prohibit consumers from financing more than five points, effectively limiting loans to the five point threshold.

In addition, the Bill would conform the statutory APR triggers with the current levels set under the Board's Regulation Z, 12 C.F.R. § 226.32(a)(1)(i): first-lien mortgage loans secured on the consumer's principal dwelling with an APR at the consummation of the transaction exceeding the comparable Treasury rate plus 8%; and junior-lien mortgage loans secured on the consumer's principal dwelling with an APR at the consummation of the transaction exceeding the comparable Treasury rate plus 10%.

c. *Revised Definition of "Points and Fees"* (section 102(a)(2), p. 5)

The definition of "points and fees" would be revised in a number of important ways.

First, it would no longer require amounts to have been paid at or prior to closing. This would appear to be necessary to incorporate certain prepayment penalties, as described below, but may have additional unintended consequences for certain amounts that have been paid after closing.

[1] We refer throughout this summary to the pertinent section of the Bill and page number as recorded on the official Congressional print copy of the Bill.

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Second, it removes the requirement that the amount be paid by the consumer, thus potentially bringing into the calculation amounts paid by the lender to various service providers. Most importantly, this removal would appear to create greater uncertainty regarding the treatment of yield spread premiums paid to mortgage brokers, and would seem to open up additional avenues for consumer claims in litigation.

Third, it revises the conditions under which mortgage broker compensation is included, to provide that points and fees include "all compensation paid directly to mortgage brokers by or on behalf of the consumer." Together with the removal of the requirement that a point or fee be paid by the consumer, this language is potentially problematic in connection with the treatment of yield spread premiums.

Fourth, it permits "4(c)(7)" real estate settlement charges to be excluded from the points and fees calculation if (i) the charge is "bona fide, competitive, and reasonable," (ii) the creditor gets no direct compensation, and (iii) the charge is paid to a third party. This language would appear to provide parity to lenders using affiliated service providers so long as the pricing is market competitive, but would include in points and fees certain amounts that are excluded from the TILA finance charge but that may be paid to a lender, such as a document preparation fee or an appraisal fee for an appraiser employed by a bank.. TILA has not previously used a standard such as "competitive" and it is unclear how the courts will interpret that term so as to give it meaning above and beyond the current "bona fide and reasonable" standard.

Lastly, the definition would include certain prepayment penalties in the calculation of points and fees -- although the Bill's current language is very unclear. The Bill provides that the calculation should include "all prepayment fees or penalties on the new loan that will be incurred by the borrower if the loan refinances a previous loan currently held by the same creditor or an affiliate of the creditor." We believe that means that the creditor must calculate the highest possible prepayment penalty under the new loan and add that in to the calculation of points and fees. The Bill language also does not specify what "held" means – it is unclear if it applies to the beneficial holder or also the servicer.

Bona Fide Discount Points Excluded (section 102(a)(2)-(3), pp. 6-7)

No more than 2 bona fide loan discount points in connection with the loan may be excluded from the amount of points and fees taken into account. The Bill defines "bona fide discount points" as "loan discount points that (A) are knowingly paid by the borrower; (B) are paid for the express purpose of lowering the interest rate; (C) reduce the interest rate applicable to the loan from an interest rate that does not exceed the benchmark rate; and (D) reduce the interest rate by a minimum of 25 basis points per discount point so long as all other terms of the loan remain the same."

The Bill defines "benchmark rate" as the interest rate that the consumer can reduce by paying bona fide discount points. The benchmark rate may not exceed (i) the yield of Treasury securities having comparable periods of maturity on the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor, and (ii) 4 percentage points. For example, if the 30-year Treasury bond on the fifteenth

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of the prior month had a yield of 4.78% (its yield as of 3/31/05), the benchmark rate from which rate discounts would be applied would be capped at 8.78%, and if the consumer was able to buy down the loan rate by at least fifty basis points to no more than 8.38%, up to two points could be removed from the "points and fees" calculation

B. Prepayment Penalties and Late Fees (section 103(a), p. 8, Section 108, pp. 59-61)

The Bill replaces HOEPA's restrictions on prepayment penalties applicable only to covered loans with broader prepayment restrictions applicable to all consumer credit transactions secured by the consumer's principal dwelling. Specifically, a prepayment penalty is permitted only if: (i) the penalty cannot be imposed if the debt is accelerated as a result of default or any other breach of the loan documents; (ii) the penalty does not apply after the end of 3 years; (iii) the consumer is offered a choice of another similar loan without a prepayment penalty and is given a description of the benefit the consumer will receive, and the consequences the consumer might encounter, for accepting a loan with the prepayment penalty; and (iv) the penalty does not exceed an amount equal to the payment of 6 months advance interest on the amount prepaid in any 12-month period in excess of 20% of the original principal amount.

The Bill also regulates late fees. A late payment fee may be charged only if such fee (i) is not in excess of 5% of the amount of the scheduled payment past due, (ii) is assessed only on a payment past due for 15 days of more, and (iii) is not charged more than once with respect to a single late payment. The new provision would appear to permit the imposition of the late fee on the entire late payment rather than just the principal and interest component thereof. This section would appear to preempt state requirements relating to late fees.

C. Revised Restrictions Applicable to High Cost Loans

a. Balloon Loans (section 103(b), p. 9)

Under the Bill, no higher-cost mortgage loans (i.e., HOEPA loans) may have a balloon payment provision, except where the payment schedule is adjusted to account for the seasonal or irregular income of the consumer or if the purpose of the loan is a bridge loan, provided that proper notice is provided to the consumer.

b. Negative Amortization (section 103(c), p. 10)

The Bill would allow negative amortization to occur on higher-cost loans in the limited case of when it results from periods of temporary forbearance allowed by the creditor. While exemption from the restriction for forbearance is helpful in certain respects, it raises the question of whether other loss mitigation techniques that might affect the payment schedule are presumably prohibited because such techniques do not similarly have an express exemption from their prohibition. For example, it is unclear whether this would affect the ability of the servicer to agree to put off the collection of delinquent amounts and collect those at payoff or the end of the term, because an agreement to do so could be construed as creating a balloon payment at the end of the term.

c. *Financing of Points or Fees* (Section 103(d), p. 10)

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Creditors would not be permitted to finance (directly or indirectly) points or fees on a higher-cost mortgage loan that exceed 5% of the total loan amount (or, if the total loan amount is $40,000 or less, an amount equal to 6% of the total loan amount). In addition, to the extent that points or fees are financed in accordance with the foregoing, the creditor must disclose that fact to the consumer together with a statement that the creditor cannot require that such point, fee or charge be financed. Because in practice most points on subprime loans are financed, this restriction, if enacted, would effectively eliminate the high cost mortgage market so carefully regulated by the Bill.

d. *Prohibition on Evasions through Structuring Transaction* (section 103(e), p. 11)

Creditors would be prohibited from circumventing or evading any HOEPA requirement by entering into a reciprocal arrangement, dividing the loan transaction into separate parts with the intent to evade, or structuring the higher-cost mortgage as a consumer loan or business loan. The necessity of this provision is questionable given that a loan that could be shown to have been entered into using these (or other) alternative structures with an intent to evade HOEPA would most likely be recharacterized by a court as having been subject to HOEPA. It also could be of concern for higher cost small business loans secured by the home of the proprietor or principal of the business.

e. *No Encouragement of Default or Nonpayment on Prior Existing Loan* (section 103(f), p. 13)

Creditors would be prohibited from recommending or encouraging default or nonpayment, including nonpayment of any period payment on an existing loan or other debt.

f. *Ability to Repay* (section 103(g), p. 14)

The Bill would amend HOEPA's prohibition on extending credit without regard to the consumer's ability to pay by providing that a creditor may presume that a consumer is able to make the scheduled payments to repay a higher-cost mortgage if, at the time the extension of credit is approved, (i) the total monthly payments on outstanding obligations do not exceed 50% of the consumer's monthly gross income, and (ii) the consumer has sufficient residual income to pay essential monthly expenses after making the scheduled monthly payments.

This presumption, however, is not applicable in the case of balloon payments (or final payment on a bridge loan) that are otherwise permissible.

The Bill would require creditors to review "reasonable documentation" of an applicant's fixed income (such as retirement or disability payments) in addition to any statement by the consumer. With respect to stated income loans, the Bill would permit the creditor to rely on the consumer's statement if the consumer signs a financial statement showing the consumer's income and obligations and the creditor has a "reasonable basis" to believe the income actually exists and can be used to support repayment of the loan.

g. *Prohibition on Single Premium Credit/Mortgage Insurance* (section 103(h), p. 17)

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A higher-cost mortgage may not include the offer or sale of any credit/mortgage insurance policy (or analogous product), including any debt cancellation or suspension agreement or contract on a single premium basis—this prohibition does not prevent creditors from collecting premiums that are calculated and paid on a regular monthly basis.

h. *Limitations on Refinancing/Loan Flipping* (section 103(i), pp. 18-23)

Creditors may not "knowingly or intentionally engage in the unfair act or practice of loan flipping." The Bill defines "loan flipping" as an extension of credit by a creditor to a consumer for a higher-cost mortgage that (i) refinances an existing home loan that was consummated within the prior 24 months, and (ii) does not have a reasonable tangible benefit to the consumer (considering all material circumstances known to the creditor). As noted below, refinancing certain "special mortgages" definitionally cannot create a reasonable tangible benefit for the consumer.

Safe Harbor. A higher-cost mortgage will be presumed to provide a "reasonable tangible benefit" to a consumer if any of the following applies:

- Mortgage purpose is to finance a personal investment or a purchase or acquisition of real property that is not the principal dwelling of the consumer;
- The interest rate on the new fixed-rate higher-cost mortgage is lower than the interest rate on the fixed-rate refinanced loan and it will take 4 years or less for the consumer to recoup the costs of the points and fees and other closing costs through savings resulting from the lower interest rate;
- Creditor makes a good-faith determination that the consumer's monthly payment to pay the higher-cost mortgage is a minimum of 15% less than the total of all minimum monthly payments on the obligations being financed, based on a consumer credit report or other reasonable documentation;
- Any cash proceeds paid either to the consumer, or on behalf of the consumer, above the payoff of the refinanced loan are in excess of twice the amount of total points and fees and closing costs that are required to be paid by the consumer;
- The refinanced loan is changed from a loan that is not a fixed-rate fully-amortizing loan to a fixed-rate fully-amortizing loan;
- The terms of repayment of the refinanced loan are changed from a longer full amortization term to a shorter full amortization term by at least 5 years;
- The consumer presents a certificate from an independent housing or credit counselor approved by HUD or State regulatory agency stating that the consumer has received counseling with regard to refinancing the existing loan;
- Consumer provides the creditor with a written, signed statement not provided by the creditor that the new loan is needed to meet a bona fide personal or family financial, health or medical emergency, or to avoid a foreclosure action; or
- The refinancing is necessary under, or in response to, any order or judgment of a court of competent jurisdiction.

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Determination of Reasonable Tangible Benefit. The Bill provides that in instances where one of the above safe harbor provisions is inapplicable (this appears to be a drafting error – it probably should be instances where none of the safe harbor provisions is applicable), the factors to be considered may include: (i) the terms and conditions of both the new and refinanced loan, (ii) the consumer's known economic and non-economic circumstances, (iii) the purpose of the loan, and (iv) the cost of the new loan.

Special Mortgages. Regardless of the safe harbor provision, a higher-cost mortgage may not be used to refinance an existing loan if "it is apparent on the face of the security instrument for the existing loan that it is a special mortgage" and by refinancing, the consumer would lose a benefit of the special mortgage. "Special mortgage" includes a consumer credit transaction that is "originated, subsidized, or guaranteed" by the Federal, State, tribal, or local government, GSE, or nonprofit organization that either (i) bears, by at least 2% points, a below-market interest rate as of the date of its consummation, or (ii) has non-standard payment terms beneficial to the consumer. The restriction on special mortgage, however, does not apply if (i) the holder consents in writing to the new higher-cost mortgage, and (ii) an independent credit counselor approved by HUD or a state agency certifies in writing that the consumer has obtained counseling.

Limitation on Legal Fees. In connection with a violation of the loan flipping provisions set forth above, the prevailing party is not entitled to recover the costs of the action and attorney's fees if the court determines, in the court's discretion, that a reasonable offer to remedy the violation and compensate the person for the violation was made to such person and the offer was rejected.

i. *Home Improvement Contracts* (section 103(j), pp. 24-26)

The Bill would revise HOEPA to prohibit creditors from using the proceeds of a higher-cost mortgage to make a final payment to a home improvement contractor (under a home improvement contract) without proof of completion—meaning (i) a completion certificate in compliance with State law, or (ii) where a completion certificate is not recognized under State law, a signed statement by both the consumer and the home improvement contractor that the contractor has fully performed the contract. In addition, an independent inspection would be required for any home improvements exceeding $10,000 to verify that the work has been completed. It is unclear how the creditor will be able to accomplish these requirements if the consumer does not inform the creditor that the loan is for home improvements

Disclosures. Before making a final payment to a home improvement contractor, the creditor must provide the following written disclosure to the consumer:

> "You will be asked, when the job is completed, to sign a statement confirming the work has been completed because the lender may not make a final payment or payment in full to the home improvement contractor without such a statement signed by both the contractor and you. If the work has not been completed according to the terms of your work agreement, do not sign the statement and notify the lender immediately. If the improvements you are financing exceed $10,000, the lender is required by law to arrange for an inspection of the job. The purpose of the

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inspection is to ensure that the job has been completed according to the terms of the contract, and it is not a warranty or guarantee of the overall quality of the work. If you would like a more detailed inspection of the contractor's work, you may want to arrange for an additional inspection on your own."

j. *Additional Specific Disclosures* (section 103(k), pp. 26-28)

The Bill amends Section 129(a)(1) of TILA (15 U.S.C. § 1639(a)(1)) by adding the following required disclosures as new subparagraphs:

- "The interest rate and the amount of fees you pay on this loan are higher than you would pay for a conventional or ''prime'' rate loan. As a result, your monthly interest payments are higher than those on a comparable loan with a lower interest rate."

- "The rate of interest and the amount of fees you pay on a loan may vary depending on which lender or broker you select. You may be able to get a loan with a lower interest rate. Your credit score can provide an indication of whether you may qualify for a lower-cost prime loan. If you have a relatively good credit score, such as a FICO score in excess of 660, you may qualify for a ''prime'' loan. In that event, you should consider shopping more for a lower-cost loan instead of simply accepting the higher-cost loan that has been offered to you."

- "If you are taking out this loan to repay other loans, look to see how many months it will take to pay for this loan and what the total amount is that you will have to pay before this loan is repaid. Even though the total amount you will have to pay each month for this loan may be less than the total amount you are paying each month for those other loans, you may have to pay on this loan for a longer period than those other loans, and that may cost you more overall."

- "You may get into serious financial difficulties if you use this loan to pay off old debts and then replace them with other new debts."

It is unlikely that the express reference to FICO in the credit scoring disclosure will survive. In addition, some of the disclosures required in this provision are largely duplicative of required disclosures under the FACTA amendments to FCRA.

k. *No Call Provision* (section 103(l), pp. 28-29)

The Bill would prevent creditors from including, in a higher-cost mortgage, terms under which the indebtedness may be accelerated by the creditor in the creditor's sole discretion, except (i) by default or pursuant to a due-on-sale provision, or (ii) due to any action or omission by the consumer that adversely affects the creditor's security interest in the dwelling or any rights of the creditor in such security.

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l. *Modification and Deferral Fees Prohibited* (section 103(m), pp. 29-30)

Creditors would not be permitted to charge consumers any fee in excess of the lesser of the amount of 1 monthly loan payment on the existing higher-cost mortgage or $300 to modify, renew, extend, or amend a higher-cost mortgage or to defer any payment due under the terms of such mortgage. The Bill provides an exception for higher-cost mortgages that are in default or more than 60 days delinquent, if the modification is part of a workout plan. It is unclear how this provision would operate in states, such as New York, in which creditors are able to save consumers considerable amounts of tax payments by structuring the loan as a modification and extension (MECA). Under this provision, a lender that offered such a product could not charge more than $300 for the refinancing or deferral.

m. *Increased Interest Rate Upon Default Permitted for Variable-Rate Higher-Cost Mortgage* (section 103(n), p. 30)

Creditors would be permitted charge an increased rate due to any change in the index rate to the extent the change of interest is not due to a default by the consumer or a permissible acceleration by the creditor. Under current law, an increased rate upon default is not permitted. This limited exemption raises the question of whether a creditor can use a "timely payment rewards" type loan structure, as a payment default results in the borrower not getting a lower rate and potentially being seen as paying an "increased rate" as a result of the payment default.

n. *Prepayment of Periodic Payments from Proceeds Prohibited* (section 103(o), p. 30)

A higher-cost mortgage would not be permitted to include terms under which more than 2 scheduled payments of interest or principal would be paid in advance or otherwise deducted from the proceeds of the loan. This will inhibit "payment holiday" loans.

o. *Payoff Statements* (section 103(p), pp. 31-32)

Creditors would be prohibited from charging a fee for informing or transmitting the balance due to pay off the outstanding balance on a higher-cost mortgage except a creditor may charge (i) a fax or courier service fee (not to exceed an amount that is comparable to fees imposed for similar services for non-higher cost mortgage loans), and (ii) a "reasonable" fee for more than 2 payoff requests in any continuous 6-month period. Lastly, a creditor would be required to send a payoff balance within 7 business days of receipt of a written request for such balance. The Bill does not accommodate the imposition of a fee for expediting a payoff statement by transmitting it by e-mail.

p. *Duty to Report Credit Information* (section 103(q), pp. 32-33)

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The Bill would require creditors to report, in connection with a higher-cost mortgage (as originator or subsequent successor or servicer), monthly the complete payment history (favorable or unfavorable) to a consumer reporting agency except that short-term holders (i.e., a holder for less than 90 days) need not report. In addition, reporting requirements do not apply to loan forbearance, workout, or the settlement of a dispute or consumer complaint. Many mortgage servicers do not report the entire credit history of a loan each month (but rather just report that month's data or the data for the current and several past months), so it is possible that this provision may require amendment to accomplish its actual goals.

q. *Steering Prohibited* (section 103(r), pp. 33-37)

The Bill prohibits steering for both lenders and brokers. However well-intentioned, any restriction on steering will be extremely difficult to implement from a compliance standpoint, and difficult to defend in litigation. Because the provision calls for the lender to place the consumer into the best credit grade for which the consumer qualifies, industry could expect many challenges from defaulted borrowers under this provision, challenges that would in essence require the parties to the litigation to re-underwrite the loan using the credit grades and program guides in effect at the time of origination. Few such challenges would be resolvable as a matter of law or on the pleadings – each would require expensive additional effort.

Creditors. Creditors that originate a higher-cost mortgage would be prohibited from steering a consumer into a loan product that is not based on the creditor's best credit grade that the consumer would qualify for under the creditor's then-current underwriting guidelines. While the language does not expressly require the creditor to provide the consumer its best available rate, it seems to point in that direction and this type of requirement will undoubtedly lead to significant loan-level litigation. In addition, the provision as drafted does not accommodate lenders with multiple origination channels lending through the same entity – this provision would require, in effect, that any channel offering a higher cost mortgage must offer all of the creditor's credit grades.

Creditors that originate a higher-cost mortgage must disclose to the consumer his or her credit score within 3 business days of the later of (i) receipt of application, or (ii) making of a determination that the consumer only qualifies for a higher-cost mortgage.

If a creditor engages in steering, the steered loan will, at the consumer's option, be rescindable or the creditor must rewrite the loan into loan product at the credit grade that the consumer would have originally qualified for but for the violation. The Bill also calls for restitution by the creditor for such violation – meaning that the creditor would refund to the consumer the difference between the originated loan rate and the rate at the credit grade at which the consumer "ought" to have been lent money all the way back to origination. The Bill's amendments to the civil liability statute of limitations provision would exclude steering claims from being made more than two years following consummation, even in the context of recoupment or setoff, making such restitution a slightly less open-ended liability.

The Bill provides a safe harbor for creditors where (i) the creditor had a reasonable basis for placing the higher-cost loan based on the information available to that creditor, or (ii) the

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consumer voluntarily, on an informed basis, agreed to a loan with a higher rate than that for which the consumer would otherwise qualify.

Mortgage Brokers. Brokers are also prohibited from steering consumers into loan products that are less favorable than those offered by the creditors with whom the broker regularly does business and for which the consumer would qualify for under such creditors' best credit grade.

A broker in violation of this rule would be liable to the consumer for $4000 as well as the consumer's actual financial damages and reasonable attorney's fees and court costs. This would represent the first instance in which a mortgage broker is liable directly to the consumer under TILA.

The Bill provides a safe harbor if the broker (i) has a reasonable basis to believe that the credit grade applied to a consumer was appropriate, or (ii) the consumer voluntarily, on an informed basis, agreed to a loan with a higher rate than that for which the consumer would otherwise qualify.

r. *Arbitration* (section 104(a), pp. 37-39)

The Bill would prohibit higher-cost mortgages from including mandatory arbitration (and other non-judicial procedure) agreements. But post-controversy voluntary agreements are permitted. These agreements must: (i) establish the venue for the arbitration in the Federal judicial district in which the real property security is located; (ii) comply with the standards set forth by a nationally recognized arbitration organization; and (iii) require the creditor to bear the reasonable costs of all parties to the arbitration.

Consumers of higher-cost mortgages would be prohibited from waiving statutory causes of action either through the mortgage loan agreement or by "voluntary agreement." If interpreted strictly, the provision could make litigation settlements difficult as such settlements typically include a consumer waiving a future right to bring various statutory claims. If a case settlement is a "voluntary agreement," then such settlements would be prohibited for higher cost loans.

s. *Property Appraisal Requirements* (section 401, p. 106-108)

The Bill would amend section 129 (15 U.S.C. § 1639) of TILA by adding a new subsection "(z)" setting forth various property appraisal requirements. Subsection (z) would prohibit creditors from extending credit in the form of a higher-cost mortgage to any consumer borrower without first obtaining a written appraisal of the property to be mortgaged.

The written appraisal would be required to be prepared in accordance with the following:

- The appraisal must be performed by a qualified appraiser[2] who conducts a physical inspection of the mortgaged property;

[2] The Bill defines "qualified appraiser" as a person who: (i) is certified or licensed by the state in which property to be appraised is located; and (ii) performs each appraisal in conformity with the Uniform Standards of Professional Appraisal Practice and Title XI of the Financial Institutions Reform, Recovery, and

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- If the purpose of the higher-cost mortgage is to finance the purchase of the mortgaged property from the seller within 180 days of the purchase of that property by the seller, and if the seller purchased the property at a price that was lower than the current sale price of the property, the creditor must, at no cost to the borrower, obtain a second appraisal from a second qualified appraiser that supports the current sale price of the property.

Creditors, in connection with a higher cost mortgage, would be required to provide one copy of each appraisal conducted in accordance with subsection (z) to the borrower without charge.

Willful failure to obtain an appraisal as required under subsection (z) would (in addition to any other liability) result in a liability to the borrower for the sum of $2,000.

D. Error Correction and Damages

Error Correction (section 104(b), pp. 39-42)

The Bill amends for all loans TILA's provision for the correction of errors by adding a 45-day period whereby the creditor or assignee may notify the consumer of the error and make appropriate restitution to the consumer of any amounts collected in error and make all appropriate adjustments to the credit transaction to correct the error. The provision continues not to protect creditors from liability under Section 125 (TILA rescission).

In addition, in connection with HOEPA's 60-day correction of errors period, the creditor must pay the consumer an error penalty of $2,000 as well as the consumer's reasonable attorney's fees (no error penalty or attorney's fees should be assessed if the creditor or assignee discovers the error through the creditor's or assignee's own procedures).

Correction of an error appears to include modifying the terms such that the transaction is no longer a higher-cost mortgage.

New TILA Penalties (section 105, pp. 42-45)

The Bill would increase existing penalties and add new penalties in connection with TILA and HOEPA as follows:

- The statutory penalty is increased from $2,000 to $4,000 for closed end real estate loans;
- For class actions on any kind of loan, the cap on class action recovery is increased from $500,000 to $1,000,000; and
- Class action damages and actual damages are coordinated such that the maximum amount of general damages will be reduced by the aggregate amount of actual damages.

Rescission (section 105(c), p. 43)

Enforcement Act ("FIRREA"), and any regulations issued pursuant thereto and in effect on the date of the appraisal.

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Consumer rescission rights would not be permitted to be waived (i) as a condition of the loan, or (ii) if the creditor advises or encourages the consumer to waive them.

Statute of Limitations (section 105(d), pp. 44-45)

The statute of limitations would be increased for violations of HOEPA from one year from the date of the occurrence of the violation to two years.

E. Assignee Liability (section 105(e), pp. 45-51)

The Bill makes significant changes to the the HOEPA assignee liability regime. The current law creates close to absolute liability for assignees, as assignees are liable for "all claims and defenses" unless the assignee can show that it could not have reasonably discovered that the loan was even subject to HOEPA. Under this assignee liability regime, the secondary market, and then the primary market, for loans subject to HOEPA has shriveled to nothing. The more rational assignee liability regime set forth in the Bill appears to create due diligence safe harbors for assignees. Without these safe harbors, the drastic reduction in the HOEPA thresholds would seem likely to greatly reduce the availability of credit for subprime customers.

Assignees (and loan purchasers generally)[3] of higher-cost mortgages will be subject to "all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage" either:

i. As a defense to the enforcement of such mortgage by the purchaser or assignee based on a default by the consumer if such default is reasonably related to a violation of "this section"[4] by the creditor (*such as nonpayment by the consumer on a loan where the creditor did not ensure the consumer's ability to repay*), unless the consumer demonstrates that the purchaser or assignee had actual knowledge of or exhibited reckless indifference to a violation in which case the consumer may raise any defensive claim without regard to whether such violation is related to the consumer's default; or

ii. As an affirmative claim, unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not determine with reasonable certainty based on information

[3] Under the Bill, the terms "purchaser" and "assignee" do not include (i) persons whose interest in higher-cost mortgages is limited to a security interest or who acquire title as a result of the foreclosure of such security interest; (ii) broker-dealers and their affiliates that trade in mortgage loans and related mortgage securities and otherwise are not involved in any material respect in the terms and conditions under which such mortgage loans were made or such securities were issued; (iii) passive investors in securities, or interest in securities, including investors who guarantee the payment of principal and interest of securities to other investors, based on and backed by a pool of residential mortgage loans; or (iv) purchasers of mortgage loan that do not take record title to such loans where, within 1 year following the initial sale, the seller is obligated by written agreement to repurchase the loans or the purchaser is obligated by written agreement to deliver the loans to a third party at the direction of a seller.

[4] It is unclear what "this section" covers—this may be an error with the language of the Bill.

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contained in the documentation required by "this title"[5] (TILA), the itemization of the amount financed, and other disclosure of disbursements that a violation had occurred (which would include the HUD-1).

We note that paragraph "(ii)" above is a departure from HOEPA's current requirement that the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine, based on the required documentation, the itemization of the amount financed, and other disclosure of disbursements that the mortgage was a (higher-cost) mortgage referred to in Section 103(aa). The new provision, as set forth in paragraph "(ii)" above, would allow an affirmative claim by the consumer unless the purchaser or assignee demonstrates that ordinary due diligence could not determine with reasonable certainty that a *violation* had occurred (not merely that the loan was a high-cost loan).

The foregoing does not affect any rights of a consumer arising under paragraphs (a), (b), or (c) of Section 131 of TILA (Liability of Assignees) or any other provision of TILA.

Exclusion. The assignee liability section does not apply if a purchaser or assignee has exercised due diligence by demonstrating that such purchaser or assignee:

- Has in place at the time of the purchase or assignment of the loans, policies that expressly prohibit the purchase or acceptance of assignment of (i) any higher-cost mortgage at all, or (ii) any higher-cost mortgage containing such violations;
- Requires, by the applicable purchase contract, that a seller (or assignor) represents and warrants to the purchaser as of the applicable sale date that: (i) the seller will not sell any higher-cost mortgage at all or higher-cost mortgages that contain such violations; or (ii) the seller is a beneficiary of a representation and warranty from a previous seller or assignor to that effect, and as a result of its purchase of the loans, the loan purchaser is a beneficiary of such representation and warranty; and
- Exercises "reasonable due diligence"[6] at or before the time of the purchase or assignment of home loans, or within a reasonable period of time after, that is intended by the purchaser or assignee to prevent the same from purchasing or taking assignment of either (i) any higher-cost mortgages at all, or (ii) any higher-cost mortgage containing such violations.

Limitation on Relief. Relief provided as a result of any action made permissible by the foregoing may not exceed the greater of: (i) with respect to actions based on a violation of TILA, the amount specified in (revised) Section 130; or (ii) with respect to other actions, the sum of the amount of all remaining indebtedness and the total amount paid by the consumer in connection with the transaction.

[5] The Bill conforms to TILA's current convention of referring to the "title." For purposes of ease of use, we refer to "TILA" where the Bill refers to "the title" in the context of TILA.

[6] The "reasonable due diligence" standard may be met by employing a statistically significant sampling methodology—i.e., does not require a loan-by-loan review.

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Limitation on Damages that do not Create Financial Losses. Damages are limited to damage for actual financial losses and attorney's fees unless the consumer demonstrates that the purchaser or assignee had actual knowledge of or exhibited reckless indifference to a violation of TILA or other applicable law.

Factors for Courts to Consider. Courts must consider all of the following: (i) the amount of any actual economic damages awarded and the extent to which the non-economic harm suffered from the violation should be compensable by the general damages; (ii) the lack of the purchaser's knowledge of or participation in the facts or circumstances giving rise to the violations and claims and defenses; (iii) the materiality of the violation; and (iv) the relative harm to the consumer.

The Bill does not attempt to fix the "all claims and defenses" language which HOEPA has applied to assignees since its enactment and which has been the subject of significant litigation. The question remains: Does "all claims and defenses" mean all claims or with respect to state law claims, such as fraud, that often may not be brought against assignees, or just claims and defenses that can be brought against assignees under state law.

F. Preemption/Coordination with State Law (section 106, pp. 51-58)

TILA's Section 111 (Effect on Other Laws) would be amended to add a section on higher-cost mortgages stating that the provisions of TILA will supersede any provision of the law of any State[7] to the extent that such provision of law attempts, directly or indirectly, to regulate, or has the effect of regulating, mortgage lending activities[8] by or through:

- The imposition of a high-cost limitation[9] including (i) through limitations or prohibitions in connection with contracts for other business with any such State or any political subdivision of any such State, (ii) by making any conduct in connection with such activities subject to civil or criminal penalties, (iii) by making activities regulated under

7 The Bill defines "law of any State" to include any constitutional provision, statute, rule, regulation, or ordinance of any State or any political subdivision of any State, including any State law as to which the Board has made a determination under section 123 (Exemption for State-Regulated Transactions), and any judicial decision or determination rendered in connection therewith.

8 The Bill defines "mortgage lending activities" to include any advertisement, solicitation, offer, negotiation, placement, application, processing, underwriting, originating, closing, funding recording, assignment, purchase, pledge, securitization, holding, servicing, collection, modification, satisfaction, or foreclosure in connection with or arising out of a consumer credit transaction secured by a lien against a consumer's dwelling, by or on behalf of a broker, creditor, secured creditor, purchaser, servicer, trustee, certificate or securities holder, or any other person or entity that may engage in any of the above enumerated activities and their respective agents, contractors, employees, officers, and directors.

9 The Bill defines "high-cost limitation" as any requirement, limitation, or prohibition on any mortgage lending activities in connection with a consumer credit transaction secured by a lien against a consumer's dwelling when the applicability of such requirement, limitation or prohibition is based in whole or in part on whether the actual or contingent, direct or indirect, interest rate, costs, fees, price or finance charges to the consumer associated with such consumer credit transaction exceed any particular threshold, however such threshold may be defined, without regard to whether the consumer credit transaction subject to such requirement, limitation, or prohibition is a higher-cost mortgage.

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real estate, foreclosure, or other laws of such State or political subdivision contingent upon the manner in which mortgage lending activities are conducted; or

- Any requirement, limitation, or prohibition without regard to whether the provisions of the requirement, limitation, or prohibition are consistent or inconsistent with Section 129 or 129A of TILA (Requirements for Certain Mortgages) or whether the consumer credit transaction is subject to such requirements is a higher-cost mortgage.

The foregoing preemption controls without respect to whether or the extent to which a provision of law adopted by a State (or political subdivision of any State) affords greater protection, substantive or otherwise, to consumers.

This preemption also includes any State law that: (i) limits a creditor's ability to extend new credit to a consumer; (ii) limits the rights, claims, defenses, or other remedies at law or equity available to a creditor, secured creditor, servicer, assignee, or other direct or indirect holder, and their respective agents or contractors, including without limitation, the right to foreclose on the lien against the consumer's dwelling in respect of a consumer's default under the related loan documents; or (iii) imposes legal liability on any party for the violations of law by another party by virtue of such first party's acquisition of any direct or indirect right, title or interest in and to, or contractual responsibility for the servicing or administration of, a higher-cost mortgage.

Exclusions. The following are excluded from preemption: (i) a law of any State, not otherwise preempted under Federal law, limiting the rate of interest reflected in the note or other instrument secured by a lien against a consumer's dwelling, to the extent that such law does not required compliance with any law that is otherwise preempted as a condition of contracting for, charging, or collecting any rate of interest otherwise permitted by such law; and (ii) a law of any State requiring the licensing, registration, or authorization of any person engaged in mortgage lending activities, except that the law of any State will be preempted to the extent that such law conditions the issuance or maintenance of such a license, registration or other authorization, or the authority granted thereby, on compliance with any law that is otherwise preempted.

Determination by the Federal Reserve Board. The Board is charged with determining whether and the extent to which a specific State law is preempted; such determination must be published in the Federal Register.

State Disclosure Requirements. State laws relating to the disclosure of information in connection with credit transactions will not be preempted, except to the extent that those laws are inconsistent with TILA, and then only to the extent of the inconsistency.

State Enforcement Authority. The Bill revises TILA to clarify that States are permitted to enforce the provisions of TILA with regard to any person licensed or chartered by such State.

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II. Mortgage Servicing

Truth in Lending Act

A. Escrow Accounts (section 301, pp. 92-97)

Creditors are required to set up an escrow account (in connection with consumer credit transactions secured by the principal dwelling of the consumer) for the payment of taxes and hazard insurance[10]. However, such an escrow account may not be required "as a condition of a real property sale contract or a loan secured by a deed of trust or mortgage on real property" unless: (i) any such account is required by Federal or State law; (ii) a loan is made, guaranteed, or insured by a State or Federal governmental lending or insuring agency; (iii) the consumer's debt-to-income ratio (taking into account income from all sources) exceeds 45%; (iv) a consumer obtains a higher-cost mortgage; (v) the original principal amount of such loan is 90% or more of the sale price, if the property involved is sold or 90% or more of the appraised value of the property securing the loan; (vi) the combined principal amount of all loans secured by the real property exceeds 95% of the appraised value of the property securing the loans; or (vii) the Board requires such an account by regulation.

Duration. The escrow account must remain in existence for a minimum of 5 years, unless the underlying mortgage is terminated.

Administration. The escrow account may be established in an insured depository institution in the State where the creditor, or servicer, if not the creditor, is located. Such an escrow account must be administered in accordance with (i) RESPA and Regulation X, and (ii) the law of the State where the real property securing the consumer credit transaction is located. It does not provide for a servicer to hold funds in a state other than the state where the servicer is located.

Payment of Interest. Creditors must pay interest to the consumer on the amount held in the escrow account in a manner prescribed in Federal or State law.

Disclosures. The creditor must disclose the following by written notice to the consumer within 3 business days before the consummation of the consumer credit transaction giving rise to the escrow account:

a. The fact than an escrow account will be established at consummation of the transaction;
b. The amount required at closing to initially fund the escrow account;
c. The amount in the initial year of the estimated taxes and hazard insurance premiums;
d. The estimated monthly amount payable for taxes and hazard insurance; and
e. The fact that if the consumer chooses to terminate the account after 5 years, the consumer will become responsible for the payment of all taxes and hazard insurance on the property unless a new escrow or impound account is established.

[10] "Hazard insurance" has the same meaning as provided under the law of the State where the real property is located.

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Exclusions. The amounts paid for escrow accounts are not treated as points or fees. The Board may also exclude, by regulation, any category or type of loan from these requirements.

B. Required Disclosures for Consumers that Opt Out of Escrow Services (section 302, pp. 97-98)

If the consumer chooses, at any time, to opt out of an escrow account, the creditor must disclose:

- Information concerning any applicable fees associated with either the nonestablishment of any such account at the time of the transaction, or any subsequent closure of any such account;
- Clear and prominent notice that the consumer is responsible for personally and directly paying the non-escrowed items, in addition to paying the mortgage loan payment, in the absence of any such account; and
- A clear explanation of the consequences of any failure to pay non-escrowed items, including the possible requirement for direct placement of insurance by the creditor and the potentially higher cost (including any potential commission payments to the servicer) or reduced coverage for the consumer in the event of any such creditor-placed insurance.

Fair Debt Collection Practices Act

C. Mortgage Servicer Exemption (section 303, pp. 99-100)

The Bill would exempt from section 807(11)[11] of the Fair Debt Collection Practices Act a "covered mortgage servicer"[12] who, whether by assignment, sale or transfer, becomes the person responsible for servicing federally related mortgage loans secured by first liens that include loans that were in default at the time such person became responsible for the servicing of such federally related mortgage loans in connection with the collection of any debt arising from such defaulted federally related mortgage loans.

Real Estate Settlement Procedures Act

D. Servicer Prohibitions (section 304(a), p. 101)

Under the Bill, a servicer of federally related mortgage loans may not:

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11 Section 807(11) makes the following a violation of the Fair Debt Collection Practices Act: The failure to disclose in the initial written communication with the consumer and, in addition, if the initial communication with the consumer is oral, in that initial oral communication, that the debt collector is attempting to collect a debt and that any information obtained will be used for that purpose, and the failure to disclose in subsequent communications that the communication is from a debt collector, except that this paragraph shall not apply to a formal pleading made in connection with a legal action.

12 "Covered mortgage servicer" is defined as a servicer of federally related mortgage loans secured by a first lien (i) that is also a debt collector, and (ii) for whom the collection of delinquent debts is incidental to the servicer's primary function of servicing current federally related mortgage loans.

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- Force place insurance unless there is a reasonable basis to believe the borrower has failed to comply with the loan contract's requirements to maintain property insurance;
- Charge fees for responding to valid qualified written requests (under this section);
- Fail to take timely action to respond to a borrower's requests to correct errors relating to allocation of payments, final balances for purposes of paying off the loan, or avoiding foreclosure, or other standard servicer's duties;
- Fail to respond within 10 business days to a request from a borrower to provide the identity, address and other relevant information about the owner assignee of the loans; or
- Fail to comply with any other obligation found by HUD to be appropriate to carry out the consumer protection purposes of RESPA.

E. Increased Penalties for Servicing (section 304(b), p. 102)

The penalties provided in Section 2605(f) of RESPA would be increased from $1,000 to $2,000 for additional individual damages, and from $500,000 to $1,000,000 for class actions.

F. Decrease in Response Times (section 304(c), p. 101)

The response requirements for borrower inquiries under Section 2605(e) of RESPA would be reduced from 20 days to 15 days in the case of a qualifying written request from a borrower. In addition, the Bill would add a limited 30-day extension of response time in connection with the servicer's "action with respect to inquiry" if, before the end of the 30-day period, the servicer notifies the borrower of the extension and the reasons for the delay in responding.

G. Requests for Pay-Off Amounts (section 304(d), pp. 102-103)

A creditor or servicer would be required to send a payoff balance within 7 business days of receipt of a written request for such balance from or on behalf of the borrower by first-class mail.

H. Prompt Refund of Escrow Accounts Upon Payoff (section 304(e), p. 103)

Any balance on an escrow account at the time the loan is paid off must be promptly returned to the borrower.

I. Mortgage Servicing Study (section 305, pp. 103-105)

HUD must (in consultation with the Board and the FTC) conduct a comprehensive study of mortgage servicing fraud. The study must include a review of: (i) timely posting and payments by servicers; (ii) the use of force placed insurance; (iii) the employment of daily interest when payments are made after a due date; (iv) the charging of late fees on the entire outstanding principal; (v) the charging of interest on servicing fees; (vi) the utilization of abusive collection practices; (vii) the charging of prepayment penalties when not authorized by either the note or law; (viii) the employment of unconscionable forbearance agreements; and (ix) foreclosure abuses.

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HUD must then issue a report and conduct a follow-up comprehensive study of means to improve the best practices of the mortgage servicing industry and Federal and State laws governing such industry.

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III. Appraisals

A. Property Appraisal Requirements (section 401, pp. 106-108)

Truth in Lending Act

As noted above, the Bill would amend section 129 (15 U.S.C. § 1639) of TILA by adding a new subsection "(z)" setting forth various property appraisal requirements. Subsection (z) would prohibit creditors from extending credit in the form of a higher-cost mortgage to any consumer borrower without first obtaining a written appraisal of the property to be mortgaged.

The written appraisal would be required to be prepared in accordance with the following:

- The appraisal must be performed by a qualified appraiser[13] who conducts a physical inspection of the mortgaged property;
- If the purpose of the higher-cost mortgage is to finance the purchase of the mortgaged property from the seller within 180 days of the purchase of that property by the seller, and if the seller purchased the property at a price that was lower than the current sale price of the property, the creditor must, at no cost to the borrower, obtain a second appraisal from a second qualified appraiser that supports the current sale price of the property.

Creditors, in connection with a higher cost mortgage, would be required to provide 1 copy of each appraisal conducted in accordance with subsection (z) to the borrower without charge.

Willful failure to obtain an appraisal as required under subsection (z) would (in addition to any other liability) result in a liability to the borrower for the sum of $2,000.

B. Appraisal Subcommittee of FIEC, Appraiser Independence & Education (section 402, pp. 108-112)

Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA")

The Bill would amend several sections of FIRREA by making the following changes:

- Annual Report. Strengthening the annual reporting requirements of the Appraisal Subcommittee to Congress;
- Open Meetings. Requiring that the Appraisal Subcommittee meet in a public session after notice to the general public;

[13] The Bill defines "qualified appraiser" as a person who: (i) is certified or licensed by the state in which property to be appraised is located; and (ii) performs each appraisal in conformity with the Uniform Standards of Professional Appraisal Practice and Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), and any regulations issued pursuant thereto and in effect on the date of the appraisal.

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- Regulations. Permitting the Appraisal Subcommittee to "prescribe regulations after notice and opportunity for comment";
- Appraiser Criteria. Bolstering FIRREA's definition of "state licensed appraiser" by changing the definition from "an individual who has satisfied the requirements for State licensing in a State or territory" to "an individual who has satisfied the requirements for State licensing in a State or territory whose criteria for the licensing of a real estate appraiser currently meet or exceed the minimum criteria issued by the Appraiser Qualifications Board of The Appraiser Foundation for the licensing of real estate appraisers." The Bill also deletes subsection (e) of section 1116 (12 U.S.C. § 3345) that prohibited the Appraiser Subcommittee from setting qualifications or experience requirements for the States in licensing real estate appraisers, including a de minimus standard. Recommendations of the Subcommittee shall be nonbinding on the States;
- Temporary Practice. Deleting subparagraph A of FIRREA section 1122(a)(1) (12 U.S.C. § 3351(a)(1)). Under former subparagraph A, a State appraiser certifying or licensing agency was required to recognize on a temporary basis the certification or license of an appraiser issued by another State if the property to be appraised was part of a federally related transaction;
- Reciprocity. Amending subsection (b) of section 1122 (12 U.S.C. § 3351(b)) to require state appraiser certifying or licensing agencies to provide reciprocal certification or licensing for individuals from another state when: (i) the appraiser licensing and certification program of the other state is in compliance with the provisions of Title 12 ("Banks and Banking"); and (ii) the appraiser holds a valid certification from a state whose requirements for certification or licensing meet the requirements for certification and licensing established by the Appraiser Qualifications Board of The Appraisal Foundation;
- Consideration of Professional Appraisal Designations. Amending section 1122(d) (12 U.S.C. § 3351(d)) to permit consideration for professional appraisal designations conferred by sponsoring organizations of The Appraisal Foundation as an indication of proficiency in addition to the criteria established by certification or licensing;
- Appraiser Independence. Amending section 1122 (12 U.S.C. § 3351) by adding a new subsection "(g)", which would prohibit mortgage lenders and bankers, mortgage brokers, real estate brokers, and any other persons with an interest in a real estate transaction involving an appraisal, from improperly influencing, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan; such persons, however, would not be prohibited from asking an appraiser to consider additional, appropriate property information, provide further detail, substantiation, or explanation for the appraiser's value conclusion, or correct errors in the appraisal report; and
- Appraiser Education. Amending subsection (g) (added by the Bill) of section 1122 (12 U.S.C. § 3351) by adding a new subsection "(h)" which would require state certifying or licensing agencies to accept courses and seminars approved by the Appraiser Qualification Board's Course Approval Program.

C. Study on Improvements in Appraisal Process and Compliance Programs (section 403, pp. 112-113)

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Pursuant to the Bill, the Comptroller General would be required to conduct a comprehensive study on possible improvements in the appraisal process generally. The study would focus on the consistency in and the effectiveness of, and possible improvements in, state compliance efforts and programs in accordance with Title XI of FIRREA.

Within 18 months following the Bill's enactment, a report on the study (along with recommendations for administrative or legislative action at the state or federal level) would have to be submitted by the Comptroller General to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

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IV. Mortgage Brokers

A. Uniform Licensing Standards

1. Federal Standards (sections 501, 502, pp. 113-114, 119)

The Bill provides that, within 3 years of the Bill's enactment into law, the Secretary of Housing and Urban Development (the "Secretary") must issue regulations setting forth minimum federal mortgage broker licensing standards (the "Federal Standards"). The Federal Standards would be established in consultation with the federal banking agencies and the National Credit Union Administration ("NCUA"), and issued following notice and opportunity for public comment.

The Federal Standards would generally require:

- Licensing for mortgage brokers;
- As a condition of the issuance of a license, that an applicant-
  - submit a written application for the license, and
  - complete at least 24 hours of education on primary and subordinate mortgage financing and pass a written examination upon the completion of such training;
- A criminal background check to be performed on the applicant;
- Minimum testing requirements for mortgage brokers;
- At least 12 hours of continuing education on a biennial basis, a minimum 2 hours of which must address ethics education; and
- The public agency or official in a given state that is responsible for the licensing of mortgage brokers to provide, directly or otherwise to the national mortgage database established under the Bill (see below), such information as may be necessary to ensure that the database is effective for the purposes for which it is established.

2. Uniform State Standards (section 501, pp. 113-118)

The Federal Standards would be applicable only to states that, upon the expiration of the 3-year period beginning on the date of the Bill's enactment, did not adopt and did not have in effect uniform state laws and regulations incorporating the minimum mortgage broker licensing requirements listed above ("Uniform State Standards"). Therefore, by enacting Uniform State Standards, states would be allowed to "opt-out" of the Federal Standards, so long as certain conditions were satisfied, as described below.

Under the Bill, any Uniform State Standards must exempt the following from treatment as mortgage brokers[14]:

[14] The Bill defines "mortgage broker" as "a person who engages for compensation, either directly or indirectly, in the acceptance of applications for mortgage loans for others, solicitation of mortgage loans on behalf of borrowers, or negotiation of terms or conditions of loans on behalf of borrowers or lenders." "Mortgage" is defined as "any indebtedness secured by a deed of trust, security deed, or other lien on real property."

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- Any bank, savings bank, savings and loan association, or credit union organized under state or federal law, or a subsidiary or affiliate thereof;
- Any budget or debt counseling service, as defined by the Secretary, that is a nonprofit organization exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986;
- Any consumer reporting agency that is in substantial compliance with the Fair Credit Reporting Bill;
- Any political subdivision, or any governmental or other public entity, corporation, or agency, whether state or federal;
- Any college or university, or entity that is controlled by a college or university, as determined by the Secretary;
- Any person or entity that:
  - (1) makes, services, buys, or sells mortgage loans;
  - (2) underwrites the loans; and
  - (3) either:
    - (a) has been approved by the Secretary as a nonsupervised mortgagee with participation in the direct endorsement program, but not including a mortgagee approved as a loan correspondent;
    - (b) has been approved by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation as a seller or servicer;
    - (c) has been approved by the Secretary of Veterans Affairs as a nonsupervised automatic lender, but not including a person approved as a nonsupervised lender, an agent of a nonsupervised automatic lender, or an agent of a nonsupervised lender; or
    - (d) is a creditor (as defined in section 103(f) of the Truth in Lending Bill) who makes or invests in residential real estate loans aggregating more than $1,000,000 per year, and irrespective of whether such creditor is licensed or supervised by an agency of a state;
- Any entity created solely for the purpose of packaging and selling, as a unit of sale as investment securities, mortgage loans that are secured by an interest in real estate, provided that the entity does not service the loans; and
- Any officer or employee of any of the persons or entities described above while such officer or employee is acting within the scope of the office of employment.

Uniform State Standards would also need to comply with any standards concerning the uniformity of information submitted to the national database of mortgage brokers (see below), as established by the Secretary.

Further the Bill states that, after the 3-year period following the Bill's enactment, the Secretary must determine, in consultation with the federal banking agencies and the NCUA, whether any Uniform State Standards in effect satisfy the uniformity requirement under section 501(a) of the Bill. Federal district courts would have exclusive jurisdiction over any challenge to this determination, and section 706 of Title 5 of the United States Code would govern a court's review of such a challenge.

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The Secretary would also be required to monitor any Uniform State Standards (presumably on an ongoing basis). The Bill provides that if the Secretary determines that the Uniform State Standards in a particular state are no longer in effect, or do not satisfy the requisite uniformity of the Bill (described above), then, 2 years after the date on which such determination is made, the state in question will become subject to the Federal Standards, unless the state re-enacts Uniform State Standards or achieves the requisite uniformity before the expiration of the 2-year period.

B. National Database of Licensed Mortgage Brokers

1. Database Requirements (sections 511, 512, pp. 120-123)

The Bill would require the Secretary to establish and maintain a national database of mortgage brokers, which would:

- Include a listing of each person licensed under state law or regulation or under the Federal Standards (described above) to act as a mortgage broker;
- Make available to the public information regarding complaints made, and final disciplinary and enforcement actions taken, against each licensed mortgage broker;
- Make available to the Secretary and to each public state agency or official responsible for licensing or testing under the Uniform State Standards (discussed above) such information regarding mortgage brokers as the Secretary, by regulation, considers appropriate for the Secretary and such agencies and officials to carry out their functions regarding regulation, licensing, or testing of mortgage brokers, including information regarding employment histories and criminal backgrounds of mortgage brokers;
- Make available to persons employing or using the services of mortgage brokers such information regarding mortgage brokers as the Secretary, by regulation, considers appropriate; and
- Provide for the maintenance of such other information as the Secretary considers appropriate.

2. Confidentiality (section 514, pp. 123-124)

Under the Bill, any state or federal law requirement concerning the privacy or confidentiality of any information or material in the possession of the Secretary or any other organization serving as the administrator of the database, and any privilege arising under state or federal law (including the rules of any state or federal court) with respect to such information or material, would continue to apply following disclosure to the database.

Further, such privileged or confidential material would not be subject to disclosure under any state or federal law governing the disclosure to the public of information held by an officer or agency of the federal government or the respective state, or subpoena or discovery, or admission into evidence, in any private civil action or administrative process, unless, with respect to any privilege held by the Secretary with respect to such information or material, the participant, in the participant's discretion, waived the privilege in whole or in part.

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Any state law (including any state open record law) relating to the disclosure of confidential supervisory information or any other information described above, deemed to be inconsistent with the above provisions regarding confidentiality, would be preempted by the Bill to the extent that the state law provided less confidentiality or a weaker privilege.

3. Liability (section 515, pp. 124-126)

A state official or agency, or employee thereof, would not be subject to any civil action or proceeding for monetary damages by reason of a good-faith action or omission of an officer or employee, while acting within the scope of office or employment, relating to collecting, furnishing, or disseminating of information concerning persons who are mortgage brokers or are applying for licensing as mortgage brokers, whether directly or through the national database.

The Bill would make it unlawful to willfully disclose to any person information concerning any person who is a mortgage broker or is applying for licensing as a mortgage broker, knowing the disclosure to be in violation of the Bill's mortgage broker provisions requiring the confidentiality of such information or establishing a privilege from disclosure for such information that has not been waived by the Secretary and the mortgage broker or mortgage broker applicant. The Bill specifies that any person who unlawfully discloses such information is subject to fines in an amount not to exceed the greater of $100,000 or the amount of the actual damages sustained by any person as a result of the violation, or a maximum of 5 years' imprisonment, or both.

The Bill is not to be construed as reducing or limiting any protection provided for any federal agency, or any officer or employee of any federal agency under section 2679 of Title 28, United States Code.

4. Administration (section 511(b), pp. 120-121)

The Bill states that the Secretary must either directly maintain and administrate the database, or contractually delegate this task—using competitive bidding procedures, as defined in section 4 of the Office of Federal Procurement Policy Bill—to a private regulatory organization. The Secretary would be obligated to consult with the American Association of Residential Mortgage Regulators, the Conference of State Bank Supervisors, and other appropriate organizations in determining the types of information to be maintained in the database, and, if the Secretary were to select a private regulatory organization to maintain and administrate the database, in selecting such organization.

The Bill states that the Secretary must periodically review the performance of any organization serving as administrator of the database, and, if the Secretary determines in writing that the organization is not fulfilling the terms of the contract, or upon expiration of the contract, the Secretary may replace the organization with another qualified organization pursuant to competitive procedures.

5. Fees (section 513, p. 123)

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The Secretary would have discretion to provide for the national database to charge reasonable fees to cover the costs of maintaining and enabling access to information from the database, so long as such fees would not be charged to the general public.

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V. Housing Counseling

Truth in Lending Act

Consumer Counseling Requirements (section 201, pp. 62-63)

The Bill would amend Section 129 (15 U.S.C. § 1639) of TILA by adding consumer counseling requirements at subsection "(y)".

Subsection (y) of revised TILA Section 129 would prohibit creditors from extending any credit in the form of a higher-cost mortgage to any consumer borrower without providing the borrower, before the consummation of the mortgage and in a manner determined by the Board, the following items:

- A separate written statement recommending that the borrower take advantage of available home ownership or credit counseling services before agreeing to the terms of the mortgage; and
- A written statement containing the names, addresses and telephone numbers of counseling agencies or programs reasonably available to the consumer that have been certified or approved and made publicly available by the Secretary of Housing and Urban Development (the "Secretary"), a state housing finance authority (as defined in section 1301 of the Financial Institutions Reform, Recovery, and Enforcement Act), or the agency referred to in subsection (a) or (c) of section 108 of TILA with jurisdiction over the creditor as qualified to provide counseling on the advisability of a higher-cost mortgage transaction and the appropriateness of such transaction for the borrower.

A creditor would be deemed to be in compliance with the above requirements if the creditor provided the borrower with a reasonably complete and updated list of counseling agencies as required by section 5(a) of RESPA.

Expanding Housing Opportunities Through Education and Counseling Act

The Bill would also enact the "Expanding Housing Opportunities Through Education and Counseling Act" (the "Housing Opportunities Act") which would amend several federal statutes, as described below:

1. <u>Department of Housing and Urban Development Act</u>

Office of Housing Counseling (section 212, pp. 64-69)

<u>Establishment</u>. A new subsection "(g)" would be added at the end of section 4 (42 U.S.C. § 3533) of the Department of Housing and Urban Development Act. Subsection (g) provides for the establishment of a new "Office of Housing Counseling" (the "Office") in the "Office of the Secretary", to be headed by a "Director of Housing Counseling" (the "Director"), who would be appointed by the Secretary of the Department of Housing and Urban Development (the "Secretary"). Generally, after the Secretary, the Director would have ultimate responsibility within the Department of Housing and Urban Development ("HUD" or the "Department")) for

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all activities and matters relating to homeownership counseling and rental housing counseling, including the following:

- Research, grant administration, public outreach, and policy development relating to such counseling; and
- The establishment, coordination, and administration of all regulations, requirements, standards, and performance measures under programs and laws administered by HUD that relate to housing counseling, homeownership counseling (including maintenance of homes), mortgage-related counseling (including home equity conversion mortgages and credit protection options to avoid foreclosure), and rental housing counseling, including the requirements, standards, and performance measures relating to housing counseling.

Director. The Director's specific functions would include establishing rules necessary for:

- The counseling procedures under section 106(h)(1) (12 U.S.C. § 1701x(h)(1)) of the Housing and Urban Development Act of 1968;
- Carrying out all other functions of the Secretary under section 106(h) of the Housing and Urban Development Act of 1968, including the establishment, operation, and publication of the availability of the toll-free telephone number under paragraph (2) of that section;
- Carrying out section 5 (12 U.S.C. § 2604) of RESPA for home buying information booklets prepared pursuant to that section;
- Carrying out the certification program under section 106(e) (12 U.S.C. 1701x(e)) of the Housing and Urban Development Act of 1968;
- Carrying out the assistance program under section 106(a)(4) of the Housing and Urban Development Act of 1968, including criteria for selection of applications to receive assistance;
- Carrying out any functions regarding abusive, deceptive, or unscrupulous lending practices relating to residential mortgage loans that the Secretary considers appropriate, which will include conducting the study under section 216 of the Housing Opportunities Act (see below); and
- Providing for operation of the advisory committee established under the Housing Opportunities Act (see below).

The Director would be obligated to ensure that homeownership counseling provided by, in connection with, or pursuant to any function, activity, or program of the Department addresses the entire process of homeownership, including the decision to purchase a home, the selection and purchase of a home, issues arising during or affecting the period of ownership of a home (including refinancing, default and foreclosure, and other financial decisions), and the sale or other disposition of a home.

Advisory Committee. Subsection (g) would require the Secretary to appoint an advisory committee (the "Committee") to provide advice and oversight regarding the carrying out of the Director's functions. The Committee would consist of not more than 12 individuals, and the membership of the Committee would equally represent all aspects of the mortgage and real estate industry, including consumers. Each member of the Committee would be appointed for a 3-year

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term, and could be reappointed at the discretion of the Secretary. However, as designated by the Secretary at the time of appointment, with respect to the Committee's initially appointed members, 4 members would be appointed for a 1-year term, and another 4 members would be appointed for a 2-year term.

Subsection (g) provides that the Committee members must serve without pay, but will receive travel expenses, including per diem in lieu of subsistence, in accordance with applicable provisions under Subchapter I of Chapter 57 of Title 5 of the United States Code. The Committee would have no role in reviewing or awarding housing counseling grants.

2. Housing and Urban Development Act of 1968

Counseling Procedures (section 213, pp. 69-78)

The Housing and Urban Development Act of 1968 would be amended by providing for the establishment, coordination, and monitoring, by the Secretary, of HUD's administration of the counseling and rental housing counseling offered in connection with any of HUD's programs, including all requirements, standards, and performance measures that relate to homeownership and rental housing counseling.

The term "homeownership counseling" is defined as counseling related to homeownership and residential mortgage loans. The term includes counseling related to homeownership and residential mortgage loans that is provided pursuant to a number of federal statutory provisions.[15]

The term "rental housing counseling" is defined as counseling related to the rental of residential property, which may include counseling regarding future homeownership opportunities and providing referrals for renters and prospective renders to entities offering counseling. It also

[15] These provisions include: Section 105(a)(20) (42 U.S.C. § 5305(a)(20)) of the Housing and Community Development Act; (ii) in the United States Housing Act of 1937—(I) section 9(e) (42 U.S.C. § 1437g(e)); (II) section 8(y)(1)(D) (42 U.S.C. § 1437f(y)(1)(D)); (III) section 18(a)(4)(D) (42 U.S.C. § 1437p(a)(4)(D)); (IV) section 23(c)(4) (42 U.S.C. § 1437u(c)(4)); (V) section 32(e)(4) (42 U.S.C. § 1437z-4(e)(4)); (VI) section 33(d)(2)(B) (42 U.S.C. § 1437z-5(d)(2)(B)); (VII) sections 302(b)(6) and 303(b)(7) (42 U.S.C. §§ 1437aaa-1(b)(6), 1437aaa-2(b)(7)); and (VIII) section 304(c)(4) (42 U.S.C. § 1437aaa-3(c)(4)); (iii) section 302(a)(4) (42 U.S.C. § 1437f note) of the American Homeownership and Economic Opportunity Act of 2000; (iv) sections 233(b)(2) and 258(b) (42 U.S.C. §§ 12773(b)(2), 12808(b)) of the Cranston-Gonzalez National Affordable Housing Act; (v) [this section] and section 101(e) of the Housing and Urban Development Act of 1968 (12 U.S.C. §§ 1701x, 1701w(e)); (vi) section 220(d)(2)(G) (12 U.S.C. § 4110(d)(2)(G)) of the Low-Income Housing Preservation and Resident Homeownership Act of 1990; (vii) sections 422(b)(6), 423(b)(7), 424(c)(4), 442(b)(6), and 443(b)(6) (42 U.S.C. §§ 12872(b)(6), 12873(b)(7), 12874(c)(4), 12892(b)(6), and 12893(b)(6)) of the Cranston-Gonzalez National Affordable Housing Act; (viii) section 491(b)(1)(F)(iii) (42 U.S.C. § 11408(b)(1)(F)(iii)) of the McKinney-Vento Homeless Assistance Act; (ix) sections 202(3) and 810(b)(2)(A) (25 U.S.C. §§ 4132(3), 4229(b)(2)(A)) of the Native American Housing and Self-Determination Act of 1996; (x) in the National Housing Act—(I) in section 203 (12 U.S.C. § 1709), the penultimate undesignated paragraph of paragraph (2) of subsection (b), subsection (c)(2)(A), and subsection (r)(4); (II) subsections (a) and (c)(3) of section 237 (12 U.S.C. § 1715z-2); and (III) subsections (d)(2)(B) and (m)(1) of section 255 (12 U.S.C. § 1715z-20); (xi) section 502(h)(4)(B) (42 U.S.C. § 1472(h)(4)(B)) of the Housing Act of 1949; and (xii) section 508 (12 U.S.C. § 1701z-7) of the Housing and Urban Development Act of 1970.

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includes counseling related to such topics that is provided pursuant to various federal statutory provisions.[16]

The Secretary would also be required to do the following:

- Toll-Free Telephone Number & Web Site. Provide for the establishment, operation, and publication of a toll-free telephone number and a World Wide Web site through which persons interested in homeownership or rental housing counseling services may locate and obtain names and contact information of persons and organizations certified under section 106(e) of the Housing and Urban Development Act of 1968 to provide such services;
- Standards for Materials. Establish standards for materials and forms to be used, as appropriate, by organizations providing homeownership counseling services;
- Multimedia Outreach Program. Develop a multimedia outreach program designed to make elderly persons, persons who face language barriers, low-income persons, and other potentially vulnerable consumers aware that it is advisable, before seeking a residential mortgage loan, to obtain homeownership counseling from an unbiased and reliable source and that such homeownership counseling is available, including through programs of the Department;
- Assistance. Provide advice and technical assistance to states, units of general local government, and nonprofit organizations regarding the establishment and operation of, including assistance with the development of content and materials for, educational programs to inform and educate consumers, particularly those most vulnerable with respect to residential mortgage loans (such as elderly persons, persons facing language barriers, low-income persons, and other potentially vulnerable consumers), regarding home mortgages, mortgage refinancing, home equity loans, and home repair loans; and
- Certification of Software Systems. Provide for the certification of various computer software programs for consumers to use in evaluating different residential mortgage loan proposals,[17] requiring for such certification that the mortgage software systems take into account—
    - o the consumer's financial situation and the cost of maintaining a home, including insurance, taxes, and utilities;
    - o the amount of time the consumer expects to remain in the home or expected time to maturity of the loan; and

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[16] These provisions include: Section 105(a)(20) of the Housing and Community Development Act of 1974 (42 U.S.C. § 5305(a)(20)); (ii) in the United States Housing Act of 1937—(I) section 9(e) (42 U.S.C. § 1437g(e)); (II) section 18(a)(4)(D) (42 U.S.C. § 1437p(a)(4)(D)); (III) section 23(c)(4) (42 U.S.C. § 1437u(c)(4)); (IV) section 32(e)(4) (42 U.S.C. § 1437z-4(e)(4)); (V) section 33(d)(2)(B) (42 U.S.C. § 1437z-5(d)(2)(B)); and (VI) section 302(b)(6) (42 U.S.C. § 1437aaa-1(b)(6)); (iii) section 233(b)(2) of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. § 12773(b)(2)); (iv) section 106 of the Housing and Urban Development Act of 1968 (12 U.S.C. § 1701x); (v) section 422(b)(6) of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. § 12872(b)(6)); (vi) section 491(b)(1)(F)(iii) of the McKinney-Vento Homeless Assistance Act (42 U.S.C. § 11408(b)(1)(F)(iii)); (vii) sections 202(3) and 810(b)(2)(A) of the Native American Housing and Self-Determination Act of 1996 (25 U.S.C. §§ 4132(3), 4229(b)(2)(A)); and (viii) the rental assistance program under section 8 of the United States Housing Act of 1937 (42 U.S.C. § 1437f). *Id.*

[17] Such certified computer programs must be used to supplement, not replace, housing counseling.

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- o such other factors as the Secretary considers appropriate to assist the consumer in evaluating whether to pay points, to lock in an interest rate, to select an adjustable or fixed rate loan, to select a conventional or government-insured or guaranteed loan and to make other choices during the loan application process.

If the Secretary determines that available existing software is inadequate to assist consumers during the residential mortgage loan application process, the Secretary must arrange for the development by private sector software companies of new mortgage software systems that meet the Secretary's specifications. The Secretary must also provide that certified computer software programs are initially used only in connection with the assistance of housing counselors certified pursuant to subsection (e) of section 106 of the Housing and Urban Development Act of 1968. After a period of initial availability, the Secretary must take reasonable steps to make certified mortgage software systems widely available through the Internet and at public locations, including public libraries, senior-citizen centers, public housing sites, offices of public housing agencies that administer rental housing assistance vouchers, and housing counseling centers.

Grants for Housing Counseling Assistance (section 214, pp. 79-80)

The Bill would amend section 106(a) of the Housing and Urban Development Act of 1968 (12 U.S.C. § 1701x(a)(3)) by adding a new paragraph "(4)" at the end of that section requiring the Secretary to:

- Make financial assistance available to states, units of general local governments, and nonprofit organizations providing homeownership or rental counseling (as such terms are defined in subsection (h) (see above)); and
- Establish standards and guidelines for eligibility of organizations (including governmental and nonprofit organizations) to receive such assistance.

The Bill provides that assistance made available under the new paragraph (4) must be distributed in a manner that encourages efficient and successful counseling programs. It would also authorize the appropriation of $75,000,000 for each of fiscal years 2006 through 2009 for—

- The operations of HUD's Office of Housing Counseling;
- The responsibilities of the Secretary under subsection (h) (see above); and
- Assistance pursuant to paragraph (4) for entities providing homeownership and rental counseling.

Requirements to Use HUD-Certified Counselors under HUD Programs (section 215, pp. 80-82)

The Bill would amend section 106(e) of the Housing and Urban Development Act of 1968 (12 U.S.C. § 1701x(e)) by:

- Replacing paragraph (1) "prohibiting organizations from receiving assistance for counseling activities under subsection (a)(1)(iii), (a)(2), (c), or (d), unless the organization provides such counseling, to the extent practicable, by individuals who have been certified by the Secretary under this subsection as competent to provide such

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counseling" with a new paragraph "prohibiting an organization from receiving assistance for counseling activities under subsection (a)(1)(iii), (a)(2), (a)(4), (c), or (d) of section 106(e), or under section 101(e), unless the organization, or the individuals through which the organization provides such counseling, has been certified by the Secretary as competent to provide such counseling";

- Expressly permitting organizations as well as individuals to provide homeownership and rental housing counseling services;
- Requiring, before the certification of an organization to provide homeownership and rental housing counseling services, that each individual through which the organization provides counseling must demonstrate competence in providing counseling in the following areas: (i) financial management, (ii) property maintenance, (iii) responsibilities of homeownership and tenancy, (iv) fair housing laws and requirements, (v) housing affordability, and (vi) avoidance of and responses to, rental and mortgage delinquency and avoidance of eviction and mortgage default;
- Providing that any homeownership counseling or rental housing counseling required under, or provided in connection with, any program administered by HUD must be provided only by organizations or counselors certified by the Secretary as competent to provide such counseling, and requiring the Secretary to take such actions as the Secretary considers appropriate to ensure that individuals and organizations providing homeownership or rental housing counseling are aware of the certification requirements and standards of section 106, subsection (e) and of the training and certification programs under section 106, subsection (f).

Definitions for Counseling-Related Programs (section 217, p. 83)

The Bill would add the following defined terms:

- The term "nonprofit organization" is defined as a nonprofit organization as defined in section 104(5) of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. § 12704(5)), with the exception of subparagraph (D) of that section.
- The term "state" is defined as each of the several states, the Commonwealth of Puerto Rico, the District of Columbia, the Commonwealth of the Northern Mariana Islands, Guam, the Virgin Islands, American Samoa, the Trust Territories of the Pacific, or any other possession of the United States.
- The term "unit of general local government" as defined as any city, county, parish, town, township, borough, village, or other general purpose political subdivision of a state.

3. Study of Defaults and Foreclosures (section 216, p. 82)

The Bill would require HUD to conduct an extensive study of the root causes of default and foreclosure of home loans, using as much empirical data as is available. The study must examine the role of escrow accounts in helping prime and nonprime borrowers avoid defaults and foreclosures. In this regard, HUD must submit a final report regarding the results of the study, which would include any recommended legislation relating to the study, and recommendations for best practices and for a process to identify populations that need counseling the most.

4. Real Estate Settlement Procedures Act

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Updating and Simplification of Mortgage Information Booklet (section 218, pp. 84-87)

The Bill would amend section 5 of the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. § 2604) by:

- Renaming the section from "Special Information Booklets" to "Home Buying Information Booklets".
- Deleting subsections (a) and (b) and inserting new subsections requiring the Secretary to prepare, at least once every 5 years, a booklet to help consumers applying for federally related mortgage loans to understand the nature and costs of real estate settlement services. The Secretary would prepare the booklet in various languages and cultural styles in order to make it understandable and accessible to homebuyers of different ethnic and cultural backgrounds. The booklet would be distributed to all lenders that make federally related mortgage loans. Such lenders would also receive lists, organized by location, of homeownership counselors certified under section 106(e) of the Housing and Urban Development Act of 1968 (12 U.S.C. § 1701x(e)) for use in complying with the requirement under subsection (c) of section 5.
  - *Booklet contents.* Each booklet would be in such form and detail as prescribed by the Secretary, and, would include in plain and understandable language the following information:
    - A description and explanation of the nature and purpose of the costs incident to a real estate settlement or a federally related mortgage loan. The description and explanation would provide general information about the mortgage process as well as specific information concerning, at a minimum, balloon payments, prepayment penalties, and the trade-off between closing costs and the interest rate over the life of the loan.
    - An explanation and sample of the uniform settlement statement required by section 4 of the Real Estate Settlement Procedures Act.
    - A list and explanation of lending practices, including those prohibited by TILA or other applicable federal law, and of other unfair practices and unreasonable or unnecessary charges to be avoided by the prospective buyer with respect to a real estate settlement.
    - A list and explanation of questions a consumer obtaining a federally related mortgage loan should ask regarding the loan, including whether the consumer will have the ability to repay the loan, whether the consumer sufficiently shopped for the loan, whether the loan terms include prepayment penalties or balloon payments, and whether the loan will benefit the borrower.

Option for Notice of Foreclosure Prevention Counseling Availability (section 219, pp. 88-91)

The Bill would also amend section 4 of RESPA (12 U.S.C. § 2603) by adding a new subsection "(c)" concerning optional notice of foreclosure prevention counseling availability. Subsection (c) provides that, in connection with any federally related mortgage loan, the mortgagee must give the borrower, at the time of the execution of the mortgage, an optional written agreement that, if signed by the borrower, allows, but does not require, the mortgagee to provide notice of

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the borrower's delinquency to a homeownership counseling entity that has agreed to notify the borrower regarding counseling and is approved by the Secretary.

Subsection (c) states that if a mortgagee chooses to give notice pursuant to the written agreement, the mortgagee should do so at the earliest time practicable after the borrower becomes 60 days delinquent with respect to any payment due under the mortgage. The notice should state that the borrower is 60 days delinquent and specify how to contact the borrower. The notice may only be provided once with respect to each delinquency period for a mortgage.

Upon notice from a mortgagee that a borrower is 60 days delinquent with respect to payments due under the mortgage, the homeownership counseling entity would be required, at the earliest time practicable, to notify the borrower: (i) of the delinquency; (ii) that the entity makes available foreclosure-prevention counseling that may assist the mortgagor in resolving the delinquency; and (iii) regarding the means of contacting the entity to arrange for such counseling.

Failure to provide the optional written agreement could be corrected by sending such agreement to the borrower not later than the earliest time practicable after the mortgagor first becomes 60 days delinquent with respect to payments due under the mortgage. Mortgage insurance, if any, provided in connection with such federally related mortgage loan may not be terminated and penalties for such failure may not be prospectively or retroactively imposed if such failure were corrected in accordance with the foregoing.

HUD would have discretion to establish and impose appropriate penalties for failure to provide the optional written agreement. A mortgagee, however, would not incur any liability or penalties for any failure of a homeownership counseling entity to provide notice. Neither would subsection (c) create any private right of action on behalf of the borrower.

For purposes of subsection (c), the following definitions would apply:

- The term "delinquency period" is defined as a period that begins upon the borrower becoming delinquent with respect to payments due under the mortgage and ends upon the first subsequent occurrence of such payments under the mortgage becoming current or the property subject to the mortgage being foreclosed or otherwise disposed of.
- The term "homeownership counseling entity" is defined as any state, unit of general local government, or nonprofit organization that provides homeownership counseling (as defined in section 106(h)(1)(B) of the Housing and Urban Development Act of 1968).

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CONSUMER MORTGAGE COALITION

Residential Real Estate Appraisals in 2005:

Are Appraisers Protecting Consumers, Lenders and Investors Against Property Flipping or Improvident Lending?

May, 2005

801 Pennsylvania Ave., NW, Suite 625, Washington, DC 20004
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Summary

H.R. 1295, the Responsible Lending Act, sponsored by Reps. Ney and Kanjorski, includes many provisions designed to address perceived abuses in higher-cost lending. The legislation would apply to "higher-cost" loans — defined as residential mortgage loans with either interest rates or up-front points and fees that exceed specified limits. This legislation has brought the issue of appraisals and appraisers back to the forefront of the issues facing the mortgage lending industry.

Section 401 of the bill would require a full, written appraisal by a certified or licensed appraiser in any "higher-cost" loan subject to the legislation. Thus, it would prevent lenders in those loans from relying on automated valuation methods or more limited evaluations by appraisers or other real estate professionals, regardless of the risk presented by a particular loan. A lender that failed to obtain an appraisal as required would be liable under the Truth in Lending Act in an individual action for $400 to $4,000 in statutory damages, plus twice the amount of finance charges and fees paid by the consumer (unless the violation was not material). Willful failure to obtain an appraisal as required would also subject the lender to an additional $2,000 in liability. The lender would be liable for up to $1 million in a class action, plus attorneys' fees and court costs. Consumers who defaulted on their loans could reduce their liability to a purchaser or assignee of the loan by these amounts if they could show that the default was reasonably related to the violation.

The bill also includes an "anti-flipping" provision that requires a second appraisal, at no charge to the borrower, where the seller purchased the property within 180 days of the current sale and is selling the house for more than its previous price. Section 402 would prohibit mortgage lenders and bankers, mortgage brokers, real estate brokers, and others with an interest in a real estate transaction involving an appraisal, from improperly influencing an appraisal, through coercion, extortion, or bribery, although that provision does not provide for private enforcement. (The bill is discussed in detail below).

Although Section 401 is ostensibly designed to reduce mortgage fraud and certain forms of "predatory lending" by reducing the incidence of inflated appraisals, it is unlikely to achieve that goal. In fact, the provision could have the perverse effect of actually *increasing* risk by forcing lenders to misallocate resources on appraisals for lower-risk transactions rather than concentrating on those in which there is a substantial risk that the property is inadequate security for the amount of the loan. It would also create a disincentive to use automated valuation systems, even where they have been demonstrated to be more effective than manual appraisals in preventing inflated valuations.

When it enacted FIRREA in 1989, Congress believed that it addressed the fraud and inflated valuation problems that Section 401 of the Ney-Kanjorski bill is designed to reduce. A House report stated:

> "Faulty appraisals make unsafe and unsound real estate loans appear adequately collateralized. Collusion between thrift managers, real estate appraisers and borrowers has cost the FSLIC

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> billions of dollars. In order to thwart real estate appraisal abuses, the legislation establishes a system of uniform national real estate appraisal standards. It also requires the use of state certified or licensed appraisers for real estate related transactions with the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the RTC, or certain real estate transaction regulated by the federal financial institution regulatory agencies."[1]

FIRREA's solution of requiring appraisals by licensed and certified appraisers for real estate secured lending – a result strongly pushed by the appraisal industry – was meant to professionalize the appraisal industry and then to have professional appraisers stand as a bulwark against loans made on the basis of inflated property valuations. Instead, the nation's growing problems with mortgage fraud and property flipping necessarily involve crooked appraisers and fraudulent appraisals. Moreover, appraisers are claiming that pressure for higher valuations from loan originators – particularly mortgage brokers who now source the majority of loans and are not subject to federal banking supervision – is causing appraisers to deliver the higher valuations that the brokers and other originators are requesting.[2] The Appraisal Institute has even instituted an "Appraiser Independence Action Center" and is regularly bringing the issue to the attention of bank regulators and congressional committees.

But the appraisal industry disregards some of the obvious answers to growing non-professionalism among appraisers. In congressional testimony, the then-President of the Appraisal Institute stated that one solution to originator pressure is that "First, the appraiser could turn down the assignment, or just say no. Many appraisers do this; however, given the dilution of the licensed appraiser market, our members report that it is likely that a financial institution will find an appraiser who is willing to bend to their request."[3] Thus the appraisers consider the direct solution – getting appraisers to act professionally and deliver uninflated appraisals as befits the parties' expectations of the appraiser's role in a real estate transaction – to be unrealistic. So instead of better policing the ranks of appraisers so that illegitimately inflated appraisals become more difficult to obtain, the appraisers instead have sought in Sections 401and 402 punishments against lenders and others who order appraisals. The question that naturally arises is whether if in the fifteen years since FIRREA was enacted, the appraisers have not grown into a true profession that is able to say "no" to clients who order services from them, a profession that has not been able to act as a bulwark against fraud and inflated valuations, why would Congress or bank regulators now further cement the position of appraisers in real estate lending by enacting requirements to use one or more traditional appraisals?

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1 H.R. Rep. No. 54(I), 101st Cong., 1st Sess., at 311 (1989).

2 "It is all too common for appraisers to be pressured by mortgage brokers and other larger real estate players, as was reportedly done here. Yet there is no law outlawing this practice, nor are many of the mortgage brokers (an increasing factor in the mortgage process) regulated." Testimony of Gary P. Taylor, President, Appraisal Institute, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee (hearing on "Broken Dreams in the Poconos: The Response of the Secondary Markets and Implications for Federal Legislation"), H.R. Rep. No. 92, 108th Cong., 2d Sess. at 201 (June 14, 2004).

3 *Id.*

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There are simpler and more rational answers to the issues raised by the issues with appraisals.

- The state licensing regime for appraisers is seen by all as a failed system, an underfunded system that cannot manage to ensure that the licensed appraisers actually meet minimum standards. A new federal system is necessary to ensure that appraisers meet and maintain minimum standards, including substantial insurance bonds and professional training.

- Although sanctions under H.R. 1295 apply only to those who order appraisals, the trend in the law is to place more responsibility on the professionals that are signing off on transactions, whether they be lawyers, accountants, or other professionals. In this case, appraisers should face much more significant penalties for delivering fraudulent or inflated appraisals. Appraisals made on the current Fannie Mae/Freddie Mac appraisal form make many certifications, yet few appraisers are ever sued for significant misvaluations of residential properties. In fact, the recent changes to the Federal Housing Administration requirements lean in the other direction, making the non-professional lender responsible for the failings of the appraiser.

- Open up the market to greater competition rather than create more requirements to use appraisers. The marketplace is moving toward greater use of both automated valuation systems and less formal appraisals, both of which are significantly less expensive than a formal appraisal and one of which is immune to both the charms of mortgage fraud and pressure from mortgage brokers. The increasing use of these alternative mechanisms not only will often lead to better valuations and makes fraud harder, it will require traditional appraisers to define situations where their skills and experience are especially needed. In many cases, a broker price opinion ("BPO") is both less expensive and more accurate than an appraisal, reflecting the opinion of a real estate sales professional who is doing transactions in the local real estate market rather than trying to reflect values purely by using comparable sales within a prescribed distance.

Full appraisals by certified or licensed appraisers are not needed in all transactions.

Current federal law generally requires a full appraisal by a certified or licensed appraiser in loans made by a federally-insured bank, thrift, or credit union, or a bank or savings-and-loan holding company, but it allows the federal banking and credit union agencies to create exceptions in relatively low-risk situations. The agencies have created exceptions for a number of low-risk situations. Most significantly, the appraisal requirement does not apply to transactions of $250,000 or less or to loans in which the appraisal conforms to Fannie Mae or Freddie Mac valuation standards, regardless of whether the loan is actually sold to a government-sponsored enterprise ("GSE") or qualifies for sale to the GSE. When the loan is exempt because it is at or below $250,000, the lender must still use valuation methods that conform to safe and sound banking practices.

Thus, since most nonprime loans that would be covered by H.R. 1295 are for $250,000 or less and many of the remainder are conforming or "conforming non-conforming" loans, the bill would force highly-regulated depository institutions and their affiliates to obtain written appraisals in many loans in which they are not currently required by law (although lenders routinely obtain them in higher-risk situations).

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In adopting the $250,000 threshold, the federal banking agencies noted that the appraiser abuses implicated in the savings-and-loan crisis, which led to the federal appraisal requirement, were "abuses [that] were related to real estate acquisition or development projects and larger loans"[4] and that the regulations continued to apply to those larger transactions. They also noted that appraisals are designed to assure that the lender is "adequately secured" and do not protect consumers. In fact, requiring an appraisal where the lender does not need one injures borrowers by increasing the time and cost of the transaction, particularly in small loans.[5]

Similarly, Fannie Mae and Freddie Mac both currently use "tiered" valuation systems in which automated valuation becomes a complete or partial substitute for a full appraisal in some lower-risk loans. For the most creditworthy borrowers in loans with a substantial amount of equity, the GSEs rely on the automated valuation system as the primary method of determining value, performing at most a limited inspection of the property by an appraiser. Freddie Mac also allows certain loans with very low risk to be processed without a property valuation. For relatively low-risk transactions that present somewhat higher risks, the GSEs require an exterior-only inspection, while they require a full appraisal by a licensed or certified appraiser for other, riskier transactions, including high loan-to-value-ratio loans. Conversely, the GSEs use their automated valuation systems as a check on the validity of an appraisal, requiring further investigation when the automated valuation conflicts with the appraisal. Large private investors use similar automated valuation models as a substitute for appraisals when their analysis indicates that the cost of a full appraisal is not justified by any reduction in risk that the appraisal might offer. H.R. 1295 would prohibit all of these cost-effective, risk-reducing alternatives for "higher-cost" loans.

Another type of transaction in which an appraisal is unnecessary and simply burdens the borrower and the lender is a loan for a low amount in which the cost of the appraisal is very high in comparison to the amount of the loan, and in which there is little question about the value of the property. For example, if an elderly person who owns a $100,000 home free and clear seeks $20,000 to repair the roof and make other repairs to the structure, an expensive full appraisal by a licensed or certified appraiser will not reduce the risk or offer any protection to the lender or borrower because it will simply confirm that the property is more than adequate security for the loan. If the loan is a "higher-cost" loan, the lender must obtain a completely unnecessary appraisal, and the charge will be passed on to the borrower. The appraisal would not, however, protect the borrower from fraudulent or deceptive conduct by an unscrupulous contractor, broker, or lender.

Any changes to appraisal rules should be careful to ensure that they do not constrain the further development of alternatives to traditional appraisals, or create another industry protected from competition by federal law.

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4 59 Fed. Reg. 29482, 29483 (June 7, 1994).

5 *Id.* at 29485.

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Requiring an appraisal by a certified or licensed appraiser does not prevent mortgage fraud or predatory lending.

Although HUD imposes stricter standards than many state certification and licensing programs, it also has adopted a statistical "risk-based" program to target appraisers who are associated with a high incidence of "early default" and other risk factors on FHA loans for intensive review of their appraisals. Thus, HUD has found that it cannot rely entirely on a manual appraisal to establish the value of the collateral for loans that it insures.

Despite the strict standards for appraisals in the FHA loan program, HUD has experienced continuing losses due to fraudulent or improper appraisals. In one recent widely-reported case, a group of mortgage service-providers, including corrupt appraisers, sold fraudulent FHA loans to Fannie Mae. In that case, Fannie Mae paid $7.5 million in restitution to a purchaser of loans originated by the same group. Given FHA's appraisal requirements, the appraiser or appraisers in that case were required to be licensed or certified, but that did not protect the government from the fraud.

One expert on mortgage fraud recently noted in congressional testimony the limitations inherent in any valuation method that relies solely on manual appraisers — the fact that a dishonest appraiser can always find ways to avoid detection by the system. In HUD's case, as noted, the major factor leading HUD to conduct a review of an FHA appraiser is the incidence of "early default" on loans in which the property was appraised by that appraiser. The expert noted that this system can be evaded by a clever operator:

> And the key here is letting it go on long enough. If those payments are made month after month with the proceeds of the first loans, then you can mask it for a year. And now you are beyond those early payment default detection programs that the industry knows about and can spot right away. And the whole thing implodes from about 18 months to 2 years from the original funding dates.[6]

By using statistical methods of pattern recognition, an automated valuation system can often detect a potentially inflated appraisal and can act as important check on the validity of a manual appraisal, or, in appropriate cases, as a cost-effective substitute for the appraisal.

Lenders are the greatest victims of inflated appraisals and have a strong incentive to avoid them.

When a property is overvalued by an inflated appraisal, the borrower may be harmed if he or she cannot make the payments and ultimately loses his or her home. A neighborhood targeted by mortgage-scam operators can be hurt if the result is many abandoned properties, and ultimately all borrowers may be affected by higher resulting costs for mortgages. But most particularly, lenders and mortgage servicers are the greatest victims of all forms of mortgage fraud, including appraisal fraud.

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6 Testimony of Arthur J Prieston, Chairman, The Prieston Group, before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, H.R. Rep. No. 116, 108th Cong., 2d Sess. at 43 (Oct. 7, 2004).

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Whether they hold loans in their portfolio or sell them to investors on the secondary market, mortgage lenders and servicers will suffer losses when a default occurs due to fraud. As a general rule, lenders and servicers do not benefit from defaulted loans. Rather they lose money, because the lender generally must buy back fraudulent loans from the secondary market and try to recover what it can from the parties who committed the fraud. These potential losses give lenders a strong incentive to avoid overvaluation of the property that serves as security for their loans. By contrast, few if any appraisers have the capital to make good on defaults caused by an erroneous or deliberately misleading appraisal, and even the most dedicated and professional appraiser may be pressured by other participants in the process to produce an inflated appraisal.

Automated valuation systems can reduce risk at lower cost than an appraisal-only system.

As noted above, the GSEs and other mainstream lenders use appraisals when they are warranted, but engage in sophisticated risk management that allows them to avoid unnecessary costs in relatively low-risk transactions. Automated valuation systems can be a very effective method of determining value in their own right. These systems can produce more consistent results because they are not susceptible to lapses of judgment, pressure from mortgage or real estate brokers, loan officers, or sellers to inflate the value, or to undue influence or bribery. Use of such systems also frees up resources to allow lenders to concentrate their efforts more intensively on loans that present the greatest risk.

These considerations aside, professional appraisers will continue to play an important role in arriving at an appropriate property valuation for mortgages for the foreseeable future. This is particularly true in the nonprime mortgage market, in which automation has not proceeded as quickly as in other market segments. Lenders are likely to continue to rely on some form of appraisal or manual property inspection in many if not most nonprime transactions for some time. But the appraiser provision of H.R. 1295 would place artificial constraints on the development of technology that can protect lenders at lower cost and more efficiently than a purely manual system.

The anti-coercion provision would be ineffective and could have unanticipated negative results.

Finally, Section 402 of the bill would prohibit improperly influencing an appraisal, through coercion, extortion, or bribery. The goal of this provision is laudable and there is a savings clause that allows some forms of interaction with an appraiser. But the term "coercion" is undefined and could be interpreted overly broadly. This provision could generate complaints to enforcement agencies from appraisers who were dismissed or not hired for valid reasons. A more effective method of preventing undue pressure would be to require appraisers to be bonded or maintain capital up to a level that would be enough to give lenders some recourse against poor appraisers — and to give appraisers an incentive to stand up to demands from other participants in the process.

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Background: Detailed Analysis of H.R. 1295 and Current Valuation Practices

The Bill's Appraisal Provisions

Section 401 of H.R. 1295, the Responsible Lending Act, sponsored by Reps. Ney and Kanjorski, would add a new Section 129(z) of the Truth in Lending Act ("TILA"),[7] requiring creditors to obtain a written appraisal from a certified or licensed appraiser in all "higher-cost" transactions subject to the legislation. The provision would make it a violation of the "higher-cost" provisions to "extend credit in the form of a higher-cost mortgage" without complying with the provision, regardless of whether the failure to obtain the appraisal causes any injury to the consumer. Thus, a lender that failed to obtain an appraisal would be civilly liable to the consumer under TILA's civil liability provision.[8] Moreover, Section 105 of H.R. 1295 would increase the maximum statutory damages (automatic damages regardless of fault or injury) in an individual action under TILA to $4,000 in closed-end (installment) loans secured by real estate, and would increase the maximum recovery in any TILA class action to $1 million. Lenders that violated the "higher-cost provisions" would also be liable, as under present law, for twice the amount of finance charges and fees paid by the consumer, unless the violation was not material.[9] They would be liable for up to $1 million in a class action, plus attorneys' fees and court costs.[10]

Section 105 of the bill also allows consumers more ability than under existing law to assert a violation of this and other "higher-cost" provisions as a defense, after defaulting on a mortgage, to an enforcement action by a purchaser or assignee of the loan, if the default is "reasonably related" to the violation or the consumer can show that "the purchaser or assignee had actual knowledge of or exhibited reckless indifference to a violation."

Section 401 contains detailed requirements for appraisals in higher-cost loans:

- A "written appraisal" would be required in all cases. A "written appraisal" is defined under existing law as:

  > [A] written statement used in connection with a federally related transaction that is independently and impartially prepared by a licensed or certified appraiser setting forth an opinion of defined value of an adequately described property as of a specific date, supported by presentation and analysis of relevant market information.[11]

  Therefore, since the statement must set "forth an opinion of defined value," this definition would apparently exclude an automated property valuation, even if the lender also considers information provided by an appraiser who does not provide an opinion as to value.

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7 *To be codified at* 15 U.S.C. § 1639(z).

8 *See* 15 U.S.C. § 1640(a).

9 *See* 15 U.S.C. § 1640(a)(4).

10 *See* 15 U.S.C. § 1640(a)(3).

11 12 U.S.C. § 3350(10).

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- The appraisal would have to be "performed by a qualified appraiser who conducts a physical inspection of the mortgaged property."
- A "qualified appraiser" would be defined as a person who: (1) is certified or licensed by the state in which property to be appraised is located; and (2) performs each appraisal in conformity with the Uniform Standards of Professional Appraisal Practice and Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), and the regulations issued under FIRREA.
- If the purpose of the higher-cost mortgage is to finance the purchase of the mortgaged property from the seller within 180 days of the purchase of that property by the seller, and if the seller purchased the property at a price that was lower than the current sale price of the property, the creditor would have to, at no cost to the borrower, obtain a second appraisal from a second qualified appraiser that supports the current sale price of the property.
- The creditor in a higher-cost mortgage would be required to provide one copy of each appraisal report to the borrower without charge. The Equal Credit Opportunity Act, as implemented in Regulation B, currently requires creditors to provide a copy of any appraisal report (including one prepared in-house by the creditor), but permits lenders to charge photocopy and postage fees.[12]

Willful failure to obtain an appraisal as required under subsection (z) would result in a liability to the borrower for the sum of $2,000, in addition to any other liability.

Section 402 of the bill would strengthen the existing FIRREA requirements for appraisers by insured depository institutions by, among other things:

- Prohibiting mortgage lenders and bankers, mortgage brokers, real estate brokers, and any other persons with an interest in a real estate transaction involving an appraisal, from improperly influencing, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan. Such persons could, however, ask an appraiser, to consider additional, appropriate property information, provide further detail, substantiation, or explanation for the appraiser's value conclusion, or correct errors in the appraisal report, without violating the law.[13] Although this provision applies on its face to any participant in a real estate transaction, the legislation does not provide an enforcement mechanism, other than the banking regulators' enforcement powers under the Federal Deposit Insurance Act.[14]
- Bolstering FIRREA's definition of "state licensed appraiser" by changing the definition from "an individual who has satisfied the requirements for State licensing in a State or territory" to "an individual who has satisfied the requirements for State licensing in a State or territory whose criteria for the licensing of a real estate appraiser currently meet or exceed the

[12] *See* Official Staff Commentary to Regulation B, §§ 202.14(a)(2)(ii)-1 and 202.14(c)-1.

[13] *See* Section 402(h) of the bill, *adding* 12 U.S.C. § 3351(g).

[14] *See* 12 U.S.C. § 1818(i).

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minimum criteria issued by the Appraiser Qualifications Board of The Appraiser Foundation for the licensing of real estate appraisers."[15]

- Deleting a provision that currently prohibits the Appraiser Subcommittee of the Federal Financial Institutions Examination Council from setting qualifications or experience requirements for the States in licensing real estate appraisers, including a *de minimis* standard.[16]

Current Law and Practice Related to Appraisals

Regulations

FIRREA requires each of the "[f]ederal financial institutions regulatory agencies" — the federal banking regulators and the National Credit Union Administration ("NCUA") — to establish "appropriate standards for the performance of real estate appraisals in connection with federally related transactions"[17] In addition to the power to set "appropriate" appraisal standards, the federal financial institutions regulatory agencies also have the specific power to set a *de minimis* loan amount below which an appraisal will not be required. *Id.* § 3341(b).

A "federally related transaction" is defined as a "real estate-related financial transaction" conducted by an entity under one of the agency's jurisdiction — *i.e.,* a federally-insured bank, thrift, or credit union, or a bank or savings-and-loan holding company[18] — that "requires the services of an appraiser. *Id.* § 3351(6). A "real estate-related financial transaction" is defined broadly as "any transaction involving . . . the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing [or] refinancing of real property or interests in real property."[19] It also includes "the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities."[20] Another provision makes a "financial institution" (an insured depository institution or insured credit union) that seeks, obtains, or gives money to pay for an appraisal in a federal related transaction when it knows that the appraiser is not state-licensed or certified subject to civil penalties, and prohibits (without any specific penalty) Fannie Mae and Freddie Mac from knowingly contracting for an appraisal by an appraiser who is not state-licensed or certified.[21]

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15 *See* 12 U.S.C. § 3345(c).

16 *See id.* § 3345(e).

17 *See* 12 U.S.C. §§ 3339 (appraisal requirement) and 3351(6) (definition of "Federal financial institution regulatory agencies").

18 The term also includes transactions engaged in or contracted for by one of the agencies or the Resolution Trust Corporation, when it existed.

19 *Id.*§ 3351(5).

20 *Id.* § 3351(5)(C).

21 *Id.* § 3349(a).

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The original regulations implementing the requirements were issued in 1990, and the current version of the agenicies' regulations largely dates to 1994.[22] Those regulations create several exceptions to the general rule that an appraisal is required in all real estate transactions. The most significant of these are that an appraisal by a state-certified or -licensed appraiser is not required:

- In transactions of $250,000 or less (or business transactions that are not real-estate sales or leases of $1 million or less);
- Where the transaction is wholly or partially guaranteed or insured by a U.S. government agency or GSE; or
- Where the transaction either qualifies for sale to a government agency or GSE, or the appraisal conforms to Fannie Mae or Freddie Mac standards for that type of real estate. In other words, conforming loans are not required to have an appraisal beyond what Fannie Mae and Freddie Mac require, and "conforming non-conforming" loans are exempt if they conform to Fannie Mae or Freddie Mac standards.[23]

If the transaction is exempt because the value is $250,000 or less, the regulation requires "an appropriate valuation of real property collateral that is consistent with safe and sound banking practices."[24]

Existing Automated Valuation Systems: GSE and FHA Policies

There are many independent providers of automated valuation services, and, in addition, both Fannie Mae and Freddie Mac allow automated valuation systems to be used as a full or partial substitute for an appraisal in some situations.

Fannie Mae and Freddie Mac

Since Fannie Mae's and Freddie Mac's policies for use of automated valuation are publicly available, they will be analyzed here. Many private investors engage in similar risk-based use of automated valuation as either a substitute for or an enhancement of the traditional manual appraisal by an appraiser.

The GSEs have incorporated automated property valuation into their overall automated underwriting systems, which also evaluate the individual creditworthiness of the borrowers. Both GSEs permit the use of automated valuation only when automated underwriting is used and only for relatively low-risk transactions.

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22 *See, e.g.*, Board of Governors of the Federal Reserve System, Appraisal Standards for Federally Related Transactions: Final Rule, 55 Fed. Reg. 27762 (Jul. 5, 1990), *as amended at* 59 Fed. Reg. 29482 (June 7, 1994), and 63 Fed. Reg. 65530 (Nov. 27, 1998), *codified at* 12 C.F.R. §§ 225.61-225.67.

23 *See, e.g.*, 12 C.F.R. § 225.63(a).

24 *See, e.g.*, 12 C.F.R. § 225.63(b). This requirement also applies to transactions that are exempt because they involve a business loan of $1 million or less or involve refinancings with the original creditor. *See id.*

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Fannie Mae's Desktop Underwriter® system will recommend one of three levels of documentation of property value:

- An appraisal with both interior and exterior property inspection;
- An appraisal with an exterior property inspection only; or
- An exterior-only property inspection, with the value determined by the automated underwriting system.[25]

The recommendation depends on a variety of factors, including the borrower's creditworthiness, whether the originator has provided a "standardized property address" that allows Fannie Mae to compare the property to data about other properties in its system, the purchase price, loan amount, occupancy, number of units, property type, and combined loan-to-value ratio.[26]

Fannie Mae restricts the use of an exterior-only property inspection (with no determination of value by the appraiser) to lower-risk transactions. To qualify for a recommendation for this automated valuation, a property must have a combined loan-to-value ratio of less than 90%, be a one-unit property, and the loan must be a purchase or a no cash-out or limited cash-out refinancing.[27] Other types of transactions, such as investment properties, manufactured homes, and two-to-four-unit properties, are ineligible.[28] Even if the transaction meets the basic criteria, Fannie Mae may require an upgrade to an appraisal with an exterior-only or exterior-interior inspection if the automated valuation is inadequate. Fannie Mae could reach that conclusion if the appraiser finds that the property does not conform to the neighborhood or has physical or environmental defects, or if the appraiser cannot provide an adequate description of the property's physical characteristics. *Id.*

Freddie Mac has a similar tiered system, but in some cases Freddie Mac does not require either a manual appraisal or an inspection. To qualify for this "No-appraisal MAF [Minimum Assessment Feedback]" treatment, the property must be rated "Accept" by Loan Prospector,® Freddie Mac's automated underwriting system, be a "purchase transaction having a total loan-to-value ratio of 80% or less," and be secured by a one-unit primary residence. In addition, the

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25 *See* Fannie Mae, Single Family: Guide to Underwriting with Desktop Underwriter®, Ch. 3, Appraisal and Inspection Fieldwork Recommendations (Mar. 2005).

26 *See id.* Ch. 3, Property Fieldwork Recommendations.

27 *See id.* Ch. 3, Desktop Underwriter Property Inspection Report (Form 2075) (Mar. 2005). A "limited cash-out refinance transaction" is defined as:

> A refinancing transaction in which the mortgage amount is generally limited to the sum of the unpaid principal balance of the existing first mortgage, closing costs (including prepaid items), points, and the amount required to satisfy any mortgage liens that are more than one-year old (if the borrower chooses to satisfy them), and other funds for the borrower's use (as long as the amount does not exceed 2% of the principal amount of the new mortgage).

Fannie Mae Single Family Selling Guide, Part XIII: Glossary and Index (June 30, 2002).

28 *Id.*

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lender must represent and warrant that title to the mortgage is in the name of the seller in the purchase contract and that title has not been transferred in the past six months.[29]

HUD

The Department of Housing and Urban Development ("HUD") has taken a different approach from the GSEs. Although HUD continues to require appraisals on all loans and does not use automated valuation technology to determine the value of collateral, it makes extensive use of statistical methods to target individual appraisers for fraud investigations. Thus, HUD has also found that required appraisals do not protect it from fraud.

HUD's standards for appraisers exceed state licensing and certification requirements:

- FHA appraisers must not only be state-licensed or -certified, but the state credentials must meet the "licensing/certification criteria issued by the Appraiser Qualifications Board (AQB) of the Appraisal Foundation." This requirement is not met for appraisers whose credentials were "grandfathered" by the state before the state adopted those criteria.

- "[P]ass a HUD/FHA examination on appraisal methods and reporting[,]" which focuses on HUD's valuation methods; and

- "[N]ot be listed on either the General Services Administration's Suspension and Debarment List, HUD's Limited Denial of Participation List, or HUD's Credit Alert Interactive Voice Response System."[30]

These high standards for appraisers were instituted in response to criticism by the General Accounting Office that HUD did a poor job of monitoring appraiser performance and removing appraisers whose performance was week from its roster of approved appraisers.[31] HUD also formalized its procedures for removal of poorly-performing appraisers in regulations.[32] HUD also instituted a "risk-based" review system in which it focuses on bad appraisers, defined essentially as those who provide a number of appraisals on properties in which the borrower defaults within the first year of the loan.[33] Although the renamed Government Accountability Office has continued to criticize HUD's monitoring of poor appraisers, HUD used this system to remove 132 appraisers from the FHA Roster in 2003.[34] HUD also recently adopted regulations that permit it to take enforcement action against lenders that submit appraisals that do not

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29 *See* Freddie Mac Single Family Seller/Servicer Guide, vol. 1, ch. 44.9(f): Appraisal and Inspection Forms and No-Appraisal MAF (Jun. 28, 2004).

30 *See* HUD Mortgagee Letter 99-35: Single-Family Loan Production — FHA Appraisal Reform and the National Appraiser Examination (Nov. 24, 1999).

31 *See* General Accounting Office, *Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process,* Report No. GAO/RCED-99-72 (Apr. 1999).

32 *See* 65 Fed. Reg. 17974 (Apr. 5, 2000), *amending* 24 C.F.R. §§ 200.204.

33 *See* Government Accountability Office, *Single-Family Housing: HUD's Risk-Based Oversight of Appraisers Could Be Enhanced,* Report No. GAO-05-14 at 3 (Nov. 2004).

34 *Id.* at 4.

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conform to FHA standards, including suspension from or permanent withdrawal of eligibility for FHA insurance ("endorsement") of loans.[35]

[35] *See* 69 Fed. Reg. 43504 (July 20, 2004), *adding* 12 C.F.R. § 25.9(ee) (administrative sanctions for submitting non-compliant appraisals); 12 C.F.R. § 25.5(d) and (e) (suspension or withdrawal included in potential sanctions).

Analysis of
The Impact of Prepayment Penalties on Residential Sub-prime Lending Coupons

May 12, 2004

Executive Summary:

For over 10 years, loan prepay penalties have been an instrumental cash flow in motivating fixed income bond investors to purchase bonds collateralized by sub-prime residential loans. If loan prepayment penalties were to be reduced in term, amount or eliminated completely, demand and/or pricing of the bonds backed by sub-prime loans could be adversely affected. We feel that in the absence of prepayment penalties:

1. Investors would want to be compensated for the heighten cash flow risk. They would either drop their bid in price or loan coupons would be forced higher to compensate for the added volatility. Higher coupons could also cause lending volumes to decline and lender profitability to erode as fixed expenses rose proportionally.

2. Additionally, securitization structures would likely be modified to reflect the rating agency's focus on the heightened cash flow volatility of the less-protected collateral pool. This adjustment would reduce sale proceeds for the lender.

Together, lower volume driven by higher coupons and higher costs (on a percentage basis) could have a significant negative impact on lenders margins. There are large lenders who, in this highly favorable interest rate and credit market, have lower overhead and benefit from scale. For some of the smaller lenders, the loss of prepayment penalties could mean the difference between small profits and losses. Borrowers seeking new loans would pay the consequences through higher coupons.

It is unreasonable to assume that the very favorable current interest rate environment and benign credit markets will remain unchanged in the future. If the markets were to revert back to more normalized environments (higher interest rates and defaults), even the large lenders could find their profitability impacted.

In this paper we seek to illustrate the impact that prepayment penalties have on the investor, the borrower and the lender. We provide this analysis based on the current market conditions which we consider to be very accommodating.

We have undertaken a quantitative analysis (outlined in the following sections) to estimate the rise in coupons necessary to compensate for the complete loss of prepay penalties. This projected increase, in the current environment given our assumptions, is 120 bps (i.e. - if current coupons were assumed to be 6.49%, this would project an increase to 7.69%). It should be noted that this increase is very sensitive to both the interest rate environment and underlying assumptions highlighted herein, and could be larger or smaller based on changes to these assumptions (i.e. - in faster prepay environments, the coupon increase would likely be greater and vice versa).

We have also used the scenarios in the above exercise to illustrate the impact to the sale proceeds of the originator. By removing the prepayment penalty income, increasing prepayment speeds assumptions and holding lending coupons constant, the impact would be a decrease of 1.98% in net sale proceeds (expressed in terms of par, see assumptions and illustration in Appendix B). This was enough to change a profitable issuance to a loss in today's environment. Similar to the coupon analysis discussed previously, this illustration is highly sensitive to the assumptions used to create it. This exercise is not intended to represent the actual margins realized by issuers; rather it attempts to quantify how margins could be affected given a change to a certain set of assumptions.

We have generated our opinions about this issue based on our direct and indirect research. Additionally, we have interviewed leading capital markets participants including but not limited to: loan and bond investors, research firms, loan originators, loan servicers, rating agencies and Wall Street dealers.

The Economics of Sub-Prime Lending:

A major shift has occurred since the sub-prime market started in the late 80's. The fixed income bond community has become the dominant provider of capital to the sub-prime borrower community. Previously, banks were the dominant capital provider. They had extensive loan origination networks and combined them with low cost deposits as their source of funding to generate attractive spread income. Currently, it is loan intermediaries such as loan brokers and conduit operators who originate, aggregate and sell the loans in bulk to the bond investment community. They use loan securitization to facilitate this process.

In the early days of the evolution from banks to bonds, the capital markets were unwilling to purchase the first loss and prepayment penalty cash flows at the offered prices. Intermediaries such as conduit managers retained a relatively large amount of credit and prepayment risk and retained the excess cash flow from prepayment penalties for taking the risk. These roles have largely changed. Now, the bond markets are more mature and the originators commit less capital in the risk because bond investors are willing to pay more. Their experience in understanding the product has improved, and capital markets have developed instruments (such as prepayment penalties) to give investors an added degree of comfort when committing capital to this volatile asset sector. The usefulness of these instruments, coupled with a benign credit environment and attractive interest rate environment, has dramatically improved the bid for sub-prime loans and the securities backed by them over the past several years.

The favorable market conditions have been a material component of the sub-prime markets success. For instance: house prices have risen materially, loan coupons have stayed low, investors have bought bonds and levered their purchase with low cost financing. Meaningful improvements have also been made to loan servicing practices. This has caused fewer loans to reach foreclosure. The result is that in more recent history, bonds investors have had a good experience and view the sector favorably.

Longer term, we feel the capital markets will continue to be the lead liquidity provider for the lenders, but the favorable current market environment should not be relied upon to support the sub-prime market to the same degree in the future. In other words, the market demand for bonds backed by sub-prime collateral may not be as robust in the future if a less desirable interest rate and/or credit environment were to occur. If prepayment penalties were to be eliminated in a period when the markets were more volatile lender liquidity could be reduced even more dramatically. Loan coupons could rise above the theoretical values calculated using today's market environment due to the combined effect.

Why are the capital markets a better bid than the banks and the loan originators?

1. A vast majority of the loans originated to date have exceeded initial credit projections.
2. The ratings for much of the previously issued debt have performed well.
3. Bond investors are generally comfortable with house prices and labor markets.
4. Investors, along with rating agencies, accept the inevitable variances associated with the "pool style" of lending. This approach involves looking at sub-prime risk in aggregate at the pool level (as opposed to the loan level), and using loan features such as prepayment penalties to stabilized cash flows even though the underlying loans are volatile.

Prepayment penalties are an important part of the proposition to invest in bonds collateralized by sub-prime loans:

Some market participants have argued that lenders could survive if prepayment penalties were eliminated in their entirety. We feel the elimination of prepay penalties could cause liquidity concerns to the sector as a whole. Eliminating prepayment penalties would impair the ability to securitize the risk by removing an important cash flow that provides diversification as well as cash flow stability. This would decrease lender's profitability which would, in turn, reduce capital available to the sector as a segment of these lenders exited the business.

Why prepayment penalties exist:

Many investors lost a lot of money in the early days of sub-prime bond investing. Most of them have said that it was a function of higher than expected losses and unpredictable prepays. Prepay penalties evolved as a partial solution to attract investors back to the sector.

Today, many loan and bond investors find sub-prime prepayment penalties particularly important. In addition to the prepay sensitivity created by interest rate volatility, the additional risk of prepayment due to credit curing is higher on sub-prime collateral. Credit curing occurs when borrowers make timely payments, improve their credit and qualify for a lower rate. Because of this additional uncertainty not found in prime loans, investors want to be paid more to take that un-hedgeable risk.

The capital markets generally prefer collateral and transaction structure consistency. History has shown that the markets can react to *small* changes in collateral and deal structures if necessary. Small is the operative word. Large changes in loan terms and securitization structure typically create unwanted market disruptions. These disruptions have historically affected liquidity and pricing in a negative fashion.

For instance - if a pool of mortgages contained 80% prepay penalties, and this percentage of loans was reduced to 70%, this change would be manageable and securitization pricing would not suffer materially. Loan coupons would likely remain unchanged. In a more dramatic example, if the number of penalty loans within a pool were dropped from 80% to 5%, investor demand would be impacted. As the percentage of loans in a pool with prepayment penalties declines, the impact to prepayment assumptions becomes more and more significant. A larger percentage decrease would force bidding assumptions and potentially securitization structure to change, causing a re-pricing of assets as well as a re-structuring of securitizations. We believe the market could adjust to less punitive penalties or shorter duration penalties, but their existence as an instrument remains fundamentally important to liquidity in the sub-prime sector.

From a lender's perspective, sub-prime loans have higher costs to originate. This makes this type of lending less profitable if a loan prepays after a short period. Investors are not willing to pay premium prices for loans that are likely to credit cure without some sort of protection to their return on the investment. The credit curing option that the borrower enjoys is un-hedgeable.

This relationship is best understood as a function of investor demand and loan supply:

The demand side: Bond Investors:

- Find that prepay penalties stabilize the cash flow pattern of the sub-prime collateral.
- Find that there is not a large derivative market in the sub prime sector (unlike the prime loan markets). As such, there are few, if any, hedging products that can offset rate speculation and credit curing exposure.

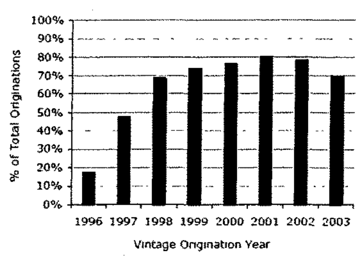
The supply side: Lenders:

- Have realized that without the bid from the capital markets, the liquidity of their loans would be significantly impaired. They also realize that these loans cannot be profitably produced given their cost to originate unless there are alternative sources of cash if the loans prepay.
- Use prepayment penalties to assist them during the period when they are aggregating new loans for sale in large bond deals. During that period,

they are exposed to prepayment risk which can be costly due to their high basis in the loans. Penalties mitigate this risk (by slowing speeds). It is important to note that a lender's all in cost for a sub prime loan is frequently higher than the penalty amount. As such, the penalty income may not be sufficient to cover the loss.

Homeowners have been a beneficiary of the bond markets strong bid for the loans. Many of the most distressed borrowers have been given loans because the markets will accept them in fractional percentages of a securitization. Others (less distressed but still sub-prime) simply enjoy a lower rate of interest than they would be offered without the same penalties.

Exhibit 2: Trends in Origination - Prepayment Penalties



Source: Banc One

The exhibit above shows the trend in the use of prepayment penalties. The percentage of loans originated with prepayment penalties has remained relatively stable since 1999, accounting for 70% to 80% of total annual originations.[1]

Definition and types of penalties:

Loan prepayment penalties are contractual features included in a mortgage that require a homeowner to pay a fee if they repay their mortgage in the early years of the loan's contracted life. The amount of the fee and the period the homeowner is required to pay this fee is disclosed in the original loan documentation.

A prepayment penalty is frequently found on different types of sub-prime mortgages (fixed rate, adjustable rate and hybrids). Usually, the penalty amount declines (to zero) with the passage of time and will not apply to repayment resulting from a home's sale.

Bond investors frequently have differing opinions about the value of prepay penalties on the three different loan types:

[1] Banc One, "ABS Yearbook 2004", pg.51

1. Prepayment penalties on fixed rate loans are heavily scrutinized by bond investors. As interest rates decline, investors want the bond cash flow to remain outstanding for the longest period. The put option of the borrower (prepayment) becomes more and more attractive to the borrower as rates continue to rally, making investors' focus on the prepayment penalty increasingly important on fixed rate loans.

2. For hybrid arms, most penalties expire no later than the first loan coupon reset date. Depending how far in the future the first reset date is, the impact can be very similar to the fixed loan example above or the ARM example below.

3. Prepayment penalties on ARMs are scrutinized the least because investors do not usually expect to have the price of their bonds deviate much from par. As such, a prepayment at par is not as costly.

There are two predominant types of prepay penalties. The first defines itself as a function of the loan coupon and the second defines itself as a function of the loan balance at the time of the repayment. Typical penalty types are are:

1. Six months interest (often on 80% of the loan balance)*
2. Flat percent of loan balance (5%, 3%, etc.)*

**Both types often have varied terms (2 yr, 3yr, 5 yr)*

Prepayment penalties effect on prepayment speeds:

Although historical loan prepayment data is available for sub-prime loans with prepayment penalties in general, prepayment data on loans sorted by prepayment penalty type is not available in a useful data set. It is our experience that most loan servicers do not keep accurate historical records in this regard. Although the data does exist with some servicers, the data that is available could be questioned as not being completely representative of all loans with these various types of penalties.

Loans with prepayment penalties are usually associated with lower rates, creating a two fold effect on projected and historical prepayment speeds. They prepay more slowly because:

1. There is an economic disincentive (penalty) in doing so, and;
2. The lower rate (than the no-penalty loan) decreases the refinancing incentive.

Figure 9a Prepayments on 2/28 Loans by Penalty Amount

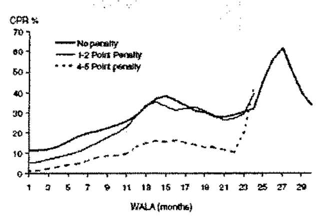
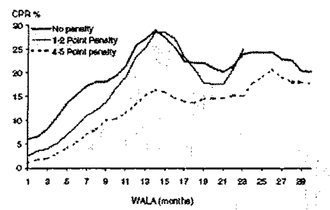


Figure 9b. Prepayments on Fixed Rate Loans by Penalty Amount



Source: Lehman Brothers

The rating agencies project the expected speed difference when they rate bond deals. Historically this decrease in prepayment speeds has been estimated to be approximately 10%[2] relative to loans without prepay penalties. In today's market, many investors estimate a decrease in prepay speeds due to the use of prepay penalties as high as 40-50%.

Concentration of prepayment penalties in sub-prime loans:

There is unquestionably a large disparity between the amounts of prime borrowers taking out loans with prepayment penalties versus the amount of sub-prime borrowers using penalties. Freddie Mac estimates that 80% of sub-prime loans carry prepayment penalties versus 2% in prime[3].

As stated earlier, prepay penalties on sub-prime loans became very popular in the mid 1990's to motivate investors to enter or return to the sub prime bond markets. Investors had inconsistent results and lenders used penalties to motivate them to buy bonds. Given the significant growth of sub-prime bond issuance since that time, it appears that this strategy was helpful. There are generally two perspectives of why there is a higher percentage of penalties on sub-prime versus prime:

1. **Opponents** to prepayment penalties would argue that many of these sub-prime borrowers are less sophisticated than prime borrowers, and often have these penalties included in their loan without fully understanding them or without understanding them at all.

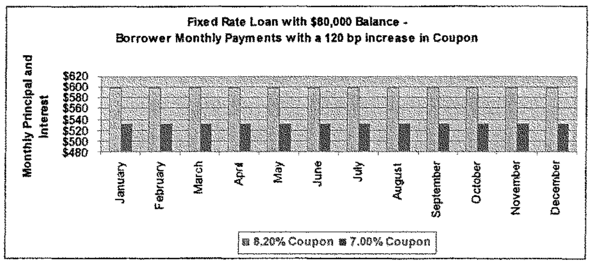
2. **Proponents** of penalties would argue that without these penalties, lenders would be forced to charge these borrowers significantly higher rates of interest, precluding many of them for qualifying for the requested loan amount. They take the perspective that borrowers freely enter this relationship because they have decided to accept the lower coupon and higher proceeds in exchange for temporary limitations.

[2] Standard & Poors, "NIM analysis: Valuing Prepayment Penalty Fee Income" January 3, 2001.
[3] Taken from "Frequently Asked Questions on Prepayment Penalties", www.freddiemac.com/singlefamily

Many borrowers are advantaged (via lower loan coupon) by the presence of prepayment penalties. Take, for instance, a prime borrower that is confident that he will be in his home for the next several years and does not wish to speculate on future lending coupons. By accepting a loan with a prepayment penalty, the borrower can enjoy a lower rate of interest (faster equity creation) over the term of the mortgage. The sub-prime borrower could be advantaged by a similar situation and/or be able to qualify for a mortgage that may have not been available without the presence of penalties due to the lower coupon.

The Borrowers Perspective – How will affordability be affected?

To illustrate the dollar impact of a lending coupon change to the sub-prime borrower, we look at a 7% fixed coupon loan with a balance of $80,000. A 120 bp increase in coupon would increase the annual payments on the loan from $6,386 to $7,178 for a difference of $792 (a significant sum for borrowers in this economic bracket, effectively putting this loan out of reach for a segment of them).



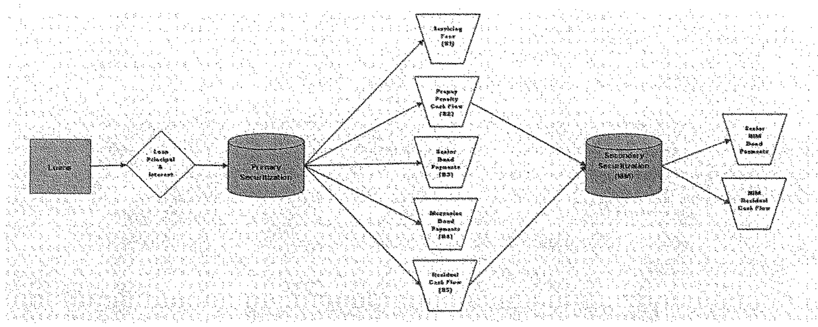
Source: Pentalpha

To look at it from another perspective, if the same borrower wanted to keep his monthly payment constant given a 120 bp rise in coupon, his loan size would have to be reduced from $80,000 to $71,250 (an over 10% decrease in the amount of money available to purchase the home).

The Investors Perspective – How will liquidity be affected?

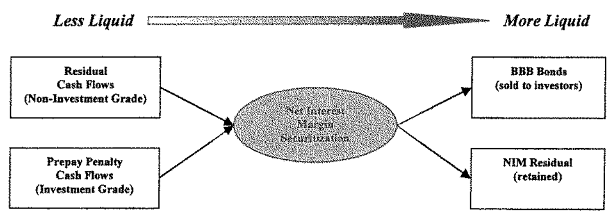
Although there are many bond transaction structures that are used in the market today, the over-collateralization structure is the most commonly used. As part of that structure, the following cash flows are created (all of the loans monthly cash flows are distributed into one of these five instruments):

1. Loan servicing cash flow
2. Prepayment penalty cash flow
3. Senior bond cash flow
4. Mezzanine bond cash flow
5. Residual cash flow



The cash flows found in #3 and #4 are commonly sold to investors in the form of bonds. The lender usually keeps cash flow #1 and applies an accounting value to that asset. An example of how the cash flows to #2 and #5 are monetized can be seen in a transaction structure called a net interest margin security ("NIM").

In a NIM securitization, an originator combines the junior residual cash flows (#5) with the senior prepayment penalty cash flows (#2) to create a new bond they can then sell to the investor community. The ability to sell these instruments to the capital markets on a combined basis creates liquidity for the lender.



It is estimated that prepayment penalties currently represent approximately 5%-15% of the projected gross cash flows in NIM transactions (depending on assumptions for prepayment rate and percent of penalties collected). The prepayment penalty cash flow is frequently considered a natural "hedge" for these transactions. If prepayment speeds were to increase (reducing cash flow to the residual), penalty income increases. Conversely, as prepayment speeds slow (increasing cash flow to the residual), penalty income decreases.

If prepayment penalties were reduced or eliminated completely, the rating agencies would likely reduce the amount of credit support and size of the senior bonds backed by NIM cash flows because of the loss of their diversification properties. Additionally, investors would also increase the yields demanded on these securities (decreasing proceeds) as the collateral would have lost this self-hedging characteristic and become inherently more risky.

The Originators Perspective - How is profitability affected?

In order to keep profitability unchanged, we estimated that the lender would need to raise loan coupons by 120 bps (our analysis is illustrated in a following section). The magnitude of this shift has been estimated by others at 100 bps[4]. It is important to note that our analysis illustrates the ***aggregate*** estimate of the move in loan coupon for an entire securitization. Individual loan coupons might have to be adjusted anywhere from 75 bps to 125 bps given the different types of penalties and credit risk that would have to be compensated for.

In order to understand the logic behind this estimated change in loan coupon, we outline here the basics of securitization economics and the steps originators take to lend profitably.

An originator will most often sell the loans it originates into the capital markets in the form of a securitization. In a securitization, the lender usually makes its money through:

1. Origination and underwriting fees associated with each loan.
2. The fee it charges to service the loans over time.
3. The collection and/or securitization of cash flow from the residual interest.
4. The collection and/or securitization of cash flow from the prepayment penalties.

[4] Chu & Kwan, Lehman Brothers "MBS&ABS Strategies" July 17, 2000.

By removing prepayment penalties as a source of cash flow, all four sources of profitability for the lender will be affected in the following ways:

Impact to issuance proceeds: Given faster prepayment speeds, securitization structures on the NIM transactions may have to be reduced in size to account for the change in cash flow characteristics. This will negatively affect the originators sale proceeds. The yield on the NIM transaction would also have to be increased as well to account for the increase in risk without the stabilizing effect of penalties. An example of the effect of faster prepayment speeds on securitization economics is illustrated in Appendix B.

Impact to residual cash flow income: Residual cash flows are often thought of as excess interest securities. Some describe residuals as paying the difference between the weighted average coupons of the collateral less the debt service on the securitization. As such, when you increase prepayment speeds (which would occur in the absence of prepayment penalties) there is less collateral to generate the excess interest and future cash flow will be reduced.

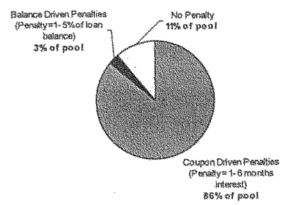
Impact to loan origination fee income: Given that many of the sub-prime borrowers will not be able to qualify/afford the higher rates necessitated by lack of penalties, there will be a smaller volume of borrowers to lend to. This results in a smaller volume of loans produced. Most lenders' profitability will likely decline as fixed expenses rise on a percentage basis.

Impact to servicing fee income: Since the servicing fee is earned on the outstanding balance of the loan, and there is empirical evidence that non-prepayment penalty loans prepay faster, the cash flow to the servicing strip will be reduced as loans exit the pool at a faster rate and fee income is decreased over time. This is problematic due to the high fixed cost of sub-prime servicing.

Impact to prepayment penalty income: The direct impact of the elimination of penalties on this source of income for the originator is obvious (it will no longer exist). The indirect impact would be seen in net interest margin re-securitizations (a source of liquidity for originators).

Originator profitability impact – an example:

In order to better understand the impact of prepayment penalties on the lender's profitability, we analyzed the economics of a recent fixed rate sub-prime transaction. The intention of this analysis was to estimate how much loan coupons would have to be increased to compensate for the absence of prepayment penalties. In this recent transaction, the size of the sub-prime fixed rate collateral was $960MM with a bond WAC[5] of 6.49%. Approximately 89% of these loans had prepayment penalties varying in term from 1 to 5 years:



In order to replicate the effect of removing prepayment penalties, two variables were stressed:

1. Prepayment projections (CPR[6]) on the collateral and;
2. The associated coupons on that collateral.

The logic being that collateral originated without penalties would be originated with a higher coupon and prepay at a faster rate.

The bonds were offered on the transaction assuming a prepayment speed of 20 HEP[7]. For purposes of this analysis, we have estimated the loss of prepayment penalty protection would increase the projected prepayment speed assumption to 30 HEP. With this faster prepayment assumption and the penalty cash flow eliminated, the coupon on the collateral was increased until the aggregate pre-loss cash flow to the servicing strip and residual was equivalent to the original scenario.

---

[5] WAC = Weighted Average Coupon
[6] CPR, (Constant Prepayment Rate) as defined by Bloomberg: CPR attempts to predict the percentage of principal that will prepay over the next 12 months based on historical principal paydowns.
[7] HEP, or (Home Equity Prepayment) Curve was developed by Prudential Securities and remains an actively used analytical tool. As Defined by Bloomberg: a prepayment measure scale with a 10 month seasoning ramp, as compared to the 30 month ramp for the PSA curve. The HEP scale ranges from 0% to 100%. A HEP value corresponds to the terminal 10th month CPR speed – having evenly stepped the preceding 9 months. For example, 20% HEP corresponds to 2% the 1st month, 4% the 2nd month, and 20% in the 10th month and thereafter. *A graphical example of 20 HEP and 30 HEP is provided as Appendix A.*

Outline of analysis:

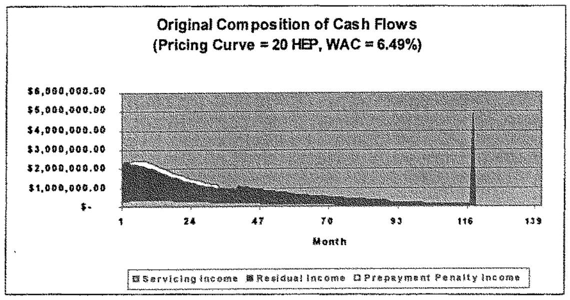
1. **Control Scenario** - The transaction was run at the securitization pricing assumptions of 20 HEP. This generated cash flows to the servicing strip, residual, and prepayment penalty class. The cash flows of the prepayment penalty and servicing classes were discounted at 8%, the residual cash flow was discounted at 18%. The net present value of the components was as follows: $15,180,397 of servicing income, $50,178,350 of residual income and $7,610,416 of prepayment penalty income. The cumulative Net Present Value (NPV) of the three cash flows was $72,969,164.

2. **Increased Prepayment Speed Scenario to Simulate Behavior of Non-Penalty Loans** - The prepayment penalty cash was removed, and the prepayment speed assumption on the associated collateral was increased to 30 HEP (from 20 HEP). The NPV of the cash flows (omitting the prepayment penalty class) in this scenario were as follows: $11,074,184 to the servicing class and $42,029,146 to the residual class. This aggregate NPV of $53,103,330 represents a loss of $72,969,164 - $53,103,330 = ($19,865,834)

3. **Increased Prepayment Speed with Lending Coupon Adjustment Scenario** – In the 30 HEP scenario, the coupon on the collateral was increased until the aggregate NPV cash flow in the adjusted scenario (#2) was equivalent to the control scenario (#1). The intention was to compensate for the loss of the penalty income (-$7,610,416), as well as the impairment to the cash flow to the residual (-$8,149,204) and servicing strip (-$4,106,214). To increase the NPV by this ($19,865,834) total, the loan coupon adjustment necessary was 115 bps. We believe there would have to be an additional 5 bps of coupon increase (estimate by Pentalpha) to compensate for the lower proceeds associated with the AAA bonds due to the likely change in assumptions used in the bidding process. This brings the total coupon increase to 120 bps.

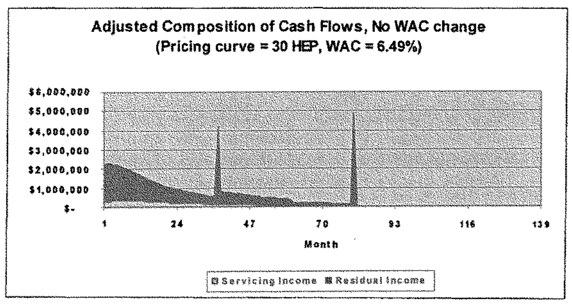
Summary Cash Flows:

Scenario #1: NPV of Cash Flows = $72,969,164



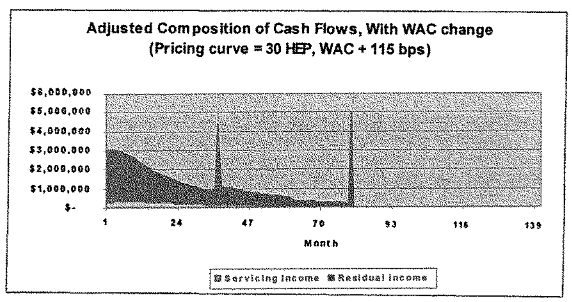
Source: Pentalpha, Wall Street Analytics

Scenario #2: NPV of Cash Flows = $53,103,330



Source: Pentalpha, Wall Street Analytics

Scenario #3: NPV of Cash Flows = $72,969,164



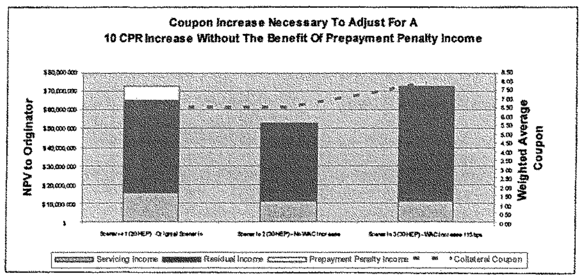
Source: Pentalpha, Wall Street Analytics

Results:

The components of the 120 bp estimated increase in loan coupon to compensate for the elimination of penalty income (given an increase in the pricing curve to 30 HEP) were as follows:

Impact of prepayment penalty income on loan coupon			
Original WAC on Mortgage Pool	6.49%		
Increase necessary to compensate for the impairment to residual class due to faster prepay speeds	0.47%	+115 bps	+120 bps
Increase necessary to compensate for the removal of prepayment penalty cash flows	0.44%		
Increase necessary to compensate for impairment to servicing strip due to faster prepay speeds	0.24%		
Approximated increase due to loss of proceeds from wider execution on investment grade bonds	0.05%	+5 bps	
Estimated WAC on Mortgage Pool after adjustment	7.69%		

Source: Pentalpha



Source: Pentalpha

The graph shows that as the prepayment speed is increased from 20 HEP in scenario 1 (penalty income) to 30 HEP in scenario 2 (without prepayment penalty income), the net present value to the residual is decreased by ($8,149,203). The net present value of the servicing strip is also reduced by ($4,106,214) in scenario 2. The net present value of the prepayment penalties ($7,610,416) is eliminated. This ($19,865,834) total ($8,149,203+$4,106,214+$7,610,416) is then recouped in scenario 3 by increasing the loan coupon by 115 bps. In scenario 3, the net present value of the cash flow in scenario 1 is equal to that in scenario 3.

Looking at the "original composition of cash flows" on page # 15, there is a large distribution in residual cash flow at month 117. This is the release of the over-collateralization in the deal to the owner of the residual class assuming no losses or delinquencies. The over-collateralization (residual) can be thought of as the first loss piece. In our scenario # 2 - "adjusted composition of cash flows" on page # 15 we can see that the increase in coupon and faster prepayment speed has triggered the release of cash to the residual in months 35 and 79 based on step-down provisions in the deal structure. This illustrates the impact that faster prepayment speeds can have on some of the trigger mechanisms imbedded in these securitizations. The "adjusted composition of cash flows" shows a shorter, more volatile cash flow stream in both the loan coupon change and no loan coupon change scenarios.

Notes to Coupon Adjustment Exercise:

1. The analysis is highly sensitive to the assumptions tied to prepayment rates, as well as the discount rates used for the servicing income, prepayment penalty income, and residual income. The assumptions used are for illustration purposes only.

2. The increase in loan coupon due to the wider bond yields expected on the AAA classes (5 bps) is an estimate by Pentalpha.

3. This is a coupon sensitivity analysis. The interest rate environment will have a significant impact on this type of analysis. In a rising rate environment the speed differential between penalty and non-penalty loans will tighten significantly.

4. The collateral used in this analysis was originated with a fixed coupon, the impact to lending coupons could be significantly different with floating rate collateral.

5. This is a pre-loss analysis. The impact of losses could alter the results.

How will the margins of the originator be effected?

From the issuers perspective - Appendix B, shows the sources and uses of cash usually found in a whole loan execution as well as a typical securitization execution. It estimates the economic impact of removing prepayment penalties assuming faster prepayment speeds without a coupon adjustment. Dollar figures for the residual class, loan servicing strip, and prepayment penalty class are taken from our previous example. The figures are expressed as a percent of par (i.e.- in a $1 billion dollar transaction $50 million is 5% of par).

The impact in this example of moving the pricing curve from 20 HEP to 30 HEP and removing penalties (without increasing coupons) is significant. The profitability on the securitization decreases by 1.98% in sale proceeds (expressed as a percent of par). This amount exceeds lender margins and creates a loss in this example.

Notes to the securitization example (Exhibit B):

1. The estimates used for whole loan prices, underwriting fees, broker fees, costs to produce the loan, prepayment speed and discount rates are all assumptions used for illustration purposes only.

2. This analysis is not intended to be an illustration of the current realized net profit margins of the issuer, actual margins in the marketplace may differ. We are attempting here to illustrate the potential economic impact of changes to these cash flows.

3. This analysis utilizes pre loss cash flows. Residual class, loan servicing and prepayment penalty classes are highly sensitive to losses and could affect the economics of the analysis.

Conclusion:

Some market participants suggest that if prepayment penalties were eliminated in their entirety, the originators would simply make less money and continue to operate less profitably. We suggest here that the loss of prepay penalties without an increase in loan coupons could upset the originators liquidity as well as the economics of the securitization process.

In practice, we would expect borrowers to be highly sensitive to the theoretical change in coupon rates presented here. It is unlikely that originators could simply raise loan coupons to adjust for this loss to their profitability without significantly effecting lending volumes. While some of the larger originators might find it possible to continue to operate at reduced margins if prepayment penalties were to be eliminated (without being able to increase coupons as dramatically as presented here), we feel many of the smaller lenders would not. Should the capital environment change for the worse (higher defaults, faster prepayment speeds, flatter yield curve) without the benefit of prepayment penalties, even the larger firms could potentially find this type of lending unprofitable.

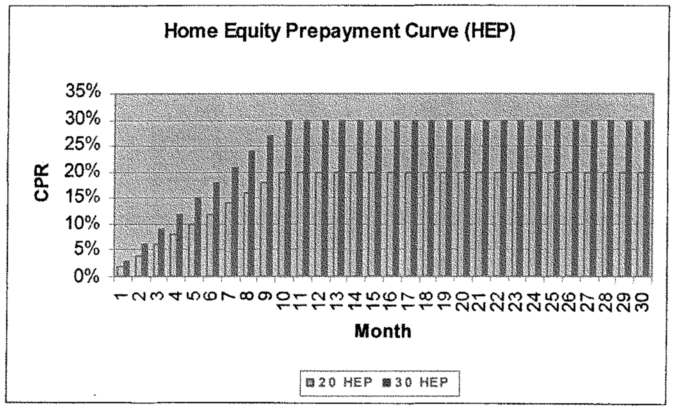
We attempt to illustrate here that there are many redeeming aspects of the prepay penalty feature that are beneficial to the borrower, originator and investor. These benefits are most commonly enjoyed as lower coupons and access to capital at the borrower level, greater liquidity at the investor level, and profitability at the originator level. Eliminating the use of prepay penalties would cause more repercussions than merely raising coupons while impairing lender liquidity and profitability. Without prepayment penalties some "challenged" borrowers could be priced out of the market and homeownership would be made unnecessarily more expensive for others. Many of the smaller lenders would experience significant financial stress given the reduced margins in the remaining volume. The decreased profitability to the sector would ultimately be paid for at the consumer level with fewer opportunities for the most distressed borrowers.

About Pentalpha Capital Group:

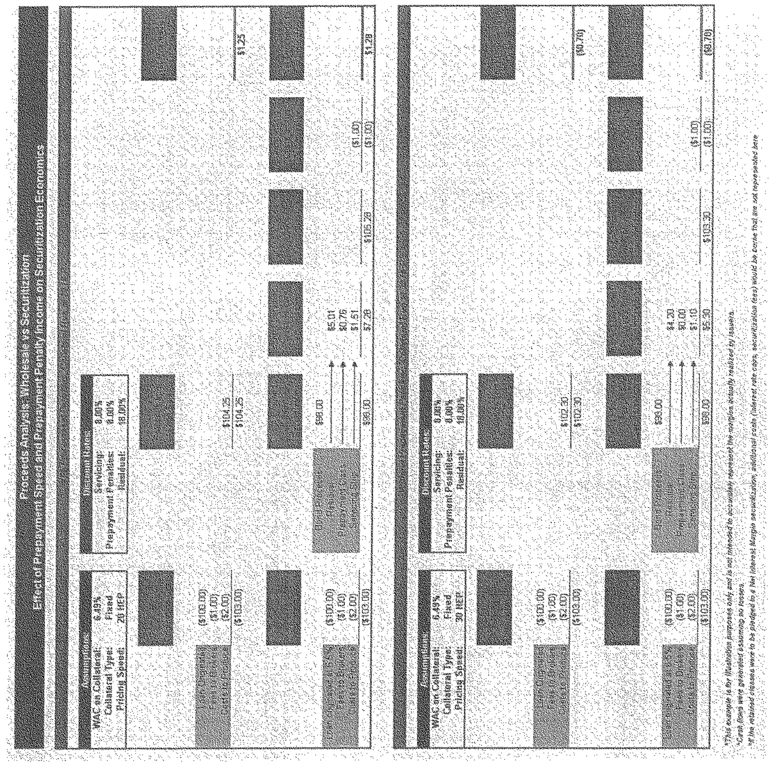
Pentalpha is an independent investment advisory and consulting firm founded in 1994. The firm specializes in complex loan and bond structures and is a consultant to leading investors, originators, servicers, and insurers of structured finance products. A more detailed description of Pentalpha can be found at www.pentalphaglobal.com.

Wall Street Analytics – an independent software development company specializing in the structured finance sector of the fixed income industry, was responsible for building the cash flow engine used in this report.

Appendix A


Home Equity Prepayment Curve (HEP)
CPR
35%
30%
25%
20%
15%
10%
5%
0%
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30
Month
20 HEP
30 HEP

Appendix B



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June 20, 2005

The Honorable Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Robert Ney
Chairman
Subcommittee on Housing and Community Opportunity
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Ney and Chairman Baucus:

This letter is to provide clarification and feedback on three questions asked by Representative Paul Kanjorski during the May 24th hearing on *"Legislative Solutions to Abusive Mortgage Lending Practices."* We request this letter be included in the hearing record.

Question 1: Should "collusion" be added to the "Appraiser Independence" standard of H.R. 1295?

Answer: Yes. Collusion occurs where two persons (or business entities through their officers or other employees) enter into a deceitful agreement, usually secret, to defraud and/or gain an unfair advantage over a third party, competitors, consumers or those with whom they are negotiating. This can include pretending to be independent of each other when actually conspiring together for their joint ends, which is a component of many mortgage fraud transactions. As evidenced by the situation in the Poconos, developers, lenders and others have colluded with appraisers to defraud and gain an unfair advantage over third parties, and this practice should be prohibited.

Question 2: What is the best way to enforce the appraiser independence standard (who should do it and how) and is there a need for effective sanctions for violations of the appraiser standard?

Answer: Section 1110 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 [12 U.S.C. 3339] authorizes each Federal financial institutions regulatory agency to prescribe appropriate rules for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of each such agency or instrumentality. With this, we read the

Appraiser Independence standard of H.R. 1295 to authorize and empower the Federal financial institution regulators to issue regulations prohibiting various inappropriate practices against real estate appraisers.

We believe the best way to enforce the appraiser independence standard is to direct the Federal financial institution regulatory agencies to promulgate such regulations. These agencies have broad responsibility over federally regulated banks, some state chartered banks and financial services institutions (mortgage brokers) working with federally regulated financial institutions. The new regulations would make clear that coercion, extortion, bribery and collusion improperly affecting the outcome or delivery of an appraisal is strictly prohibited.

Moreover, yes, there is a need for effective sanctions against prohibited behavior, such as civil penalties including fines up to ten thousand ($10,000) per violation. With specific sanctions such as these, combined with the Appraiser Independence standard broadened into a regulation—which has the force of law—unethical practices should take place less frequently.

It should be noted, however, that it may not be possible for the Appraiser Independence standard to apply to all parties involved in real estate transactions, as there are limitations to the reach of the federal government in this area. For instance, the licensure of realty agents is currently an endeavor taken on by the states without any input or influence by the federal government. Nevertheless, we believe that strong action by the federal financial institution regulators would send a very strong statement to all parties involved regarding the importance of appraiser independence.

Question 3: Should H.R. 1295 be amended to provide funding for state appraisal board activities?

Answer: Yes. Many state appraisal boards are having acute difficulties maintaining effective regulatory systems. That lack of resources creates a system that allows some unscrupulous and unqualified appraisers to continue practicing and provides little or no recourse for their actions.

The Government Accountability Office recently conducted a lengthy investigation on the appraiser regulatory structure, and one of the findings in their report was that insufficient funding of state appraisal board activities was a major hindrance to enforcement[1]. Currently, it is common for portions of state appraiser licensing fees (separate from the $25 per applicant submitted to the Appraisal Subcommittee) to go into a state's general fund, causing the state appraisal board to compete with other state discretionary programs for funding. A GAO survey of state appraisal boards reported resource limitations as the primary impediment in carrying out their oversight responsibilities. For example, of the 54 states and territories that responded to the survey, 26 (48 percent) reported that the current number of investigators was insufficient for meeting its regulatory responsibilities, 37 (69 percent) cited a need for increasing the staff directed at investigations, and 22 (41 percent) cited a need for more resources to support litigation.

[1] "Opportunities to Enhance Oversight of the Real Estate Appraisal Industry," Government Accountability Office, May, 2003.

According to this survey, the average state appraisal board has approximately three staff members who are responsible for overseeing almost 2,000 appraisers. Many of these state agencies reported that they need to share resources—administrative staff, office space, investigators, or all three—with other state agencies in order to perform their Title XI duties. The majority of states sharing resources share investigators, who often have no real estate appraisal experience. The survey results indicated that investigations of complaints about problem appraisers suffer most from these shortages. The GAO report recommended that the Appraisal Subcommittee explore potential options for funding or otherwise assisting states in carrying out their Title XI activities, particularly the investigation of complaints against appraisers. We are not currently aware of the status of this directive.

Presently, the Appraisal Subcommittee's operations are funded exclusively by individual state certified and licensed appraisers through a $25 annual fee assessed by their state, passed through to the Appraisal Subcommittee, which has resulted in a sizable reserve fund that exists with no identified purpose. The Appraisal Subcommittee told the GAO that it did not believe it had the legal authority to use these funds for grants to state appraisal boards. We see a few options available to Congress in this area, and we encourage the Committee to explore these options to help with the current state appraisal board funding crisis.

1. Granting the Appraisal Subcommittee the authority to establish and manage a grant program to state appraisal boards for the purpose of conducting enforcement activities.
2. Requiring state appraiser licensing fees to be used for state appraiser licensing and enforcement.
3. Requiring the Appraisal Subcommittee to add "funding" as one criterion it looks at when auditing a state program.

Thank you for giving us the opportunity to enhance our testimony with the information contained herein. Please contact me should you have any questions at 202-298-5583 or dkelly@appraisalinstitute.org.

Sincerely,

Donald E. Kelly
Vice President, Public Affairs

Cc: The Honorable Paul Kanjorski

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June 10, 2005

The Honorable Bob Ney
Chairman
Subcommittee on Housing and Community Opportunity
B-303 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Ney:

I appreciate your efforts to provide increased oversight to the subprime lending market through the introduction of H.R. 1295, the Responsible Lending Act. The hearing on May 24, 2005, was very productive and demonstrated the effectiveness of your legislation.

I would like to submit the following questions to the record for Mr. Martin D. Eakes from Self-Help.

In your testimony at the May 24, 2005 hearing, you indicated that you understand the subprime market since Self-Help is really a subprime lender and all of your residential mortgage loans were considered subprime loans. After hearing something about Self-Help's operations, I am interested to learn more as you may be doing things (e.g., delinquency and foreclosure management) in ways that other subprime lenders might benefit and thereby help more subprime borrowers.

On the other hand, Self-Help's lending operations might not be comparable to the major nationwide lenders that make most of the nonprime residential loans. Your website says that since 1980, Self-Help has made only 2,285 loans, totaling $136 million, directly to consumers and that although 2003 is cited as a "record" year for Self-Help's direct lending, you made only 371 loans directly to consumers, totaling $31 million. In contrast, major subprime lenders often originate over 10,000 loans, exceeding $1 billion, per month in direct subprime mortgage loans.

Please answer the following questions for the hearing record:

1. Loan Funding & Interest Rates – How does Self-Help's direct consumer mortgage program operate? What is your average loan size and what are your average charges for points, fees and other loan closing costs? What percent of your loans are first mortgages as compared to junior liens? What percent of your loans are

originated through retail versus wholesale channels? What is your source of funding for the loans that you close? Do you generally offer loans to residential borrowers using risk-based pricing at market rates generally being charged by major subprime lenders or are Self-Help's loans made at lower or higher rates? Do you include all fees and closing costs in the loan interest rate? If not, do you permit borrowers to borrow the fees and closing costs to close their loans, or do you require them to have cash at the closing? If you require them to have cash at the closing, where do they get this money typically? Do you have a lower cost of funds than many commercial subprime mortgage companies? If so, how? (e.g., by being a tax exempt credit union or because as a community development institution you have special lower capital requirements than most credit unions) Does Self-Help or other parties subsidize your direct residential loan borrowers' interest rates and/or closing costs? If so, how and how much? What were the total number, total dollar volume, and percent of your direct residential mortgage loans that were sold into the secondary market in the years 2002, 2003 and 2004?

2. Delinquencies & Foreclosures – You indicated in your testimony and in a press release that subprime loans go into foreclosure 10 times more often than prime mortgages and that one in five subprime mortgages ends in foreclosure. What documentation is there to confirm the accuracy of these figures?

   In contrast the general subprime mortgage lending industry, you noted that Self-Help has a very low foreclosure rate and your testimony states that Self-Help's *"loss rate is no more than 0.5 percent per year."* On the other hand, your reports filed with the National Credit Union Administration (NCUA) indicate that as of March 31, 2005, Self-Help had $93,391,806 in first mortgage loans on its books, $10,023,016.00 of which, or about 10.7% was delinquent. Please indicate for each of the years 2002, 2003 and 2004: (1) what was the total number of direct subprime residential mortgage loans made by Self-Help that year? (2) what number and percent of Self-Help's direct residential mortgage loans were delinquent as of 12/31 of that year? (2) What number and percent of those loans were more than 60 days delinquent? For those loans, what loss remediation efforts are made with respect to those loans before starting foreclosure? (3) What was the number and dollar volume of Self-Help's residential loans that started foreclosure? (4) What was the number and dollar volume of Self-Help residential loans that actually went through the foreclosure process with the borrowers losing their homes? What happens to the homes that you take back in foreclosure? Do you allow the borrower to redeem the house? (5) Are your delinquency rates on residential mortgages lower, about the same, or higher than other credit unions that are considered your peers? (6) Given that Self-Help has a substantial number of seriously delinquent loans, how do you manage to keep a low loss or foreclosure rate? With regard to those loans that you securitize, how are delinquencies and foreclosures treated? (7) Do you have programs or policies that involve providing financial assistance or subsidies or debt forgiveness or rewriting of the loan to help borrowers who are delinquent and/or in foreclosure cure their loan defaults? If so, please explain how this is done.

(Please focus all your answers for numbers 1 and 2 only on loans made directly to borrowers to purchase or refinance 1 to 4 family residences.)

3. Self-Help reported to the NCUA that as of December 31, 2004, you had 3 loans totaling $2,764,342 outstanding to Self-Help officials and senior executive staff. What was the purpose of these large insider loans? Why did Self-Help make such large loans to insiders instead of deploying these funds directly to families in underserved communities?
4. Mr. Eakes is it appropriate for a state-chartered, federally-insured community development credit union such as Self-Help Credit Union to commingle or coordinate its operations with a lobbying and advocacy organization like the Center for Responsible Lending (CRL)? [See http://www.self-help.org/aboutus/corporatestructure.asp] How do these entities make decisions in instances in which financial or other priorities are not aligned? Why has Self-Help used its limited assets to buy an office building at Farragut Square in Washington, DC, where CRL has offices for many of its lobbyists, instead of directing those assets to community development projects or helping economically disadvantaged consumers purchase homes in NC?

Thank you again for your leadership on this issue. I look forward to working with you and our colleagues to enact common sense regulation that protect consumers, safe-guard the marketplace, and increase competition amongst reputable financial institutions. Should you have any questions, please feel free to contact Jon Causey in my office.

Sincerely,

Patrick McHenry
Member of Congress

SELF HELP

July 1, 2005

The Honorable Patrick McHenry
House of Representatives
Washington, DC 20515

Dear Representative McHenry,

Thank you for the opportunity to further discuss how Self-Help's lending operations contribute to increasing home ownership and wealth in underserved communities, and how predatory lending threatens the gains made by the many programs like ours around the country. We view homeownership as critical in helping families to improve their economic position and believe it provides communities with a solid foundation on which to grow and prosper. Homeownership has been the primary way for families in the U.S. to build wealth and serves as a bedrock of economic security. Families use home equity to send children to college, start new businesses, or weather crises such as job loss or extended illness. At the same time, it is also essential that home lending be done responsibly, and we support efforts to prevent abusive mortgage loans that instead strip equity away from hard-working families who are trying to save for the future.

Please find attached the answers to the questions you submitted. Thank you again for the opportunity to respond and further explain our testimony.

Sincerely,

Martin Eakes
Chief Executive Officer
Self-Help and Center for Responsible Lending

QUESTION 1

- How Does Self-Help's direct consumer mortgage program operate?

Self-Help provides home loans for borrowers throughout North Carolina who cannot qualify for conventional financing. Our home lending helps homebuyers with weak credit or limited down payment funds, enabling them to build financial security and giving them a stake in their communities. We also have special programs that finance rehabilitation of older homes, which contributes both to building home ownership and improving neighborhoods that are at risk of deterioration. We have home loan officers in 7 regional offices across North Carolina (Asheville, Charlotte, Durham, Fayetteville, Greensboro, Greenville, and Wilmington), and in the last year have begun to explore making home and small business loans in Washington, D.C. Borrowers can apply for a home loan through Self-Help's offices.

Since 1980, Self-Help has made direct home loans worth $156 million to 2,493 North Carolina families. These home loans went to:

- 74% minorities
- 35% women-headed households
- 37% rural households

Here are some basic facts about our loan products:

- Average loan size in 2004: $88,513
- Average charges for points, fees, and other loan closing costs: 1% origination fee, with a minimum fee of $300. All other fees are actual cost (to Self-Help), with no junk fees.
- Proportion of first mortgages and junior liens: All loans are first mortgages, with the exception of down payment assistance/subordinate mortgages. Those loans are made in Self-Help's name, but are funded by, and subject to the conditions of, third-party funding sources.
- Percent originated through retail channels: To date, all direct home loans have been offered through retail offices and personnel. We may offer Self Help Credit Union home loans through brokers or correspondents in the future.
- Source of Funds: Deposits from our credit union members fund our loans.

- Interest Rates: Self-Help rates are typically lower than other subprime lenders and do not require private mortgage insurance.

Loan Product	Rate, as of June 21, 2005
Fannie Mae and USDA, 30 year fixed	6.0%
30 year Fixed, 80% LTV or below (Portfolio)	6.75%
30 year Fixed, above 80% LTV (Portfolio)	7.25%
97% LTV (Portfolio)	8.25%
100% LTV	9.0%

- Funding of closing costs: Fees and closing costs are not included in the interest rate. Borrowers may borrow funds for closing costs and fees. At a minimum, borrowers must invest $500 (or $1000 depending on loan product) of their own funds into the transaction. These funds must be from their own savings (not gift funds).

- Cost of Funds: Our cost of funds is based on what it costs to attract and retain member deposits. Our rates are generally near the top of the market for deposits among credit unions, banks and thrifts in North Carolina. Our members include individuals, non-profit organizations, religious institutions and other socially-responsible investors who wish to support our mission.

- Does Self-Help or other parties subsidize your direct residential loan rates and costs? For our portfolio home loan products, there is no subsidy. We do have limited participation in some government guarantee programs, such as programs offered by the U.S. Department of Agriculture, that generate a subsidized rate on a relatively small percentage of our mortgages. Self Help Credit Union also participates in the bond financing program of the North Carolina Housing Finance Agency.

- Total number, dollar volume, percent of direct loans sold into the secondary market in 2002, 2003, 2004:

  - 2004: $16,561,127 (approx. 16% of total direct loans)
    2003: $17,106,966 (approx. 25% of total direct loans)
    2002: $0

QUESTION 2

In our testimony, we highlighted that abusive subprime loans often push homeowners further into financial distress, with many subprime loans eventually ending in foreclosure. Further, because subprime loans, especially those with abusive terms, go disproportionately to minority and rural families, related foreclosures are also likely to disproportionately affect such families. For this reason, it is essential that any legislative response to predatory lending specifically address loan terms on subprime loans, such as abusive prepayment penalties and other excessive fees, that are known to put families at risk of foreclosure.

The source for the foreclosure statistics mentioned in our testimony is a recent report by the University of North Carolina Center for Community Capitalism at the Kenan-Flagler Business School. The report is available at http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf. See p. 3 for the fact that subprime loans go into foreclosure more than 10 times more often than prime mortgages and p. 21 for the fact that one in five subprime mortgages end up in foreclosure. In addition, other sources support UNC's calculations, or suggest the figure could be higher:

- Subprime foreclosure rate is 23.7 times that of prime. Subprime serious delinquency rates (90day+ and foreclosure) are 19.0 times that of prime. Table 1, p.30 (http://www.freddiemac.com/news/pdf/subprime_012704.pdf)
- "The estimated conditional monthly default and prepayment rate for nonprime loans in the 28th month of the loan is approximately 8.2 and 1.3 times higher than prime loans." (p13) (http://www.ofheo.gov/media/archive/docs/working/02-1cross.pdf)

In addition to recent studies linking subprime lending and more specifically, abusive loan terms, to foreclosure, Self-Help's own experience with delinquencies and foreclosures also suggests that the high rate of foreclosure in the subprime market cannot be explained solely by the slightly higher risk of lending to borrowers with blemished credit. It has been our experience that while borrowers may fall behind temporarily on mortgage payments, they will make every effort to catch up and hold on to their home. For this reason, while our loans have had somewhat higher delinquency rates than the prime market, we have had extremely few loans end up in foreclosure. Our experience stands in contrast to that of many lenders in the subprime market.

- Total direct subprime mortgage loans made by Self-Help (2002-2004):
  Originations by year:
  2002= 205
  2003= 365
  2004= 422

(These numbers do not include government or conventional loans (a handful of our total loans).

- Number and percent of direct residential mortgage loans delinquent as of 12/31:

  Total Delinquency by year: 30+
  2002= 20.7%
  2003= 17.5%

2004= 10.8%

- Number and percent that were more than 60 days delinquent:

  60 Day Delinquency by year:
  2002= 11.5%
  2003= 8.6%%
  2004= 5.8%

- Loss and remediation efforts made before foreclosure:

Self-Help contracts with a local bank to service its direct home loans. This servicer is responsible for contacting borrowers when the loans go delinquent. The servicer makes the industry standard collection calls, sends letters and attempts via telephone to establish repayment plans. Self-Help also offers a default counseling program. At the 45th day of delinquency, the borrower is referred to a counseling agency for budgeting and debt management assistance. Self-Help has a policy that prohibits the servicer from referring the loan to a foreclosure attorney without Self-Help approval.

After the servicer has exhausted collection efforts and workout options, the loan is referred to Self-Help's internal loss mitigation staff. Although the servicer has sent letters and made calls to the borrower, Self-Help staff also makes attempts to reach the borrower and offer alternatives to foreclosure.

If the borrower does not respond with interest or ability to save the home, Self-Help approves the loan for foreclosure. If the borrower responds and wants help to retain the home and has the financial ability, Self-Help reviews the loan for repayment plan or loan modification. The servicer foreclosure referral recommendation is not approved if Self-Help can work out an alternative to the sale. From August 2002 through December 2004, Self-Help loss mitigation staff reviewed a total of 91 loans and 90% of the borrowers retained their homes and 3% avoided foreclosure by either a deed in lieu or short sale.

- Foreclosure Sales approved by year:

2002= 6 loans with a UPB of $445,025.17
2003= 12 loans with a UPB of $622,018.88 *
2004= 13 loans with a UPB of $828,085.25 **

* In 2003, 5 loans with a UPB of $239,988.71 were taken out of foreclosure and approved for home retention alternatives

**In 2004, 3 loans with a UPB of $173,909.11 were taken out of foreclosure and approved for home retention alternatives

- Number and dollar volume of Self-Help residential loans that actually went through the foreclosure process:

Foreclosure Sales Completed by year:
2002= 4 loans with a UPB of $312,309.31
2003= 4 loans with a UPB of $211,347.46
2004= 7 loans with a UPB of $477,796.22

- Process after home is taken in foreclosure:

As with any regulated lender, in a completed foreclosure, Self Help Credit Union takes possession of the borrower's home. The condition of the property is assessed and repairs are made to bring the properties back to acceptable standards to be resold. As a part of our mission, Self-Help's strategy is to repair the properties and sell to new owner-occupants as the first option.

- Redemption process:

In North Carolina the borrower has 10 days after the sale to redeem the property by either paying off the debt or filing bankruptcy. Self-Help complies with this state statue and does not consider the sale final until the 10-day upset bid period has expired.

- Comparison of delinquency rates to peers: We are not aware of any credit union our size that has a mission of serving low-wealth, credit-impaired consumers. Thus, no other credit union of a comparable size has a loan portfolio made up exclusively of home loans to credit-impaired borrowers. Self-Help's net charge-off ratio has averaged 0.34% over the past three years, compared to a peer average for all credit unions over $100 million, of 0.60%.

- How do you manage to keep a low loss or foreclosure rate? With respect to securitized loans, how are delinquencies and foreclosures treated?

We manage the foreclosure rates with the implementation of our counseling program and with the efficient efforts of our servicer and internal loss mitigation staff (statistical data found in response to question number 4). We believe that offering home loans without prepayment penalties that trap borrowers and with the lowest upfront fees of any subprime lender (that we are aware of) is a major reason for Self Help Credit Union's low foreclosures and losses.

- Do you have programs or policies that involve financial assistance to help borrowers who are delinquent or in foreclosure?

Self-Help offers repayment plans, forbearance plans and loan modifications to assist borrowers in avoiding foreclosure. The modification of the loan may involve maturity extension or interest rate reduction to assist the borrower with a more affordable payment.

QUESTION 3

The Self-Help Credit Union call report for December 31, 2004 included a filing error that has since been corrected. In accord with its conflict of interest policy, there are and were no SHCU loans to directors or senior executive staff. A corrected call report for December 31, 2004, as well as our recently filed March 31, 2005 call report, is enclosed for your information.

QUESTION 4

The mission of Self-Help is creating ownership and economic opportunity for minorities, women, rural residents and low-wealth families. Self-Help's work is based on the belief that ownership allows people to improve their economic position, while a lack of assets limits choice and opportunity. For this reason, we have focused on providing credit to communities that have historically been ignored by traditional financial institutions, helping families to buy a home or start a small business, and lending to organizations that serve local community needs.

Both the Self-Help Credit Union (SHCU) and the Center for Responsible Lending (CRL) help to support our overall mission of building wealth and opportunity. After we saw that predatory lending threatened to drain wealth from minority and low-income communities faster than we could help create it, it became clear that a policy and advocacy organization was critical to supporting our organization's mission. The financial priorities of the Credit Union support our mission, and we see the goals and priorities of both organizations as well aligned. Further, we believe our experience as a lender informs our ability to formulate workable policy solutions that help to both preserve access to credit and ensure that credit is offered to borrowers on fair terms.

CRL first began working on predatory lending issues as part of a broad coalition of organizations that included many financial institutions. In response to mortgage lending abuses in North Carolina, the coalition and policymakers worked together to enact anti-predatory lending legislation. N.C Senate Bill 1149 was passed by the North Carolina General Assembly with a nearly unanimous vote in 1999 and was endorsed by the North Carolina Bankers Association, the North Carolina Credit Union Network, the North Carolina Mortgage Bankers Association, the NC Association of Financial Institutions, the NC Association of Mortgage Brokers, as well as a coalition of housing, civil rights, and other organizations representing over 3 million North Carolinians. CRL estimates show that the new law saved consumers at least $100 million per year by preventing predatory loan terms that would have been expected to occur in the law's absence.

One of the key components of Self-Help's success since 1980 has been its commitment to the regions and communities around North Carolina. Part of that commitment is to have a physical presence in each region-- we have recently met our goal of purchasing and/or renovating a downtown property in each city where we have a regional branch office. These office buildings give Self-Help visibility, and bring together nonprofit organizations that would otherwise not work as well together.

Purchasing a building in Washington, D.C. enabled Self-Help to accomplish two goals. First, as in North Carolina, the building permitted us to bring together organizations that complement Self-Help's economic development mission, specifically in this case, organizations working to develop public charter schools. Second, purchasing the building was a good investment, enabling Self-Help to cap its long-term office occupancy costs in a city whose rents are escalating dramatically. Purchase of the building has not displaced any of Self-Help's lending activity in North Carolina.

OPTION ONE MORTGAGE Start Here. Finish Here. H&R BLOCK mortgage

FAIR LENDING PRACTICES

When we began our business in 1992, we started by creating a strong foundation. Even before developing a business plan, we established a set of values that we live each day. Our associates and our customers test everything we do against these values:

Do what is ethical, fair and makes good business sense.
Do our best.
Treat others as we want to be treated.

As residential mortgage lenders, we focus on helping our borrowers achieve the dream of homeownership or other important dreams, such as paying down high-interest credit-card debt, sending their children to college or remodeling their homes to increase their value for current enjoyment or future sale. We believe in homeownership as an important step in building wealth and improving the lifestyles of families throughout our nation.

Our commitment is to make our loans available to diverse communities and customers on an equal opportunity basis. We lend without regard to race, color, religion, national origin or ancestry, gender, marital status, handicap status, familial status, age (as long as the applicant is able to enter into a binding contract), receipt of public assistance, property location or the exercise of rights under the Consumer Credit Protection Act.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive lending practices, which harm not only consumers but also affect the reputations of all mortgage bankers. As responsible lenders, we comply fully with all mortgage-lending laws. These include the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act and the Equal Credit Opportunity Act.

When we created our Best Practices in Origination, we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time for mortgage products and services.

Serving You Right From The Start

At Option One and H&R Block Mortgage, our belief is that making good loans – loans that offer clear benefits -- to informed borrowers is the right thing to do.

Understanding How the Mortgage Process Works
We want you to be comfortable with the home-loan process and knowledgeable about your options so we start by providing educational information on various loan options before you even choose a loan. When you apply for a loan with us – whether through a mortgage broker or one of our loan officers -- you receive a brochure that explains the

lending process, definitions of key terms and information on contacting HUD-approved credit counseling agencies.

We are committed to financial literacy and support organizations such as:

- *BorrowSmart* (www.borrowsmart.org), a nonprofit educational foundation that specializes in helping consumers understand what to consider when refinancing a home loan.
- *JumpStart* (www.jumpstart.org), a nonprofit foundation that focuses on ways to increase the financial knowledge of young people.
- *Don't Borrow Trouble* (www.dontborrowtrouble.com), a program that is dedicated to increasing consumers' financial literacy, especially in understanding the risks, rights and responsibilities involved in taking out a home equity loan.
- *Junior Achievement (*www.ja.org*)*, a nonprofit organization dedicated to educating young people about business, economics and free enterprise. Option One associates support Junior Achievement's programs for young people in the classroom.

In addition to our materials, we recommend you consult these sources for information.

Making Sure Loan Requirements Are Met

Based on the information you have provided on your application, we work hard to see that you are able to repay your loan and that the terms of the loan are appropriate for your particular situation.

This includes:

- Offering products that meet diverse credit profiles and incomes.
- Determining that you are able to repay the loan by:
  - Verifying sources of fixed income.
  - Verifying disposable income in cases where debt payment already exceeds 45 percent of the income you have disclosed on your application or you make less than $2,500 a month.
- Only accepting appraisals performed by a licensed professional and completed in accordance with the Uniform Standards of Professional Appraisal Practice. We trust the appraisal professional's local market knowledge and ability to place an appropriate value on the home. We never ask an appraiser to submit a report with a home value that we've pre-determined. When submitted, all appraisals are reviewed by Option One's trained underwriters and, at times, by licensed review appraisers.

Providing You With Options

Refinance Options That Benefit You

Refinancing may seem like a good deal, but there are many factors involved in determining if it is right for you. Using the information you have provided, Option One works hard to determine whether a refinance loan will benefit you. Factors considered in determining customer benefit include:

- Interest rates on the current and new loan.
- Amount of cash you would receive on the new loan.
- Points and fees on the new loan.
- Any prepayment charges that might apply on the current loan.
- Loan term comparison of current and new loan.
- Terms of any special loans or second mortgages that exist.

- Whether costs on a new loan could be recouped within 48 months.
- Whether it has been more than 24 months since the last refinance.
- Relieving a financial hardship.

In addition, we have a benefits review committee that looks at a sample of loans after funding. If a loan is brought to the committee's attention that did not clearly benefit the customer, the committee will take corrective action, which may include:

- Refunding points and fees.
- Creating more favorable loan terms at no cost to the borrower.
- Retraining or disciplining associates involved.

Prepayment Charge Options

Borrowers can choose a loan with or without a charge for repaying the loan early. Some borrowers may prefer to benefit from a lower annual percentage rate (APR) in exchange for choosing a loan with a prepayment charge. For example, some borrowers who plan to stay in their home for the length of the prepayment period could find the lower APR very beneficial. For other borrowers, a loan without a prepayment charge might be the best option for their situation. The choice is yours, and we explain this to you in a brochure you receive when you apply for a loan. Most of our loans that have prepayment options expire after two years and none are longer than three years.

Clear Loan Disclosures

Because we want borrowers to understand the terms of their loans, we have a strong disclosure process. After you submit a loan application, you can expect to receive our disclosures within three days even if you've already received disclosures from a mortgage broker. When you apply for a loan, you'll receive a brochure that explains the lending process. When your loan closes, we also provide you with an easy-to-understand summary of the terms of the loan.

Option One also has an early re-disclosure process. As soon as we learn of any change in your loan terms, including points and fees, we will notify you promptly. To eliminate surprises, if key changes are found within 48 hours of closing, we will give you the option to reschedule the closing so you have enough time to review and fully understand the changes.

Protections for You

Protecting You Against Fraud

Because we have zero tolerance for fraud, we also have a process to help customers who may, in rare instances, be defrauded by parties not affiliated with Option One. To identify and address these unfortunate situations we:

- Train certain associates to recognize evidence of possible fraud.
- Maintain a dedicated fraud unit at our headquarters to investigate and respond effectively to activities by unfair or fraudulent parties.

We are also a financial supporter of Stop Mortgage Fraud, www.stopmortgagefraud.com, a Mortgage Bankers Association-sponsored effort to combat fraud in our business.

Your Identity

Option One has an identity-theft hotline for current customers, which is staffed by trained associates who can provide information on how to report identity theft to local law enforcement agencies and credit bureaus. You can reach our hotline at 800.704.0800, ext. 30080.

Your Personal Information Is Kept Private
We do not sell your personal information. We use it only to conduct the business we have with you and we have strong internal controls to protect your personal information.

High-Cost Loans Are Not a Part of Our Product Line
Option One and H&R Block Mortgage do not offer loans defined as 'high cost' by federal, state or local laws.

Loans That Are a Benefit to You
There are some loans we don't think are usually in our customers' best interests, so we do not offer them. These include:

- Loans based purely on the equity in the property.
- Stated-income loans or loans that do not require income documentation if you are on a fixed income, such as Social Security or a pension.
- Negative amortization loans, which are loans where the principal amount of the loan does not decrease as payments are made.
- Loans with increasing interest rates in the event payments are missed.
- Loans that contain single-premium credit life or disability insurance, or any other types of credit or disability insurance when your loan is made.
- Loans that deduct initial principal and interest payments at closing.

Practices That Benefit You
We keep our customers' best interests in mind.

- We never disburse funds directly to home-improvement contractors. You choose your contractor, and you conduct all business dealings directly with them.
- To make certain there is no personal financial benefit for someone to charge you a higher rate, we:
  - Do not pay yield-spread premiums to brokers, which means the broker does not receive a financial incentive to charge a higher interest rate than our published rate.
  - Do not pay overages to our loan officers, which means the loan officer does not receive a financial incentive to charge a higher interest rate than our published rate.
- If we service your loan, we do not solicit you to refinance unless you ask. If you request information on refinance options, we have a team of associates who can help.
- We do not offer mandatory arbitration.

Behind the Scenes at Option One

Code of Business Ethics and Conduct
All associates annually re-commit themselves to the company's Code of Business Ethics and Conduct. By signing the code, associates promise to conduct business in accordance with the law, protect customers' privacy, and treat customers, other associates and business partners with fairness, respect and dignity.

Training
All associates involved in the lending process get training, including learning about fair lending practices and determining how a loan benefits the borrower.

Quality Control and Audits Are a Regular Part of Running our Business
There are a lot of things you'll never see or experience that are happening behind the scenes at Option One to help us serve you better, including:

- Our Compliance Department regularly reviews business processes and procedures for compliance with state and federal laws and regulations.
- Our Internal Audit Department regularly audits business processes and procedures and reports the results to Option One's management team.
- Our customer service and collections phone services are monitored to see that customer calls are handled professionally and accurately.
- Our due-diligence team audits a random sample of loans to make sure they are problem free.
- If a problem is suspected, another team takes over, checking for evidence of fraud.
- We have quality control measures in place to monitor and promote the best practices we've established to serve you well.

Working with our Brokers and Lenders to Serve You

Option One originates loans through a national network of brokers and lenders. To provide the highest quality experience for you, we've established the following practices:

Deleted: best practices

Deleted: for the professionals who work with us

Licensing Audits
A broker who wants to become an approved broker with Option One must apply to the company, providing information about his or her brokerage. We also verify that the mortgage broker has a current state license – and we check that license at renewal time, typically once a year. We also require that brokers comply with all federal, state and local laws.

A Commitment to Continuous Learning
We strive to give our brokers educational materials and experiences that will help them serve you better.

Established in 2002, Option One University provides our brokers and lenders with topical information on a variety of subjects, from responsible non-discriminatory lending practices to the appraisal process. These classes help mortgage professionals serve the borrowing public even better.

We also help keep our brokers current through a variety of other tools, including a quarterly publication specifically designed for them. And we have developed a Web site to keep them informed about legislation that impacts borrowers, including laws that could limit the ability of consumers to get credit when they need it.

We Require Factual Information
To become a broker with Option One, brokers must sign a broker agreement. That agreement specifies that all customer information submitted to us must be accurate and complete to the best of broker's knowledge.

We Hold Brokers Responsible

Option One has zero tolerance for fraud. We move quickly to terminate our relationship with brokers who have committed fraud and report them to the state licensing-agency and/or to federal, state or local law enforcement agencies.

We Welcome Change

Our goal is to get better and better at what we do. We make a practice of evaluating our best practices on an ongoing basis so that we are always doing things better, finding solutions to your needs and working harder to serve you.

May 13, 2005

The Honorable Michael Oxley
Chairman
House Financial Services Committee

The Honorable Barney Frank
Ranking Member
House Financial Services Committee

Dear Chairman Oxley and Ranking Member Frank:

We, the undersigned organizations, are writing to express our opposition to the so-called Responsible Lending Act bill (H.R.1295) recently introduced by Representatives Ney and Kanjorski. If enacted, the bill would devastate current legal restrictions and likely would lead to an *increase* in predatory lending. In addition to preempting state laws of any kind protecting homeowners, H.R. 1295 would dismantle current prohibitions against predatory lending in the federal law as well as key avenues of consumer redress.

Under the guise of covering more loans under the Home Ownership and Equity Protection Act (HOEPA), H.R.1295 would actually *expand* the number of predatory loans made in this nation. The bill would:

Encourage Predatory Loan Terms. The bill would *reduce* loan protections by

- expanding the amount in prepayment penalties that can be charged to homeowners in many states;
- encouraging more unaffordable loans by reducing income verification requirements;
- increasing equity stripping by allowing the sale of single-premium credit insurance; and
- eliminating state anti-predatory lending laws and potentially all other state protections on home loans.

Increase Incentives for Lending Discrimination. Lending discrimination thrives when a lender can mask fees. This bill potentially preempts state laws that limit the ability of lenders to pay kickbacks to brokers for arranging overpriced loans.

Fuel Wall Street's Support for Predatory Lending. Enforcement of any HOEPA protections would evaporate due to a huge loophole in the bill.

- Purchasers of loans would have no incentive to police their loan purchases. Instead, investors could fund and profit from predatory lending without facing liability. In fact, the bill could even be read to provide super-protection from state law claims like fraud, for which these purchasers are unquestionably liable under current law.

Create an Escape Hatch From Liability. The bill's comprehensive right to cure for creditors and assignees would remove any incentive to comply with remaining restrictions in the law. Violations of law would simply be a cost of doing business.

- In the relatively rare instance in which the consumer could prove a violation of the law, compliance with the law *at that time,* plus payment of a small penalty, would suffice to "cure" the illegal action. Creditors who regularly flaunt the law would only have to comply with the law in the rare instances they were actually caught.

- The right to cure also would render hollow a consumer's only remaining remedy. Rescission—the most powerful and effective remedy for consumers and the greatest incentive for lenders to obey the law—would be substantially weakened.

As you know, predatory mortgage lending continues to be an exploding problem in many communities across America. Hundreds of thousands of homeowners have not only lost their homes to foreclosures, but also have lost their primary source of savings—their home equity—to overreaching and unethical mortgage lenders.

The broad array of organizations listed below speaks in a unified voice in opposing this bill. It would unquestionably exacerbate the predatory lending problems facing our nation and our communities. H.R. 1295 would *reduce* the existing federal protections provided in HOEPA and the Truth in Lending Act (TILA.) Moreover, it would also wipe out the state anti-predatory lending laws that currently protect homeowners and would block the enactment of similar laws in the future.

Sincerely,

ACORN
American Federation of State, County and Municipal Employees (AFSCME)
Bronx Council on the Arts
Center For Community Change
Center for Responsible Lending
Communication Workers of America (CWA)
Consumer Action
Consumer Federation of America
Consumers Union
Gamaliel Foundation
Leadership Conference on Civil Rights
National Association for the Advancement of Colored People (NAACP)
National Association of Consumer Advocates
National Consumer Law Center
National Council of La Raza

National Fair Housing Alliance
National People's Action
NCB Development Corporation
Poverty and Race Research Action Council
Service Employees International Union, AFL-CIO, CLC
USAction
US PIRG

NATIONAL
COMMUNITY
REINVESTMENT
COALITION
NCRC

April 5, 2005

The Honorable Michael Oxley, Chairman
House Committee on Financial Services
Washington, DC 20510

The Honorable Barney Frank, Ranking Member
House Committee on Financial Services
Washington, DC 20510

Dear Chairman Oxley and Ranking Member Frank:

The National Community Reinvestment Coalition (NCRC) is comprised of 600 local and national non-profit community organizations from across the country. We are writing to express opposition to the Responsible Lending Act, HR 1295, introduced by Representatives Ney and Kanjorski. The bill as introduced does not effectively address the abusive practices of predatory lenders. The loopholes and "safe harbors" woven throughout the bill provide protections to predatory lenders instead of the vulnerable consumers who have fallen victim to these unscrupulous practices. NCRC has highlighted some of the weaknesses of the bill that will enable abusive lending to persist.

- ***Pre-payment Penalties.*** Ney Kanjorski would prohibit prepayment penalties on loans after three years, *but* many if not most subprime loans have prepayment penalties occurring in the time period between two and three years.

- ***Flipping.*** Ney-Kanjorski applies protections against flipping or repeated financing of a high cost loan *but* then includes a series of safe harbors or exemptions that can allow for abusive refinancings. For example, a refinance loan that is paid off five years earlier than the original loan would qualify for the safe harbor despite the possibility that the new loan can have a high amount of fees.

- ***Steering.*** Ney Kanjorski contains a provision that would appear to outlaw steering or making a high cost loan to a borrower who can qualify for a prime loan. *But* Ney Kanjorski then has a huge loophole that allows a lender to make a high cost loan to a borrower creditworthy for a prime loan if the borrower "voluntarily" agreed to the high cost loan.

- ***Mandatory Arbitration.*** Ney-Kanjorski prohibits mandatory arbitration clauses in high cost loans, *but* then allows arbitration if the consumer "voluntarily" agrees to arbitration.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Therefore, it is our collective position as the nations leading coalition working for responsible lending practices that HR 1295 falls seriously short in it's stated promise to both consumers and industry alike. We respectfully request that you consider meaningful national anti predatory lending legislation in dialogue with our members that facilitates strong Federal law and concurrent enforcement of State consumer protection laws. HR 1295 will neither eliminate the incentives that encourage abusive lending practices nor promote a healthy business environment that fosters equal access to credit and responsible lending. Therefore NCRC endorses HR 1182, introduced by Representatives Miller, Watt and Frank.

Sincerely,

Jesuit Conference USA
American Community Partnerships
Alabama Micro Enterprise Network, Birmingham AL
Community Action Partnership of North Alabama, Decatur AL
Chicanos Por La Causa, Phoenix AZ
PPEP Microbusiness and Housing Development Corporation Inc., Tucson AZ
Nehemiah Corporation of America, Sacramento CA
California Reinvestment Coalition, San Francisco CA
Norwalk Fair Housing Council, Norwalk CT
Housing Assistance Council, Washington DC
Delaware Community Reinvestment Action Council, Wilmington DE
Latino Leadership Inc., Orlando FL
Florida Latino Community Reinvestment Coaltion, Orlando FL
Community Enterprises Investment Inc., Pensacola FL
St Johns Housing Partnership, St. Augustine FL
John Lewis Community Services, Davenport IA
United Neighbors Inc, Davenport IA
Scott County Housing Council, Davenport IA
Illinois Facilities Fund, Chicago IL
Local Economic & Employment Development Council, Chicago IL
Woodstock Institute, Chicago IL
Northwest Indiana Community Reinvestment Alliance, Hammond IN
Housing and Credit Counseling Inc, Topeka KA
Lawyers' Committee for Civil Rights Under Law of the Boston Bar Association, Boston MA
Massachusetts Association of Community Development Corporations, Boston MA
Massachusetts Affordable Housing Alliance, Dorchester MA
Institute for Community Economics Inc, Springfield MA
Urban Edge, Roxbury MA
Coastal Enterprises, Inc., Wiscasset ME
Michigan Community Reinvestment, Detroit MI
Beyond Housing/Neighborhood Housing Services, St. Louis MO
Metropolitan St. Louis Equal Housing Opportunity Council, St. Louis MO
Housing Education & Economic Development, Jackson MS
North Carolina Fair Housing Center, Durham, NC
Community Reinvestment Association of North Carolina, Henderson NC
New Jersey Citizen Action, Newark NJ
Project Change Fair Lending Center, Albuquerque NM
Rural Housing Inc., Albuquerque NM

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

The 2004 Fair Lending Disparities: Stubborn and Persistent

April 2005
National Community Reinvestment Coalition
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Washington, DC 20005
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The National Community Reinvestment Coalition

The National Community Reinvestment Coalition (NCRC) is the nation's trade association for economic justice whose members consist of local community based organizations. Since its inception in 1990, NCRC has spearheaded the economic justice movement. NCRC's mission is to build wealth in traditionally underserved communities and bring low- and moderate-income populations across the country into the financial mainstream. NCRC members have constituents in every state in America, in both rural and urban areas.

The Board of Directors would like to express their appreciation to the NCRC professional staff who contributed to this publication and serve as a resource to all of us in the public and private sector who are committed to responsible lending. For more information, please contact:

John Taylor, President and CEO
David Berenbaum, Executive Vice President - Program
Joshua Silver, Vice President, Policy and Research
Noelle Melton, Research & Policy Analyst

We would also like to thank our contractor, the KRA Corporation, for their timely and tireless work on this project.

Abstract

NCRC's survey of 15 large lending institutions includes a substantial share of the total lending market for 2004, perhaps up to one fourth of the loans reported by institutions in HMDA (Home Mortgage Disclosure Act) data. The previous HMDA data for 2003 revealed that lending institutions issued 2 million conventional subprime loans and 17 million prime loans. Our sample using the 2004 data includes 4.6 million prime and 649,000 subprime conventional loans.

Minorities, women, and low- and moderate-income borrowers across the United States of America receive a disproportionate amount of high cost loans. Across the country, African-Americans received 18 percent of the conventional subprime loans but only 6 percent of the conventional prime loans during 2004. In contrast, whites received a greater percentage of prime than subprime loans. Whites received 55.3 percent and 66.4 of the subprime and prime loans, respectively. Disparities are also present by gender. Females received 36.8 percent of the subprime conventional loans but just 28 percent of the prime conventional loans in NCRC's sample of 2004 loans. Males, in contrast, received a higher percentage of prime loans (67.5 percent) than subprime loans (59.8 percent).

Of all the conventional loans made to low- and moderate-income and middle-income borrowers, between 18 to 21 percent were subprime. In contrast, of all the conventional loans made to upper-income borrowers, just 9.6 percent were subprime. The disparities by income level were among the greatest disparities only to be surpassed by the African-American/white disparity. Of all the conventional loans made to African-Americans, 29.4 percent were subprime. In contrast, of all the conventional loans issued to whites, only 10.4 percent were subprime. Hispanics and Native Americans also received a disproportionate amount of subprime loans. About 15 percent and 13.6 percent of the conventional loans made to Hispanics and Native Americans, respectively, were subprime loans.

Similar disparities were found when analyzing refinance, home purchase, and home improvement lending separately. Large disparities were also found in manufactured housing and subordinate lien loans. For example, of all the manufactured housing loans made to African-Americans, a high 52.6 percent were subprime. Manufactured housing lending is disproportionately high cost lending; even 32.7 percent of manufactured housing loans received by whites in NCRC's 2004 sample were subprime.

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The 2004 Fair Lending Disparities: Stubborn and Persistent

Executive Summary

The new fair lending disparities look remarkably like the old. Minorities, women, and low- and moderate-income borrowers across the United States of America receive a disproportionate amount of high cost loans. For the first time, the new Home Mortgage Disclosure Act data (HMDA) for the year 2004 contains information on pricing for high cost loans. In previous years, the general public had to rely on a list of subprime lenders from the Department of Housing and Urban Development (HUD) in order to determine patterns of high cost lending. This year, the data has more precision. Yet, the fact remains that fair lending disparities by race, gender, and income remain stubborn and persistent.

Prime loans are loans made at prevailing interest rates to borrowers with good credit histories. Subprime loans, in contrast, are loans with rates higher than prevailing rates made to borrowers with credit blemishes. The higher rates compensate lenders for the added risks of lending to borrowers with credit blemishes. While responsible subprime lending serves credit needs, public policy concerns arise when certain groups in the population receive a disproportionate amount of subprime loans. When subprime lending crowds out prime lending in traditionally underserved communities, price discrimination and other predatory and deceptive practices become more likely as residents face fewer product choices. In this report, we consider subprime loans as those with price information reported since the federal government estimates that the loans with price information are the vast majority of subprime loans.[1]

NCRC's survey of 15 large lending institutions for 2004 includes a substantial share of the total lending market, perhaps up to one fourth of the loans reported by institutions in HMDA data. The 2003 HMDA data revealed that lending institutions issued 2 million conventional subprime loans and 17 million prime loans. Our sample, using the 2004 data, includes 4.6 million prime and 649,000 subprime conventional loans. The distribution of prime and subprime lending is also remarkably similar over the two years. In 2003, about 10.7 percent of conventional single family loans were subprime. Our sample shows that 12.2 percent of the loans reported price information or were considered subprime for 2004. Based on a few key comparisons, NCRC believes that HUD's list of subprime lenders did a good job describing overall patterns of the subprime market and that analyses of previous years' data using HUD's list will find patterns consistent with the new 2004 HMDA data.[2]

Across the country, African-Americans received 18 percent of the conventional subprime loans but only 6 percent of the conventional prime loans during 2004. In contrast, whites

[1] Agencies Announce Answers to Frequently Asked Questions About the New HMDA Data, March 31, 2005, NR 2005-37, see http://www.occ.gov

[2] HUD refines its lists on an annual basis. HUD's web page (http://www.huduser.org/datasets/manu.html) has more information about the lists and has copies of the lists.

received a greater percentage of prime than subprime loans. Whites received 55.3 percent and 66.4 of the subprime and prime loans, respectively. Disparities are also present by gender. Females received 36.8 percent of the subprime conventional loans but just 28 percent of the prime conventional loans in NCRC's sample of 2004 loans. Males, in contrast, received a higher percentage of prime loans (67.5 percent) than subprime loans (59.8 percent).

Of all the conventional loans made to low- and moderate-income and middle-income borrowers, between 18 to 21 percent were subprime. In contrast, of all the conventional loans made to upper-income borrowers, just 9.6 percent were subprime. The disparities by income level were among the greatest disparities only to be surpassed by the African-American/white disparity. Of all the conventional loans made to African-Americans, 29.4 percent were subprime. In contrast, of all the conventional loans issued to whites, only 10.4 percent were subprime. Hispanics and Native Americans also received a disproportionate amount of subprime loans. About 15 percent and 13.6 percent of the conventional loans made to Hispanics and Native Americans, respectively, were subprime loans.

Similar disparities were found when analyzing refinance, home purchase, and home improvement lending separately. Large disparities were also found in manufactured housing and subordinate lien loans. For example, of all the manufactured housing loans made to African-Americans, a high 52.6 percent were subprime. Manufactured housing lending is disproportionately high cost lending; even 32.7 percent of manufactured housing loans received by whites in NCRC's 2004 sample were subprime.

Again, it is noteworthy how key disparities are similar in 2004 and 2003 although the racial categories and other elements of the HMDA data changed during the two years. In 2003, for example, NCRC used CRA Wiz, produced by PCI Services, to calculate that 28 percent of all the conventional loans received by African-Americans were subprime. In 2004, our sample revealed that 29 percent of all conventional loans received by African-Americans were subprime.

Much has already been written about how the new HMDA data, by itself, cannot prove the existence of discrimination. Observers, including the federal banking agencies, note that HMDA data omits key underwriting variables including borrower creditworthiness, loan-to-value ratios, and debt-to-income ratios. NCRC and our 600 member organizations had advocated for the inclusion of these data elements so that HMDA data would be most useful for identifying the complete causes of pricing disparities. But the absence of the key underwriting variables does not reduce the data to little value. The regulatory agencies themselves note that the new price data is a "useful screen, previously unavailable, to identify lenders, products, applicants, and geographic markets where price differences among racial or other groups are sufficiently large to warrant further investigation."[3]

[3] See Answers to Frequently Asked Questions about HMDA Data, p. 5.

NCRC will be one of the stakeholders using the new HMDA data to conduct further investigations and pursue enforcement options when warranted. In the meantime, the presence of disparities means that all stakeholders (responsible lenders, community organizations, and public officials) have our work cut out for us in increasing access to affordable loans for traditionally underserved populations.

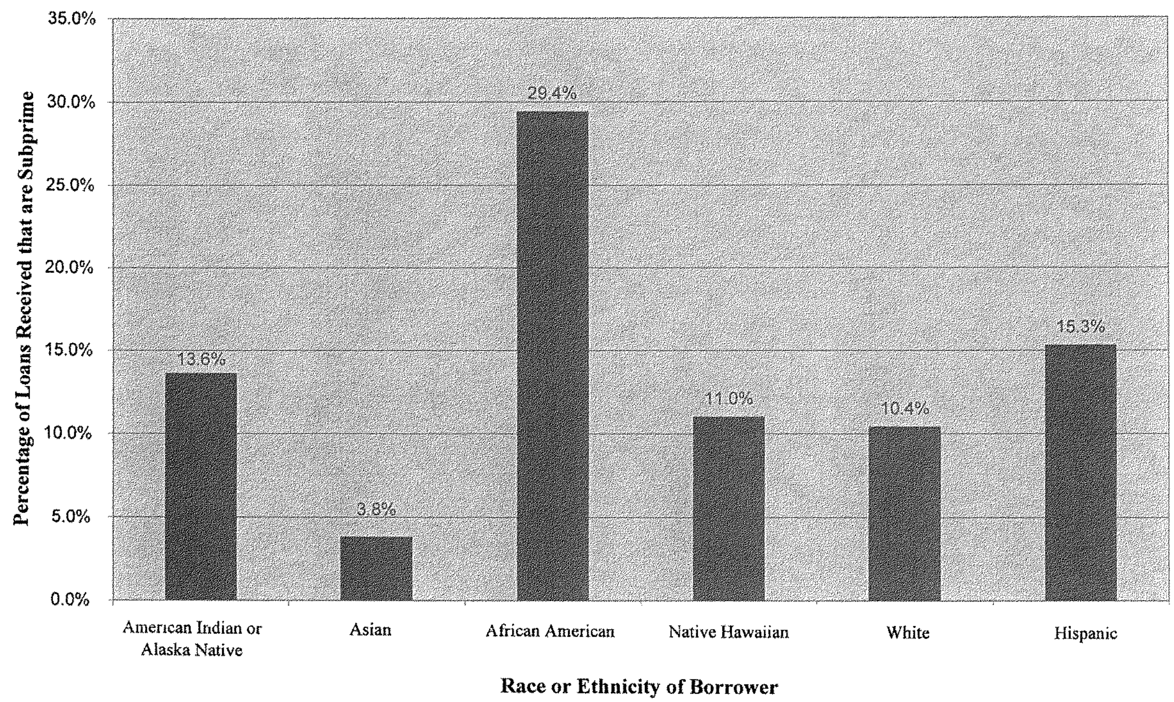
No stakeholder can be complacent. The fact that the new 2004 data shows similar disparities to earlier years suggests that after controlling for creditworthiness and other key underwriting variables, discrimination is a likely contributor to the disparities. In a previous report, *The Broken Credit System*, NCRC obtained creditworthiness data on a one time basis and combined it with 2001 HMDA data.[4] We found that after controlling for creditworthiness, housing characteristics, and economic conditions the number of subprime loans increased markedly in minority and elderly neighborhoods in ten large metropolitan areas. Our study revealing pricing disparities even controlling for creditworthiness was consistent with an analysis conducted by a Federal Reserve economist.[5] Since disparities with the new 2004 data remain stubborn and persistent, we believe that a good chance exists that troubling indications of discrimination will still be revealed in further studies that combine the 2004 HMDA data with other datasets containing key underwriting variables.

The lenders surveyed for this report are among the largest institutions in the country, and a number of them have significant supbrime operations. We requested data directly from the lenders before March 1. Per the HMDA regulations and statute, these lenders provided us with their data by April 1. In alphabetical order, the lenders are:

Ameriquest
Bank of America
Citigroup
Countrywide
HFC
HSBC Bank
JP Morgan Chase
Key Bank
National City
Option One
Suntrust
US Bank
Wachovia Bank
Washington Mutual
Wells Fargo

[4] Study is available on the NCRC web page of http://www.ncrc.org or via contacting us on 202-628-8866.
[5] Paul S. Calem, Kevin Gillen, and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, October 30, 2002. See also Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter, *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, in Fannie Mae Foundation's Housing Policy Debate, Volume 15, Issue 3, 2004 pp. 603-622.

Minorities Receive Disproportionate Amount of Subprime Loans



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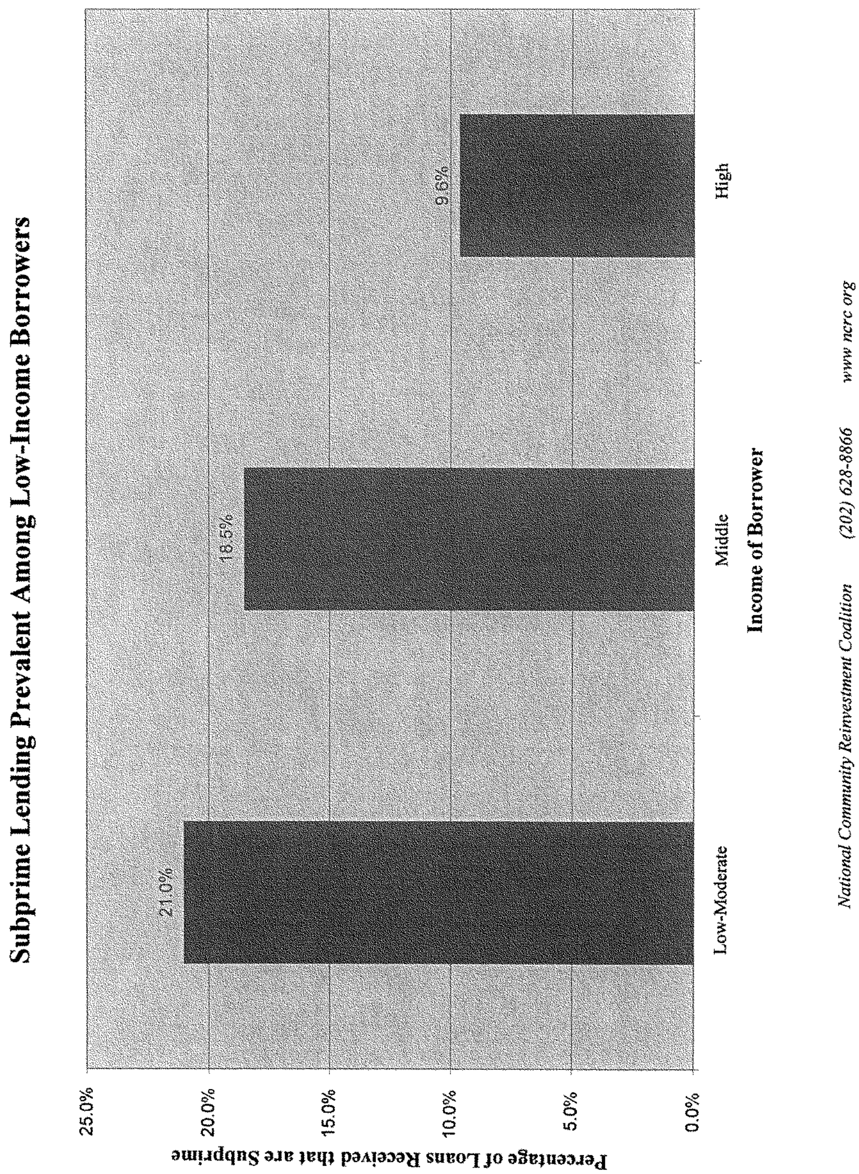
Subprime Lending Prevalent Among Low-Income Borrowers
Percentage of Loans Received that are Subprime
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
21.0%
18.5%
9.6%
Low-Moderate
Middle
High
Income of Borrower
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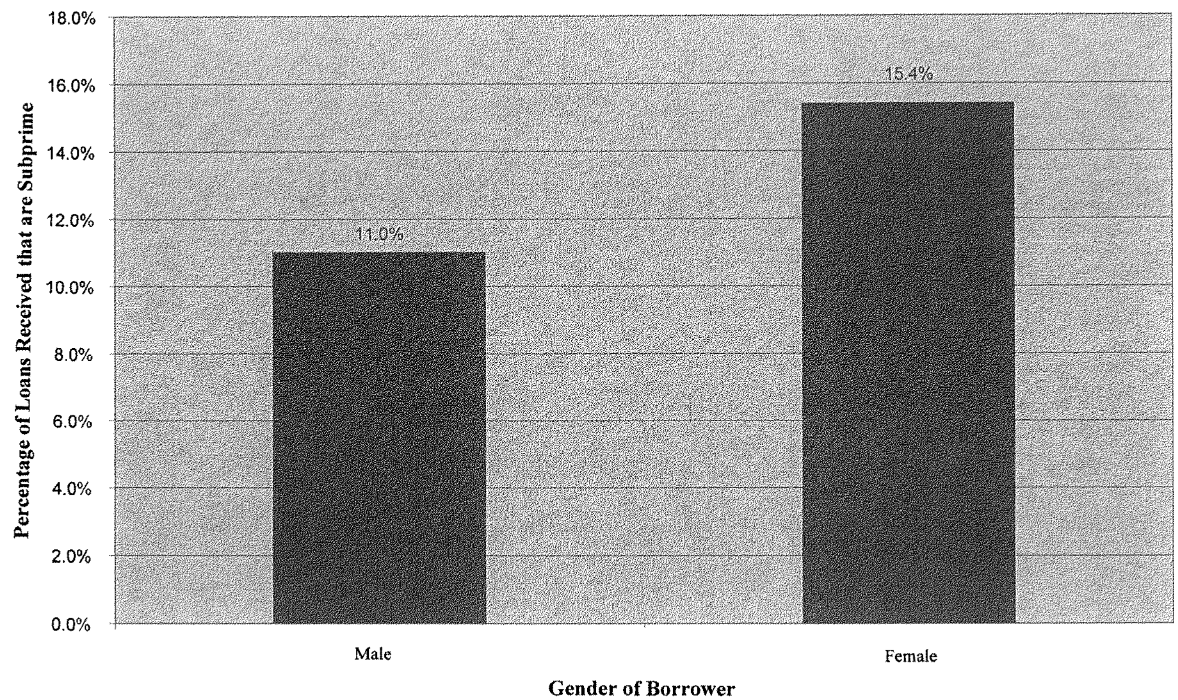
Women Receive Disproportionate Amount of Subprime Loans



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Findings

Conventional Single Family Loans – Table 1

- When considering loans by race, the NCRC sample included 4.6 million prime conventional loans without price information and 649,000 subprime loans with price spread information. Subprime loans were 12.2 percent of the total conventional loans in the 2004 sample (see Table 1 in the appendix).

- African-Americans received 18 percent of the conventional subprime loans but only 6 percent of the conventional prime loans during 2004. In contrast, whites received a greater percentage of prime than subprime loans. Whites received 55.3 percent and 66.4 of the subprime and prime loans, respectively.

- Of all the conventional loans made to African-Americans, 29.4 percent or 116,913 were subprime. In contrast, of all the conventional loans issued to whites, only 10.4 percent were subprime. Hispanics and Native Americans also experienced more disparities than whites. Of all the conventional loans issued to Hispanics and Native Americans, 15.3 percent and 13.6 percent, respectively, were subprime. Asians received fewer subprime loans (only 3.8 percent) as a portion of total conventional loans than whites.

- Disparities are present by gender. Females received 36.8 percent of the subprime conventional loans but just 28 percent of the prime conventional loans in NCRC's sample of 2004 loans. Males, in contrast, received a higher percentage of prime loans (67.5 percent) than subprime loans (59.8 percent).

- When considering borrower income, NCRC used a national median income figure derived from a 2003 Census Bureau survey of about $43,000.[6] We then applied CRA definitions of low- and moderate-income (up to 80 percent of median income), middle-income (81 to 120 percent of median income) and upper or high income of 121 percent or greater of median income. Of all the conventional loans made to low- and moderate-income and middle-income borrowers, between 18 to 21 percent were subprime. In contrast, of all the conventional loans made to upper-income borrowers, just 9.6 percent were subprime. The disparities by income level were among the greatest disparities only to be surpassed by the Black-white disparity.

- The mean and median price spreads for subprime loans do not differ that much by race, income, or gender. The new 2004 data reports how many percentage points an Annual Percentage Rate (APR) of a first lien loan is above the rate of Treasury securities of comparable terms if the spread between the loan and Treasury

[6] Selected Characteristics of Households, by Total Money Income in 2003, Source: U.S. Census Bureau, Current Population Survey, 2004 Annual Social and Economic Supplement. http://pubdb3.census.gov/macro/032004/hhinc/new01_001.htm While we would have preferred 2004 income figures, the 2003 figure was based on the most recent Census survey we could find.

securities is 3 percentage points or more. The median spread for subprime loans varies by about 40 basis points from 3.62 for Asians on the low end to 4 for African Americans and 4 for low- and moderate-income borrowers on the high end. The more significant story is the disparity in the portion of subprime and prime loans received by different categories of borrowers than disparities in price spreads in the subprime loans. When the Federal Reserve Board (FRB) was considering pricing information in HMDA data, NCRC had urged the FRB to include price information for all loans in order to provide the fullest possible picture of price distributions for various categories of borrowers. This initial sample of HMDA data provides information to support NCRC's recommendation concerning pricing information.

Government-Insured Single Family Loans – Table 2

- The NCRC sample contained few subprime government-insured loans. Lending institutions sampled issued just 489 subprime government-insured loans while they made 314,709 prime government-insured loans when considering loan totals by race.

- A notable finding is that of the 489 subprime government-insured loans, African-Americans received 23.9 percent, a percentage much higher than any other minority group.

Conventional and Government-Insured Single Family Loans – Table 3

- The trends when combining conventional and government-insured loans are very similar to the trends when considering conventional loans by themselves due to the much greater number of conventional loans and conventional subprime loans than government-insured loans.

Conventional Refinance Single Family Loans – Table 4

- Consistent with previous research, NCRC's sample shows that refinance loans constitute the majority of subprime loans. Subprime conventional refinance loans are 401,188 or 61.8 percent of the 649,101 total subprime conventional loans in NCRC's 2004 sample.

- African-Americans received 17.3 percent of subprime refinance loans but only 6.7 percent of prime refinance loans. Whites, in contrast, received a higher percentage of prime than subprime refinance loans (66.6 percent versus 56.9 percent).

- Of the total conventional refinance loans received by African-Americans, 29 percent were subprime. In contrast, just 11.9 percent of all refinance loans were subprime for whites. Hispanics had a higher portion of subprime loans at 15.3 percent of total conventional refinance loans.

- Females received 36.9 percent of subprime refinance loans, but just 27.8 percent of prime refinance loans. In contrast, males received a higher portion of prime than subprime refinance loans (67.2 percent versus 59.3 percent).

- Of all the refinance loans made to low- and moderate-income and middle-income borrowers, between 20 to 21 percent were subprime. In contrast, just 11.1 percent of conventional refinance loans issued to upper-income borrowers were subprime.

Conventional Home Purchase Loans – Table 5

- Lenders in NCRC's 2004 sample made 210,337 conventional subprime home purchase loans and 1,975,027 conventional prime loans.

- African-Americans received 19.7 percent of subprime home purchase loans but just 4.92 percent of prime home purchase loans. Whites, in contrast, received a higher portion of prime than subprime loans (66.4 percent versus 51.8 percent). Hispanics received 17.3 percent of subprime home purchase loans and 10.8 percent of prime home purchase loans.

- Of all the home purchase loans issued to African-Americans, 29.9 percent were subprime. Only 7.7 percent of conventional home purchase loans for whites were subprime, but 14.6 percent of home purchase loans for Hispanics were subprime. Only 3.5 percent of the home purchase loans for Asians were subprime.

- Females received 36.2 percent of the subprime home purchase loans but just 28 percent of the prime home purchase loans. Males enjoyed a higher percentage of prime than subprime loans (68.1 percent versus 61.1 percent).

- Disparities by income levels are significant. Low- and moderate-income borrowers, for example, received 18 percent of subprime home purchase loans but just 7.7 percent of the prime loans. Middle-income borrowers received 28.3 percent of subprime loans but just 17 percent of prime loans. Upper or high-income borrowers received a much greater portion of prime than subprime loans (75.3 percent as opposed to 53.7 percent).

- Of all the home purchase loans made to low- and moderate-income borrowers, 19.9 percent were subprime. The comparable figures for middle- and upper-income borrowers were 15.1 percent and just 7.1 percent, respectively.

Conventional Home Improvement Loans – Table 6

- While subprime home improvement is a relatively small portion of overall conventional subprime lending, a high percentage of home improvement lending is subprime. Almost 21 percent of home improvement lending in our sample is subprime, compared with 12 percent of total conventional lending.

- African-Americans experienced significant disparities in home improvement lending. They received 16.4 percent of subprime home improvement loans but just 9.5 percent of prime home improvement loans. Of all the home improvement loans made to African-Americans, a high 31.1 percent were subprime. This compares with about 20 percent of all home improvement loans being subprime for most other racial groups of borrowers.

- Females received 39.1 percent of subprime home improvement loans, and a lower percentage (32.4 percent) of prime home improvement loans. In contrast, males received a higher percentage of prime than subprime loans. Of all the home improvement loans issued to women, 24 percent were subprime. Just 19.2 percent of all the home improvement loans made to men were subprime.

- Of all the home improvement loans made to low- and moderate-income borrowers, 27.5 were subprime. For middle- and upper-income borrowers, the figures were 26.2 percent and just 17 percent, respectively.

Manufactured Housing – Table 7

- The 2004 HMDA data has another new element in that it has a separate data code indicating if the loan was made to a borrower residing in a manufactured home as opposed to a traditional single family home. Researchers have documented that lending patterns for manufactured homes are different than for traditional single family homes. The 2004 data in this sample confirms that a much higher portion of loans for manufactured homes are high cost loans. Almost 34 percent or 22,571 of the loans for manufactured homes were subprime, in contrast to 12 percent of all conventional loans.

- Once again, African-Americans receive a disproportionate amount of manufactured housing subprime loans. Of the manufactured housing loans made to African-Americans, a high 52.6 percent were subprime. This is in sharp contrast to the 33 to 34 percent figure for most other racial groups.

- Not even low- and moderate-income borrowers receive as a high a portion of manufactured housing subprime loans as African-Americans. Of all the manufactured housing loans made to low- and moderate-income borrowers, 39.6 percent were subprime. Just 28.1 percent of the manufactured housing loans made to upper-income borrowers were subprime.

- The price spreads are higher in manufactured housing than traditional single family home loans. The APRs on manufactured housing loans are higher than 4 percentage points above Treasury rates of comparable maturities. The higher spreads are for Asians (4.6 percentage points above Treasuries), Hispanics (4.2), females (4.3), and low- and moderate-income borrowers (4.4).

Subordinate Liens – Table 8

- The Federal Reserve Board required lenders to report price information if the spread between the APR on a subordinate lien loan and Treasury securities of comparable terms was 5 percentage points or more. The median spread is around 6 for most groups of borrowers. On the high end, it is 6.5 for African-Americans, 6.4 for whites, and 6.7 for low- and moderate-income borrowers.

- Overall, median spreads do not reveal much difference in prices of subprime subordinate lien loans received by various groups of borrowers. The more significant story is the distribution of subprime subordinate lien loans among different groups of borrowers.

- Subordinate or junior lien loans are typically higher cost than first lien or first mortgage loans. The NCRC 2004 sample bears this out. Of all the subordinate lien loans issued, 36.6 percent or 197,513 were subprime in contrast to just 12.2 percent of all first lien loans.

- Almost 49 percent of the subordinate lien loans made to African-Americans and Hispanics were subprime in contrast to 33 percent for whites.

- Of all the subordinate lien loans made to females, 40.3 percent were subprime while the figure for males is 35.9 percent.

- Forty percent, 42.6 percent, and 34.7 percent of subordinate lien loans for low- and moderate-income, middle-income, and upper-income borrowers, respectively, were subprime. It is interesting that middle-income borrowers receive a slightly higher percent of subprime subordinate lien loans than low- and moderate-income borrowers.

Specifications for Data Analysis

Table 1- Conventional, Single Family

Loan Type – Conventional
Property Type – Single Family
Purpose of Loan – Home purchase, home improvement, refinancing
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only.

Table 2 – Government Insured, Single Family

Loan Type – FHA, VA, FSA (All government insured loans)
Property Type – Single Family
Purpose of Loan – Home purchase, home improvement, refinancing
Owner-Occupancy – owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 3 – Conventional and Government Insured, Single Family

Loan Type – Conventional and government-insured
Property Type – Single Family
Purpose of Loan – Home purchase, home improvement, refinancing
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 4 – Conventional Refinance Single Family Loans

Loan Type – Conventional
Property Type – Single Family
Purpose of Loan – Refinance
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 5 – Conventional Home Purchase Single Family Loans

Loan Type – Conventional
Property Type – Single Family
Purpose of Loan – Home purchase
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 6 – Conventional Home Improvement Single Family Loans

Loan Type – Conventional
Property Type – Single Family
Purpose of Loan – Home Improvement
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 7 – Manufactured housing

Loan Type – Conventional
Property Type – Manufactured housing
Purpose of Loan – Home purchase, home improvement, refinancing
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by first lien only

Table 8 – Subordinate (Second Liens)

Loan Type – Conventional
Property Type – Single Family
Purpose of Loan – Home purchase, refinance, home improvement
Owner-Occupancy – Owner, non-owner, and NA
Action Taken – Loan originated only
Lien Status – Secured by second lien only

Treatment of Race, Ethnicity, and Gender

All race/ethnic categories, except Black and Hispanic, are "non-Hispanic." Blacks are categorized as Hispanic and non-Hispanic Blacks.

Hispanics in our tables can be of any race except African-Americans. We excluded African-Americans because we wanted mutual exclusive borrower groups for African-Americans and Hispanics.

We coded a loan as made to a particular race (for example, African-Americans) if the primary race (African-American) listed for the borrower was the particular race. HMDA data has five data fields for race of applicant to account for borrowers of multiple races.

Race of borrower was categorized based on the race of the applicant, not the co-applicant. Regarding gender, we used the same procedure regarding co-applicants.

Finally, loan totals by race, income, and gender will differ in some instances because a different number of loans will have missing information for race, income, and gender.

Recommendations: Legislative & Regulatory

Enhance the Quality of HMDA Data

NCRC believes that Congress and the Federal Reserve Board (which implements the HMDA regulations) must enhance HMDA data so that regular and comprehensive studies can scrutinize fairness in lending. Specifically, are minorities, the elderly, women, and low- and moderate-income borrowers and communities able to receive loans that are fairly priced? More information in HMDA data is critical to fully explore the intersection of price, race, gender, and income. HMDA data must contain credit score information similar to the data used in NCRC's *Broken Credit System* report released in the winter of 2003. For each HMDA reportable loan, a financial institution must indicate whether it used a credit score system and if the system was their own or one of the widely used systems such as FICO (a new data field in HMDA could contain 3 to 5 categories with the names of widely-used systems). The HMDA data also would contain one more field indicating which quintile of risk the credit score system placed the borrower. In addition, HMDA data must contain information on other key underwriting variables including the loan-to-value and debt-to-income ratios.

Using this data, regulators, researchers, the media, and the public could determine if any of the credit score systems were placing minorities and other protected classes in the higher risk categories a disproportionate amount of time. The data would facilitate more econometric analysis to assess whether the prices of loans are based on risk, race, gender, or age.

Federal Reserve Board Must Step Up Anti-Discrimination and Fair Lending Oversight

The Government Accountability Office concluded that the Federal Reserve Board has the authority to conduct fair lending reviews of affiliates of bank holding companies. The Federal Reserve Board, however, continues to insist that it lacks this authority.[7] This issue must be resolved because comprehensive anti-discrimination exams of all parts of bank holding companies are critical. Most of the major banks have acquired large subprime lenders that are then considered affiliates and become off-limits to Federal Reserve examination. A pressing question is the extent to which the subprime affiliates refer creditworthy customers to the prime parts of the bank so that the customers receive loans at prevailing rates instead of higher subprime rates. Or does the subprime affiliate steer creditworthy borrowers to high cost loans? These questions remain largely unanswered. Consequently, we do not know the extent of steering by subprime affiliates and/or their parent banks. Thus, it is past time for the Federal Reserve to examine affiliates as well as the parent bank.

Comprehensive Anti-Predatory Lending Legislation

Since our analysis revealed a disproportionate amount of subprime lending targeted to vulnerable borrowers and communities, Congress must respond by enacting comprehensive anti-predatory lending legislation along the lines of bills introduced by Representatives Watt, Miller, and Frank and Senator Sarbanes. Comprehensive and strong anti-predatory lending legislation would eliminate the profitability of exploitative practices by making them illegal. It could also reduce the amount of price discrimination since fee packing and other abusive practices would be prohibited. A comprehensive anti-predatory law would also strengthen the Community Reinvestment Act (CRA) if

[7] Government Accountability Office, *Large Bank Mergers: Fair Lending Review Could be Enhanced with Better Coordination*, November 1999, GAO/GGD-00-16.

regulatory agencies severely penalize lenders through failing CRA ratings when the lenders violate anti-predatory law.

Stop Regulators from Weakening CRA

CRA imposes an affirmative and continuing obligation on banks to serve the credit needs of all communities, including low- and moderate-income neighborhoods. Federal examiners issue a publicly available rating to banks with assets over $250 million based on how many loans, investments, and services they make to low- and moderate-income neighborhoods. The three part CRA exam (lending, investment, and service tests) for institutions with more than $250 million in assets has been instrumental in increasing access to loans, investments, and services for residents in low- and moderate-income communities.

However, this past summer the Office of Thrift Supervision (OTS) eliminated the investment and service tests for savings and loans with assets between $250 million and $1 billion. Eliminating these tests means that banks will no longer have the incentive to make investments in affordable housing, such as Low-Income Housing Tax Credits, and will no longer be scrutinized by examiners on how many branches and affordable banking services they are making available in low- and moderate-income neighborhoods. CRA also took a further blow from the OTS when that agency most recently ruled to allow thrifts with over $1 billion in assets to choose whether they even want to undergo the investment and service tests, thus giving them the power to pick and choose which community needs they will meet. Yet another proposal from the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency would dilute CRA exams for banks with assets between $250 million and $1 billion.

Given the persistence of disparities by income and race as illustrated in this study, it is counterproductive to lessen CRA oversight. If CRA oversight continues to diminish, the level of abusive lending to vulnerable populations is likely to increase even further as traditional lenders reduce the number of branches, bank products, and affordable housing investments in low- and moderate-income communities. Instead, regulators must strengthen CRA exams and hold lenders accountable to communities.

Strengthen CRA by Applying It to Minority Neighborhoods and All Geographical Areas Lenders Serve

In order to increase prime lending for minority borrowers and reduce lending disparities, CRA exams must evaluate the banks' records of lending to minority borrowers and neighborhoods as well as scrutinizing banks' performance in reaching low- and moderate-income borrowers and neighborhoods. CRA's mandate of affirmatively meeting credit needs is currently incomplete as it is now applied only to low- and moderate-income neighborhoods, not minority communities.

CRA must also be strengthened so that depository institutions undergo CRA examinations in all geographical areas in which they make a significant number of loans. Currently, CRA exams assess lending primarily in geographical areas in which banks have their branches. But the overlap between branching and lending is eroding with each passing year as lending via brokers and correspondents continues to increase. NCRC strongly endorses the CRA Modernization Act, HR 865, introduced in the 107th Congress. HR 865 mandates that banks undergo CRA exams in geographical areas in which their market share of loans exceeds one half of one percent in addition to areas in which their branches are located. NCRC will be working with members of Congress to update and reintroduce CRA Modernization legislation.

Short of statutory changes to CRA, NCRC believes that the regulatory agencies have the authority to extend CRA examinations and scrutiny to geographical areas beyond narrow "assessment" areas in which branches are located. Currently, the federal banking agencies will consider lending activity beyond assessment areas if the activity will enhance CRA performance. Likewise, the CRA rating must be downgraded if the lending performance in reaching low- and moderate-income borrowers is worse outside than inside the assessment areas.

CRA Exams Must Scrutinize Subprime Lending More Rigorously

Currently, CRA exams are not adequately assessing the CRA performance of subprime lenders. For example, the CRA exam of the subprime lender, Superior Bank, FSB, called its lending innovative and flexible before that thrift's spectacular collapse.[8] Previous NCRC comment letters to the regulators have documented cursory fair lending reviews for the great majority of banks and thrifts involved in subprime lending.[9] If CRA exams continue to mechanistically consider subprime lending, subprime lenders will earn good ratings since they usually offer a larger portion of their loans to low- and moderate-income borrowers and communities than prime lenders.

At this point, the regulatory agencies have stated in an "Interagency Question and Answer" document that banks will be downgraded if their lending violates federal anti-predatory law. NCRC has not seen rigorous action to implement this guidance. Fair lending reviews that accompany CRA exams do not usually scrutinize subprime lending for compliance with anti-predatory law, for possible pricing discrimination, or whether abusive loans are exceeding borrower ability to repay. NCRC recommends that all CRA exams of subprime lenders must be accompanied by a comprehensive fair lending and anti-predatory lending audit. In addition, CRA exams must ensure that prime lenders are not financing predatory lending through their secondary market activity or servicing abusive loans.

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[8] Office of Thrift Supervision Central Region's CRA Evaluation of Superior Bank, FSB, Docket #: 08566, September 1999. Available via http://www.ots.treas.gov, go to the CRA search engine and select "inactive" for the status of the institution being searched.

[9] NCRC comment letter to federal banking agencies on joint CRA proposal, April 2, 2004. Available via: http://www.ncrc.org.

GSEs Must Abide by Anti-Predatory Safeguards

The Government-Sponsored Enterprises (GSEs), including Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, purchase more than half of the home loans made on an annual basis in this country. It is vitally important, therefore, that the GSEs have adopted adequate protections against purchasing predatory loans. Fannie Mae and Freddie Mac have voluntarily adopted significant protections such as purchasing no loans with fees exceeding five percent of the loan amount, no loans involving price discrimination or steering, no loans with prepayment penalties beyond three years, and no loans with mandatory arbitration. The Department of Housing and Urban Development (HUD) has ruled that Fannie Mae and Freddie Mac will not receive credit towards their Affordable Housing Goals for any loans that contain certain abusive features.

HUD's ruling is an important first step, but it needs to be enhanced. HUD's ruling, for example, does not include disqualification from goals consideration of loans with mandatory arbitration. The Federal Housing Finance Board, as the regulator for the Federal Home Loan Banks, has not formally applied protections against abusive loans to the Home Loan Banks. Congress has an opportunity to further bolster the anti-predatory protections applied to GSE loan purchasing activity as Congress considers GSE regulatory reform this year. For instance, Senator Reed is expected to re-introduce an amendment this year for a GSE bill that would prohibit the GSEs from purchasing loans with mandatory arbitration.

Lender Affiliates Used in Report

This list includes many, but not all the affiliates of lenders analyzed in this report.

Ameriquest:

Ameriquest
Argent
Olympus

Bank of America:

Bank of America
FleetBoston
Other Bank of America affiliates

Countrywide

Countrywide Home Loans
Countrywide Bank

Countrywide LLC

Citigroup:

CitiMortgage, Inc.
Citibank, FSB
Citibank, NA
Citibank (West), FSB
CitiFinancial
Citicorp Trust Bank
CitiFinancial Mortgage Company
Associates International Holding Corp.
Associates Housing Finance
Principal Residential Mortgage, Inc.
Washington Mutual Finance

HFC:

HFC
Decision One
Beneficial

HSBC:

HSBC Bank USA, N.A.
HSBC Mortgage Corp.

JP Morgan Chase:

Chase Manhattan Bank USA, NA
Chase Manhattan Mortgage Corp.
JP Morgan Chase Bank

Key Bank:

All affiliates as supplied by parent company

National City:

National City Bank of Kentucky
National City Bank of the Midwest
National City Bank
Wayne County National Bank
National City Bank of Indiana
National City Bank of Pennsylvania
Savings Bank & Trust (Wayne)

Provident Bank
Provident Community Development Co.
Red Mortgage Capital Inc.
National City Mortgage Service Co.
National City Home Loan Services, Inc.
HomeSync Financial Services, LLC
Home Mortgage Centre, LLC
Pinehurst Mortgage, LLC
Mortgage One, LP
Regional First Mortgage, LLC
Home Financing, LLC
Virginia First Mortgage, LLC
Valley Mortgage Services, LLC
Town and Country Lending, LLC
First Patriot Mortgage, LLC
American Best Mortgage, LLC
Premier Lending Services, LP
Mid Atlantic Mortgage, LLC
AmeriMax Mortgage, LLC
Action Home Mortgage, LLC
Hometown Mortgage, LLC
Lower Bucks Mortgage, LLC
Covenant Mortgage, LLC
Heartland Security Mortgage, LLC
Freedom Financial Advisors, LP
Home Central Mortgage, LLC
Reliable Mortgage Investors, LLC
Tower Mortgage, LLC
Liberty West Mortgage, LP
Heritage Home Mortgage, LLC
REO Mortgage Services, LLC
Mortgage PROS, LLC
Virginia Home Mortgage, LLC
Peninsula Mortgage, LLC
Tidewater First Mortgage, LLC
First Flight Mortgage, LLC
Gateway First Mortgage, LLC
Homesource Mortgage Services, LLC
Freedom First Mortgage, LLC
All American First Mortgage, LLC
First Capital Home Mortgage, LLC
Town Square Mortgage, LLC
Capstone Mortgage Funding, LLC
Intercoastal Mortgage, LLC
Mortgage Construction Finance, LLC
Enter Mortgage, LLC

Ultimate Home Loans, LP
Platinum First Mortgage, LP
Executive Home Mortgage, LLC
HomePride Mortgage, LP
National American Mortgage, LLC
Supreme Capital Mortgage, LLC
1st Premier Mortgage, LP
AccuLend Mortgage, LP
The First Mortgage Group, LLC
1st Choice Mortgage, LLC

Option One:

Option One
H & R Block

SunTrust:

Sun Trust Bank
Sun Trust Mortgage, Inc.
National Bank of Commerce

US Bank:

US Bank North Dakota
US Bank, NA

Wachovia:

Wachovia Bank
Wachovia Mortgage Corporation
Wachovia Bank of Delaware

South Trust Bank
South Trust Mortgage Corporation

Washington Mutual:

Washington Mutual Bank
Washington Mutual Bank, FA
Washington Mutual Bank, FSB

Wells Fargo:

WELLS FARGO BANK, NA
WELLS FARGO BANK NORTHWEST, NA

WELLS FARGO FUNDING
WELLS FARGO FIN'L ARIZONA, INC
WELLS FARGO FIN'L TEXAS, INC
WELLS FARGO FINANCIAL UTAH, INC.
WELLS FARGO FINANCIAL WYOMING, INC.
WELLS FARGO FINANCIAL NEW JERSEY, INC.
WELLS FARGO FIN'L NEBRASKA,INC
WELLS FARGO FINL WEST VIRGINIA
WELLS FARGO FINL WISCONSIN INC
WELLS FARGO FIN'L TENNESSEE
WELLS FARGO FIN'L OKLAHOMA,INC
WELLS FARGO FIN'L MONTANA, INC
WELLS FARGO FINANCIAL NORTH DAKOTA, INC.
WELLS FARGO FIN'L MINNESOTA
WELLS FARGO FINANCIAL MARYLAND, INC.
WELLS FARGO FINANCIAL LOUISIANA, INC.
WELLS FARGO FIN'L KENTUCKY INC
WELLS FARGO FIN'L KANSAS, INC
WELLS FARGO FIN'L INDIANA, INC
WELLS FARGO FIN'L MISSOURI INC
WELLS FARGO FINANCIAL COLORADO, INC.
WELLS FARGO FIN'L ALASKA, INC
WELLS FARGO FIN'L SOUTH DAKOTA
WELLS FARGO FIN'L ILLINOIS INC
WELLS FARGO FIN'L GEORGIA, INC
WELLS FARGO FINANCIAL DELAWARE, INC.
WELLS FARGO FIN'L SO CAROLINA
WELLS FARGO FIN'L RHODE ISLAND
WELLS FARGO FIN'L CALIFORNIA
WELLS FARGO FIN'L ALABAMA, INC
WELLS FARGO FIN'L IDAHO, INC
WELLS FARGO FINANCIAL HAWAII, INC.
WELLS FARGO FIN'L OREGON, INC
WELLS FARGO FINANCIAL PENNSYLVANIA, INC.
WELLS FARGO FIN'L CRED SERV NY
WELLS FARGO FIN'L AMERICA, INC
WELLS FARGO FIN'L IOWA 3, INC
WELLS FARGO FIN'L MAINE, INC
WELLS FARGO FIN'L NEVADA 2,INC
WELLS FARGO FINANCIAL NEW MEXICO, INC.
WELLS FARGO FIN'L NO CAROLINA
WELLS FARGO FINANCIAL OHIO 1, INC.
WELLS FARGO FINANCIAL WASHINGTON, INC.
WELLS FARGO FINL MASSACHUSETTS
WELLS FARGO FIN'L SYS FLORIDA
WELLS FARGO FINANCIAL SYSTEM VIRGINIA, INC.

WELLS FARGO FIN'L ACCPTCE AMER
WELLS FARGO FIN'L ACCPT SYS FL
WELLS FARGO FIN'L ACCPT IOWA
WELLS FARGO FINANCIAL ACCEPTANCE MARYLAND 1, INC.
WELLS FARGO FINANCIAL ACCEPTANCE SYSTEM VIRGINIA
WELLS FARGO FIN'L MISSISSIPPI
Community First Mortgage LLC
Southeastern Residential Mtg
1ST CAPITAL MORTGAGE, LLC
1ST FINANCIAL SERVICES OF COLORADO, LLC
ACADEMY FINANCIAL SERVICES, LLC
ADVANCE MORTGAGE
ADVANCE MORTGAGE PARTNERS, LLC
AMERICAN PRIORITY MORTGAGE, LLC
AMERICAN SOUTHERN MORTGAGE SERVICES, LLC
APM MORTGAGE, LLC
ASHTON WOODS MORTGAGE, LLC
AVENUE FINANCIAL SERVICES, LLC
BELGRAVIA MORTGAGE GROUP, LLC
BENEFIT MORTGAGE, LLC
BHS HOME LOANS, LLC
BUILDERS CAPITAL MORTGAGE, LLC
BUILDERS MORTGAGE COMPANY, LLC
BW MORTGAGE, LLC
CAPITAL PACIFIC HOME LOANS, LP
CENTRAL FEDERAL MORTGAGE COMPANY
CHATEAU HOME MORTGAGE, LLC
COLORADO MORTGAGE ALLIANCE, LLC
COLORADO PROFESSIONALS MORTGAGE, LLC
DELUCA-REALEN MORTGAGE, LLC
DISCOVERY HOME LOANS, LLC
EB CAPITAL MORTGAGE, LLC
EDWARD JONES MORTGAGE, LLC
EMPIRE HOMES FINANCIAL SERVICES, LLC
EXPRESS FINANCIAL & MORTGAGE SERVICES
FAMILY HOME MORTGAGE, LLC
FINANCIAL RESOURCES MORTGAGE, LLC
FINANCIAL SERVICES OF ARIZONA, LLC
FIRST FOUNDATION MORTGAGE, LLC
FIRST MORTGAGE CONSULTANTS, LLC
FIRST MORTGAGE OF FLORIDA, LLC
FORECAST HOME MORTGAGE, LLC
FOUNDATION MORTGAGE SERVICES, LLC
GOLD COAST HOME MORTGAGE
GOLD COAST MORTGAGE
GREAT EAST MORTGAGE, LLC

GREENRIDGE MORTGAGE SERVICES, LLC
GUARANTEE PACIFIC MORTGAGE, LLC
HALLMARK MORTGAGE GROUP, LLC
HEARTHSIDE FUNDING, LP
HENDRICKS MORTGAGE, LLC
HOME LOAN EXPRESS, LLC
HOME MORTGAGE EXCHANGE, LLC
HOMELAND MORTGAGE, LLC
HOMESERVICES LENDING, LLC 1
HOMETOWN MORTGAGE, LLC
HORIZON MORTGAGE, LLC
IMS MORTGAGE COMPANY
JOHN LAING MORTGAGE, LP
JTS FINANCIAL, LLC
LEADER MORTGAGE, LLC
LEGACY MORTGAGE
LINEAR FINANCIAL, LP
MC OF AMERICA, LLC
MERCANTILE MORTGAGE, LLC
MERIDIAN HOME MORTGAGE, LP
MICHIGAN HOME MORTGAGE, LLC
MJC MORTGAGE COMPANY, LLC
MORRISON FINANCIAL SERVICES, LLC
MORTGAGE 100, LLC
MORTGAGE DYMANICS, LLC
MORTGAGE ONE
MORTGAGE PROFESSIONALS OF TAMPA BAY, LLC
MORTGAGES ON-SITE, LLC
MORTGAGES UNLIMITED, LLC
MSC MORTGAGE, LLC
MUTUAL SERVICE MORTGAGE, LLC
NAPERVILLE MORTGAGE, LLC
NATIONAL MORTGAGE, LLC
NDC FINANCIAL SERVICES, LLC
NEW ENGLAND HOME LOANS, LLC
NEXT HOME MORTGAGE
OHIO EXECUTIVE MORTGAGE COMPANY
PCM MORTGAGE, LLC
PERSONAL MORTGAGE GROUP, LLC
PINNACLE MORTGAGE OF NEVADA, LLC
PLAYGROUND FINANCIAL SERVICES, LLC
PREMIER HOME MORTGAGE
PRIORITY MORTGAGE, LLC
PRIVATE MORTGAGE ADV, LLC
PROFESSIONAL FINL SERVS OF ARIZONA, LLC
PROSPERITY MORTGAGE COMPANY

PROVIDENT MORTGAGE COMPANY, LLC
REAL ESTATE FINANCIAL
REAL ESTATE LENDERS
REAL LIVING MORTGAGE, LLC
REALTEC FINANCIAL SERVICES, LLC
REALTY HOME MORTGAGE, LLC
RELOACTION MORTGAGE, LLC
RESIDENTIAL COMMUNITY MORTGAGE COMPANY
RESORTQUEST MORTGAGE, LLC
RIVER CITY GROUP, LLC
RODDEL MORTGAGE COMPANY, LP
SANTA FE MORTGAGE, LLC
SECURESOURCE MORTGAGE, LLC
SECURITY FIRST FINANCIAL GROUP, LLC
SIGNATURE HOME MORTGAGE, LP
SMART MORTGAGE, LLC
SMITH FAMILY MORTGAGE, LLC
SOUTH COUNTY MORTGAGE
SOUTHEAST HOME MORTGAGE, LLC
SOUTHERN OHIO MORTGAGE, LLC
SPH MORTGAGE
STEINBECK ADVANTAGE MORTGAGE, LLC
STOCK FINANCIAL SERVICES, LLC
STONERIDGE MORTGAGE, LLC
SUMMIT NATIONAL MORTGAGE, LLC
SUNDANCE MORTGAGE, LLC
SUNSOUTH MORTGAGE, LLC
TOUCHSTONE HOME MORTGAGE, LLC
TRG FINANCIAL, LLC
TRICOM MORTGAGE, LLC
TRINITY MORTGAGE AFFILIATES
TRIPLE DIAMOND MORTGAGE & FINANCIAL, LLC
UBS MORTGAGE LLC
UNITED MICHIGAN MORTGAGE, LLC
UNITED MORTGAGE GROUP
VISTA MORTGAGE, LLC
WATERWAYS HOME MORTGAGE, LLC
WELLS FARGO HOME MORTGAGE OF HAWAII, LLC
WESTFIELD HOME MORTGAGE, LLC
WF/TW MORTGAGE VENTURE, LLC
WINDWARD HOME MORTGAGE, LLC
YOUNG HOMES MORTGAGE, LLC

Appendix – Tables 1 through 8

Table 1 - Conventional

Race and Ethnicity

		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total
Sub-Prime	Count	68,922	2,932	10,588	116,913	2,509	358,614	88,623	649,101
	Row %	10.62%	0.45%	1.63%	18.01%	0.39%	55.25%	13.65%	
	Col %	12.30%	13.58%	3.79%	29.43%	11.05%	10.37%	15.25%	12.20%
	Table %	1.30%	0.06%	0.20%	2.20%	0.05%	6.74%	1.67%	
	Mean	4.15	4.15	3.83	4.17	3.99	4.11	3.95	
	Median	4	4	3.62	4	3.77	3.93	3.72	
Prime	Count	491,323	18,655	268,829	280,369	20,204	3,099,888	492,509	4,671,777
	Row %	10.52%	0.40%	5.75%	6.00%	0.43%	66.35%	10.54%	
	Col %	87.70%	86.42%	96.21%	70.57%	88.95%	89.63%	84.75%	87.80%
	Table %	9.23%	0.35%	5.05%	5.27%	0.38%	58.26%	9.26%	

Gender

		Male	Female	Information not provided by applicant	Not applicable	Total
Sub-Prime	Count	388,293	239,031	21,718	59	649,101
	Row %	59.82%	36.82%	3.35%	0.01%	
	Col %	10.96%	15.43%	9.55%	1.87%	
	Table %	7.30%	4.49%	0.41%	0.00%	
	Mean	4.08	4.10	4.25	4.13	
	Median	3.91	3.95	4	3.87	
Prime	Count	3,153,196	1,309,734	205,786	3,104	4,671,820
	Row %	67.49%	28.03%	4.40%	0.07%	
	Col %	89.04%	84.57%	90.45%	98.13%	
	Table %	59.26%	24.61%	3.87%	0.06%	

Median Income

		Low Mod	Middle	High	Total
Sub-Prime	Count	119,568	184,706	337,863	642,137
	Row %	18.62%	28.76%	52.62%	
	Col %	20.98%	18.48%	9.55%	
	Table %	2.34%	3.62%	6.61%	
	Mean	4.30	4.15	4.01	
	Median	4	4	3.84	
Prime	Count	450,475	814,588	3,200,686	4,465,749
	Row %	10.09%	18.24%	71.67%	
	Col %	79.02%	81.52%	90.45%	
	Table %	8.82%	15.95%	62.66%	

Table 2 - Government Insured

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	60	3		117	2	268	39	489	298	175	16		489	127	131	207	465
	Row %	12.27%	0.61%		23.93%	0.41%	54.81%	7.98%		60.94%	35.79%	3.27%			27.31%	28.17%	44.52%	
	Col %	0.26%	0.16%		0.23%	0.19%	0.14%	0.10%	0.16%	0.14%	0.19%	0.18%			0.19%	0.16%	0.23%	
	Table %	0.02%	0.00%		0.04%	0.00%	0.09%	0.01%		0.09%	0.06%	0.01%			0.05%	0.05%	0.09%	
	Mean	4.93	3.60	.	3.38	3.21	3.54	3.41		3.80	3.45	3.47	.		3.36	3.43	4.01	
	Median	3.23	3.67	.	3.18	3.21	3.19	3.19		3.185	3.19	3.345	.		3.18	3.19	3.2	
Prime	Count	23,211	1,829	3,847	49,997	1,059	195,355	39,411	314,709	214,585	91,170	8,810	151	314,716	66,414	82,514	91,422	240,350
	Row %	7.38%	0.58%	1.22%	15.89%	0.34%	62.07%	12.52%		68.18%	28.97%	2.80%	0.05%		27.63%	34.33%	38.04%	
	Col %	99.74%	99.84%	100.00%	99.77%	99.81%	99.86%	99.90%	99.84%	99.86%	99.81%	99.82%	100.00%		99.81%	99.84%	99.77%	
	Table %	7.36%	0.58%	1.22%	15.86%	0.34%	61.98%	12.50%		68.06%	28.92%	2.80%	0.05%		27.58%	34.26%	37.96%	

Table 3 - Conventional & Government

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	68,982	2,935	10,588	117,030	2,511	358,882	88,662	649,590	388,591	239,206	21,734	59	649,590	119,695	184,837	338,070	642,602
	Row %	10.62%	0.45%	1.63%	18.02%	0.39%	55.25%	13.65%		59.82%	36.82%	3.35%	0.01%		18.63%	28.76%	52.61%	
	Col %	11.82%	12.53%	3.74%	26.16%	10.56%	9.82%	14.29%	11.53%	10.34%	14.58%	9.20%	1.78%		18.80%	17.08%	9.31%	
	Table %	1.22%	0.05%	0.19%	2.08%	0.04%	6.37%	1.57%		6.89%	4.24%	0.39%	0.00%		2.24%	3.46%	6.32%	
	Mean	4.15	4.15	3.83	4.17	3.99	4.11	3.95		4.08	4.10	4.25	4.13		4.30	4.15	4.01	
	Median	4	4	3.62	4	3.77	3.93	3.72		3.91	3.95	4	3.87		4	4	3.84	
Prime	Count	514,534	20,484	272,676	330,366	21,263	3,295,243	531,920	4,986,486	3,367,781	1,400,904	214,596	3,255	4,986,536	516,889	897,102	3,292,108	4,706,099
	Row %	10.32%	0.41%	5.47%	6.63%	0.43%	66.08%	10.67%		67.54%	28.09%	4.30%	0.07%		10.98%	19.06%	69.95%	
	Col %	88.18%	87.47%	96.26%	73.84%	89.44%	90.18%	85.71%	88.47%	89.66%	85.42%	90.80%	98.22%		81.20%	82.92%	90.69%	
	Table %	9.13%	0.36%	4.84%	5.86%	0.38%	58.47%	9.44%		59.75%	24.86%	3.81%	0.06%		9.66%	16.77%	61.55%	

Table 4 - Refinance - Single Family

		Race and Ethnicity								Gender					Median Income			
		Not applicable or Information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	48,228	1,843	5,081	69,411	1,559	228,435	46,631	401,188	237,917	148,143	15,082	46	401,188	74,122	115,971	209,673	399,766
	Row %	12.02%	0.46%	1.27%	17.30%	0.39%	56.94%	11.62%		59.30%	36.93%	3.76%	0.01%		18.54%	29.01%	52.45%	
	Col %	14.76%	14.47%	3.90%	29.03%	12.06%	11.85%	15.32%	13.58%	12.17%	17.28%	10.67%	3.63%		20.93%	20.23%	11.17%	
	Table %	1.63%	0.06%	0.17%	2.35%	0.05%	7.73%	1.58%		8.05%	5.01%	0.51%	0.00%		2.64%	4.13%	7.48%	
	Mean	4.17	4.23	3.88	4.23	4.02	4.15	4.03		4.14	4.15	4.27	4.26		4.34	4.19	4.06	
	Median	4	4	3.67	4	3.82	3.97	3.79		3.98	4	4	4.11		4	4	3.91	
Prime	Count	278,453	10,891	125,297	169,712	11,372	1,699,745	257,762	2,553,232	1,716,913	708,922	126,205	1,221	2,553,261	280,007	457,425	1,667,629	2,405,061
	Row %	10.91%	0.43%	4.91%	6.65%	0.45%	66.57%	10.10%		67.24%	27.77%	4.94%	0.05%		11.64%	19.02%	69.34%	
	Col %	85.24%	85.53%	96.10%	70.97%	87.94%	88.15%	84.68%	86.42%	87.83%	82.72%	89.33%	96.37%		79.07%	79.77%	88.83%	
	Table %	9.42%	0.37%	4.24%	5.74%	0.38%	57.53%	8.72%		58.11%	24.00%	4.27%	0.04%		9.98%	16.31%	59.46%	

Table 5 - Home Purchase - Single Family

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	17,103	879	5,015	41,353	793	108,918	36,276	210,337	128,620	76,203	5,502	12	210,337	36,786	58,017	110,064	204,867
	Row %	8.13%	0.42%	2.38%	19.66%	0.38%	51.78%	17.25%		61.15%	36.23%	2.62%	0.01%		17.96%	28.32%	53.72%	
	Col %	7.87%	11.39%	3.52%	29.87%	9.10%	7.66%	14.56%	9.62%	8.73%	12.09%	6.89%	0.66%		19.94%	15.07%	7.08%	
	Table %	0.78%	0.04%	0.23%	1.89%	0.04%	4.98%	1.66%		5.89%	3.49%	0.25%	0.00%		1.73%	2.73%	5.18%	
	Mean	4.04	3.92	3.77	4.02	3.91	3.97	3.79		3.94	3.94	4.14	3.50		4.10	4.01	3.88	
	Median	3.94	3.86	3.58	3.97	3.71	3.82	3.62		3.79	3.82	4	3.47		4	3.93	3.72	
Prime	Count	200,329	6,835	137,561	97,082	7,922	1,312,469	212,816	1,975,014	1,344,561	554,328	74,326	1,812	1,975,027	147,667	327,038	1,444,412	1,919,117
	Row %	10.14%	0.35%	6.97%	4.92%	0.40%	66.45%	10.78%		68.08%	28.07%	3.76%	0.09%		7.69%	17.04%	75.26%	
	Col %	92.13%	88.61%	96.48%	70.13%	90.90%	92.34%	85.44%	90.38%	91.27%	87.91%	93.11%	99.34%		80.06%	84.93%	92.92%	
	Table %	9.17%	0.31%	6.29%	4.44%	0.36%	60.06%	9.74%		61.53%	25.37%	3.40%	0.08%		6.95%	15.40%	68.00%	

Table 6 - Home Improvement - Single Family

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	3,591	210	492	6,149	157	21,261	5,716	37,576	21,756	14,685	1,134	1	37,576	8,660	10,718	18,126	37,504
	Row %	9.56%	0.56%	1.31%	16.36%	0.42%	56.58%	15.21%		57.90%	39.08%	3.02%	0.00%		23.09%	28.58%	48.33%	
	Col %	22.26%	18.44%	7.61%	31.18%	14.71%	19.52%	20.67%	20.75%	19.17%	24.01%	17.75%	1.39%		27.53%	26.24%	16.98%	
	Table %	1.98%	0.12%	0.27%	3.40%	0.09%	11.74%	3.16%		12.01%	8.11%	0.63%	0.00%		4.84%	5.99%	10.12%	
	Mean	4.42	4.45	3.95	4.41	4.09	4.38	4.35		4.37	4.38	4.51	5.53		4.80	4.42	4.16	
	Median	4	3.97	3.655	4	3.77	4	3.86		4	4	4	5.53		4.21	4	3.87	
Prime	Count	12,541	929	5,971	13,575	910	87,674	21,931	143,531	91,722	46,484	5,255	71	143,532	22,801	30,125	88,645	141,571
	Row %	8.74%	0.65%	4.16%	9.46%	0.63%	61.08%	15.28%		63.90%	32.39%	3 66%	0.05%		16.11%	21.28%	62.62%	
	Col %	77.74%	81.56%	92.39%	68.82%	85.29%	80.48%	79.33%	79.25%	80.83%	75.99%	82 25%	98.61%		72.47%	73.76%	83.02%	
	Table %	6.92%	0.51%	3.30%	7.50%	0.50%	48.41%	12.11%		50.64%	25.67%	2 90%	0.04%		12.73%	16.82%	49.50%	

Table 7 - Manufactured Housing

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	2,046	173	110	1,310	28	17,510	1,394	22,571	14,005	7,263	1,303		22,571	8,618	7,437	6,494	22,549
	Row %	9.06%	0.77%	0.49%	5.80%	0.12%	77.58%	6.18%		62.05%	32.18%	5.77%			38.22%	32.98%	28.80%	
	Col %	36.86%	33.92%	31.70%	52.61%	34.57%	32.74%	34.92%	33.97%	31.49%	37.47%	50.29%			39.61%	34.90%	28.09%	
	Table %	3.08%	0.26%	0.17%	1.97%	0.04%	26.35%	2.10%		21.08%	10.93%	1.96%			13.02%	11.24%	9.81%	
	Mean	4.73	4.73	4.89	4.67	4.26	4.68	4.67		4.62	4.75	4.94	.		4.90	4.63	4.45	
	Median	4.2945	4.57	4.565	4.2	3.775	4.12	4.24		4.08	4.269	4.599	.		4.36	4.14	4	
Prime	Count	3,504	337	237	1,180	53	35,969	2,598	43,678	30,467	12,119	1,288	5	43,879	13,137	13,873	16,621	43,631
	Row %	7.99%	0.77%	0.54%	2.69%	0.12%	81.98%	5.92%		69.43%	27.62%	2.94%	0.01%		30.11%	31.80%	38.09%	
	Col %	63.14%	66.08%	68.30%	47.39%	65.43%	67.26%	65.08%	66.03%	68.51%	62.53%	49.71%	100.00%		60.39%	65.10%	71.91%	
	Table %	5.27%	0.51%	0.36%	1.78%	0.08%	54.13%	3.91%		45.85%	18.24%	1.94%	0.01%		19.85%	20.96%	25.11%	

Table 8 - Subordinate Lien

		Race and Ethnicity								Gender					Median Income			
		Not applicable or information not provided	American Indian or Alaska Native (non-Hispanic)	Asian (non-Hispanic)	Black or African American (Hispanic & non-	Native Hawaiian or Other Pacific Islander	White (non-Hispanic)	Hispanic (non-Black)	Total	Male	Female	Information not provided by applicant	Not applicable	Total	Low Mod	Middle	High	Total
Sub-Prime	Count	22,536	874	5,555	22,778	1,181	108,181	36,408	197,513	122,525	64,873	10,042	75	197,515	16,817	47,531	132,759	197,107
	Row %	11.41%	0.44%	2.81%	11.53%	0.60%	54.77%	18.43%		62.03%	32.84%	5.08%	0.04%		8.53%	24.11%	67.35%	
	Col %	33.15%	29.59%	28.64%	48.53%	39.97%	33.23%	48.82%	36.55%	35.93%	40.31%	26.26%	38.66%		39.68%	42.60%	34.73%	
	Table %	4.17%	0.16%	1.03%	4.22%	0.22%	20.02%	6.74%		22.67%	12.00%	1.86%	0.01%		3.14%	8.86%	24.76%	
	Mean	6.83	6.59	6.34	6.76	6.51	6.77	6.44		6.67	6.73	6.82	7.76		6.97	6.82	6.62	
	Median	6.48	6.32	6.01	6.54	6.14	6.43	6.03		6.33	6.41	6.46	7.66		6.66	6.5	6.28	
Prime	Count	45,446	2,080	13,841	24,155	1,774	217,412	38,170	342,878	218,491	96,074	28,200	119	342,884	25,564	64,053	249,492	339,109
	Row %	13.25%	0.61%	4.04%	7.04%	0.52%	63 41%	11 13%		63 72%	28 02%	8.22%	0.03%		7.54%	18.89%	73.57%	
	Col %	66.85%	70.41%	71.36%	51.47%	60.03%	66 77%	51 18%	63.45%	64 07%	59 69%	73.74%	61.34%		60.32%	57.40%	65.27%	
	Table %	8.41%	0.38%	2.56%	4.47%	0.33%	40 23%	7 06%		40 43%	17 78%	5.22%	0.02%		4.77%	11.95%	46.53%	

February 28, 2005

The Honorable Michael Oxley
Chairman
House Financial Services Committee

The Honorable Barney Frank
Ranking Member
House Financial Services Committee

Dear Chairman Oxley and Ranking Member Frank:

We, the undersigned organizations, are writing to express our support for strong policies to address predatory lending in the subprime mortgage market. During recent years, responsible mortgage lenders and consumer advocates have recognized the urgent need to curb abusive lending practices that harm homebuyers and homeowners. When the Committee considers this issue, we respectfully urge you to ensure that any legislation supplements existing law by promoting four basic objectives:

- **Elimination of incentives for lenders to make predatory loans;**
- **A fair, competitive market that responsibly provides credit to consumers;**
- **Access to justice for families caught in abusive loans; and**
- **The preservation of essential federal and state consumer safeguards.**

First, the subprime market now rewards lenders and brokers who charge homeowners excessive points and fees. Homeowners typically don't pay these fees in cash. Rather, they borrow more to cover the costs, resulting in inflated loan balances. Many in the industry are not concerned with a borrower's ability to make monthly payments, because the broker or lender can quickly sell the loan on the secondary market. Originators profit from fees collected at the time of closing, so they focus on volume and make as many loans as possible. Many lenders and brokers repeatedly refinance loans, making thousands of dollars from each origination. The fees financed for each transaction drain wealth from homeowners, who see their home equity decrease rather than grow over time.

Second, a large segment of the subprime market operates to prevent qualified borrowers from receiving favorable credit terms. Up to 80% of subprime home loans contain burdensome prepayment penalties that can cost families thousands of dollars when they refinance or pay off their loans early. These are not provided in exchange for lower interest rates; they are simply another method of stripping home equity. Moreover, yield spread premiums encourage brokers to sell loans at interest rates higher than the rates for which borrowers qualify, and the market is not transparent enough for homeowners to shop effectively for better deals.

Third, industry has used its market power to limit homeowners' access to justice. Most subprime mortgage contracts require homeowners to give up their rights to go to court if any legal problems arise from their loans. All too often, families facing foreclosure because of abusive loans find they have no recourse through the court system. Furthermore, many cannot defend their homes because their loans have been sold into the secondary market without legal accountability.

Fourth, any new law to curb predatory mortgage lending must preserve and strengthen existing federal and state protections for homeowners. Current law contains certain essential consumer protections designed to address some of the egregious practices of the predatory mortgage industry. Because market flaws lead to a wide range of abuses that may vary from one region to another, coalitions of individual citizens and of diverse organizations have successfully fought for effective reforms at the state and local level.

Incentives in today's subprime mortgage market encourage the stripping of home equity wealth through fee-packed loans. Abusive subprime practices also trap homeowners in over-priced loans and contribute to an epidemic of foreclosures. We are open to effective solutions to these problems based on the principles outlined here. We look forward to working with you on this critical issue, and we appreciate your time and consideration.

Sincerely,

AARP

AFL-CIO

Leadership Conference on Civil Rights

National Association for the Advancement of Colored People

National Council of La Raza

National Urban League

Association of Community Organizations for Reform Now

Bronx Council on the Arts

California Reinvestment Coalition.

Coastal Enterprises Inc., Maine

Community Development Ventures Capital Association

Coalition of Community Development Financial Institutions

Center for Responsible Lending

Center for Community Change

Consumer Action

Consumer Federation of America

Consumers Union

Demos: A Network for Ideas and Action

Federation of Appalachian Housing Enterprises

Hispanic Organizations Leadership Alliance (HOLA)

Housing Assistance Council.

Inglewood Neighborhood Housing Services.

Latino Community Credit Union, North Carolina

National Association of Consumer Advocates

National Rural Housing Coalition

National American Indian Housing Council

National Federation of Community Development Credit Unions

National NeighborWorks Association

National Neighborhood Coalition

National Coalition for Asian Pacific American Community Development

NCB Development Corporation

National Community Reinvestment Coalition

National Community Capital Association

National Consumer Law Center

National Fair Housing Alliance

National People's Action

National Training and Information Center

Poverty and Race Research Action Council

Responsible Wealth

United for a Fair Economy

U.S. Public Interest Research Group

CENTER FOR RESPONSIBLE LENDING

Ney-Kanjorski Rolls Back Federal & State Protections Against Predatory Mortgage Lenders

H.R. 1295

CRL Policy Brief No. 11 April 2005

Predatory lenders cost homeowners and buyers more than $9 billion a year. In the last Congress Rep. Ney introduced H.R. 833, which purported that it would clamp down on these lenders. This year Rep. Ney introduced what he said was a compromise, H.R. 1295, with Rep. Kanjorski. Unfortunately, the new bill is even worse for homeowners. In its current form it would weaken federal law and wipe out strong state laws. H.R. 1295:

Rolls back the federal Home Ownership and Equity Protection Act by

- Removing many fees that are currently included when calculating the threshold for whether special protections apply to high-priced loans, such as single-premium credit insurance costs, which is so abusive that most lenders have abandoned the product
- Letting lenders tack on another 2% in fees on subprime loans, on top of other loopholes, before the threshold applies.
- Making it harder for federal regulators to protect homeowners from new abuses.

Fails to provide protections against practices that strip wealth from homeowners by

- Continuing to let lenders charge big penalties for paying off a loan early, locking buyers into expensive loans; and pay bonuses to brokers for steering buyers into expensive loans
- Failing to require counseling for homeowners considering a risky, high-cost loan
- Failing to include meaningful limits on financing exorbitant fees on risky, high-cost loans
- Failing to prevent lenders from "flipping" – repeatedly refinancing a loan just to generate fees
- Letting predatory lenders continue to use mandatory arbitration clauses on most home loans, forcing borrowers to give up their rights, when many lenders are abandoning this practice

Weakens enforcement and remedies by

- Lowering the cap on class-action awards in lawsuits involving high-cost mortgages and limiting judges' discretion on the damages predatory lenders should pay
- Making it easier for lenders to talk borrowers out of their right to rescind a home loan
- Rewriting the rules so investors who buy home loans have no incentive to check if a loan is predatory, and making it harder for owners to protect their homes from foreclosure
- Permitting lenders to escape liability by changing the loan terms after an action has been filed, in effect, avoiding any remedies available under the law.

Provides for sweeping preemption of state laws by

- Prohibiting states from regulating mortgage lending, including predatory lenders
- Requiring states to exempt many brokers from licensing standards, gutting state laws
- Prohibiting states from setting their own standards for lenders they do business with

CENTER FOR RESPONSIBLE LENDING

The Ney-Kanjorski Bill

Replaces effective state protections against predatory lending with a weak federal standard

CRL Bill Analysis: H.R. 1295 March 16, 2005

Representatives Robert Ney (R-OH) and Paul Kanjorski (D-PA) have introduced legislation that would preempt state anti-predatory mortgage lending laws that have proven effective at curbing abusive lending practices and would replace these state laws with a weak federal standard that falls far short of principles for effective legislation to eliminate predatory lending.

<u>The Ney and Kanjorski bill would fail to protect borrowers from predatory lending.</u> Existing state laws, federal legislation proposed by Representatives Miller, Watt and Frank, and current practices of responsible lenders provide much stronger and more effective protections for borrowers.

PROBLEMS WITH THE NEY-KANJORSKI BILL

Fails to take comprehensive approach to excessive points and fees.

The Ney-Kanjorski bill excludes almost all prepayment penalties and appears to exclude yield spread premiums from the calculation of whether a loan has points and fees at a level that triggers the protections in the Act.

- Protections for high-cost loans are only meaningful if all lender and broker compensation is included in the calculation to determine if a loan is a high-cost loan. Otherwise, unscrupulous lenders will evade the bill's scope simply by shifting compensation to these excluded fees.
- The Miller-Watt-Frank bill takes the approach of numerous state laws to include these fees, ensuring that all borrowers who receive high-cost loans are protected by anti-predatory lending legislation.
- Prepayment penalties on subprime loans strip hard-earned home equity, trap borrowers in unaffordable loans, and are tied by research to increased foreclosures. Under the Ney-Kanjorski proposal, penalties for paying off the home loan early are not counted towards whether a borrower has received a "high-cost" loan, except in rare circumstances where a lender refinances its own loan.
- Kickbacks to mortgage brokers, known as yield spread premiums, encourage the steering of borrowers into higher-priced loans than borrowers qualify for, but it appears this form of broker compensation is not treated like other fees in determining whether a borrower has received a "high-cost" loan in the Ney-Kanjorski proposal.

Fails to effectively address abusive loan flipping.

The Ney-Kanjorski bill addresses flipping only for high-cost loans, allowing lenders to repeatedly flip borrowers into loans that provide no net benefit as long as the upfront fees are only 4.99% of the loan amount each time and only applying the prohibition when a refinance is within two years of the original loan. The bill's exceptions to its flipping provision create a road map for abusive flips that would be permitted under the law. In contrast, Miller-Watt- Frank have followed the successful approach of North Carolina and other states, prohibiting abusive flipping practices on all home loans.

Fails to prevent equity-stripping for borrowers who receive high-cost loans.

Protections for high-cost loans apply only in those rare circumstances when borrowers incur more than 5% of the loan amount in points and fees or interest rates above approximately 12.5% in today's market, loans that put borrowers at extreme risk of equity loss or foreclosure. The Ney-Kanjorski bill would allow a lender to finance up to 5% of the loan amount in conjunction with a high-cost loan, and would not require any counseling prior to obtaining a loan.

- In many high-cost loans, borrowers never realize the significance of the exorbitant hidden fees on the loan because they don't pay for them in cash, but instead finance the points into the loan. Limits on financing high fees and a counseling requirement for high-cost loans are essential to deterring equity stripping through fees, making it much more difficult for lenders to mislead a borrower into agreeing to an overpriced loan and encouraging lenders to put risk into interest rate, a cost that is much more transparent to the borrower.
- The state of North Carolina and the Miller-Watt-Frank bill prohibit the financing of any fees on a high-cost loan, encouraging lenders to express any additional risk in the loan in terms of interest rate, rather than requiring borrowers to finance a loan with high fees out of their home equity. Many other states have adopted a similar approach, allowing only 2-3% of the loan amount to be financed on a loan with high fees.
- Similarly, the Miller-Watt-Frank bill and at least seven states, including Arkansas, Georgia, Massachusetts, North Carolina, New Jersey, New Mexico, and South Carolina require counseling for loans that have an extremely high interest rate or excessive points and fees.

Fails to ban mandatory arbitration on all home loans.

The Ney-Kanjorski proposal bans mandatory arbitration on high-cost home loans only, while the Miller-Watt-Frank bill prohibits the use of mandatory arbitration clauses in all home loans. Most of the leading subprime lenders, including Ameriquest, Countrywide, Option One, New Century, and Washington Mutual, prohibit mandatory arbitration on subprime loans, including subprime loans that fall well below any high-cost definition. As a result, the Ney-Kanjorski bill falls short of best practices in the industry.

Fails to prevent abusive prepayment penalties on subprime loans.

While the bill limits prepayment penalties on all home loans to 3 years, it permits lenders to charge a high prepayment fee (typically 4%-5% of the loan). An increasing number of subprime lenders have reduced the amount of these penalties, and the Ney-Kanjorski bill lags behind the market leaders. For instance, HSBC (Household) limits prepayment penalties to 2% of the loan amount. As a result, the bill endorses a practice that requires borrowers who have loans with higher interest rates to pay bigger prepayment penalties in order to refinance into a more affordable loan. Further, if enacted, the proposal would preempt laws in the majority of states that have prohibited or further limited prepayment penalties.

Significantly reduces assignee liability protections under existing federal law.

The Ney-Kanjorski bill would roll back protections available under current federal law that allow borrowers with high-cost loans to seek recourse if their loan has been sold on the secondary market. Because most subprime loans are sold, these severe limitations on assignee liability will mean that many borrowers will be unable to defend their home against foreclosure if they have received a predatory loan. In contrast, numerous states, including Illinois, Massachusetts, New Mexico, and North Carolina have found an effective approach to assignee liability that balances the ability of the secondary market to purchase subprime loans and the need for borrowers to be able to protect their home against abusive practices. Further, the Miller-Watt-Frank bill would maintain existing protections in the Home Ownership and Equity Protection Act (HOEPA) that have been in place and successful since 1994.

Broadly preempts state protections for homeowners.

Rather than preserve and strengthen existing state and federal protections for homeowners, the Ney-Kanjorski bill wipes out state anti-predatory lending laws that have been proven effective at preventing abusive practices and significantly weakens some protections available under the federal law today.

Includes numerous loopholes that undercut the stated purpose of the bill.

- While the Ney-Kanjorski bill purports to lower the points and fees threshold, changes to the definition of points and fees make the definition less inclusive than current federal law under HOEPA.
- Exceptions to a prohibition against subterfuge would in fact encourage loan-splitting, allowing lenders to avoid making a high-cost loan and thereby triggering protections for such loans.
- Exceptions to the ability to repay provision would limit its effectiveness and preempt ongoing state efforts to address such abuses.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

For additional information, please visit our website at **www.responsiblelending.org**.

Home Insecurity

How Widespread Appraisal Fraud Puts Homeowners at Risk

BY DAVID CALLAHAN

Borrowing to Make Ends Meet Briefing Paper #4, March 2005

While many U.S. households have benefited from the recent rise in real estate prices, homeowners who have bought at record high prices are vulnerable to a fall in property values that could leave them owing more on their mortgage than their home is worth. This risk is aggravated by the fact that many Americans have reduced the equity in their home to pay off credit card debts and cover day-to-day expenses. More troubling still is evidence that many appraisers fraudulently inflate property values during the buying or refinancing of homes. This paper explores the implications of appraisal fraud.

Key Findings

- Serious conflicts of interest pervade the mortgage industry. Lenders, brokers, and real estate agents often have an incentive to inflate the value of residential properties. The process of appraising a property — among the most important steps in either the purchase or refinancing of a home — is sometimes done dishonestly as appraisers go along with requests to overstate the value of a home.
- Appraisal fraud can lead homeowners to borrow more money than their homes are worth, putting themselves at risk of being "upside down" in a home — e.g., not being able to sell for a high enough price to pay off their mortgage — even if there is no downturn in the real estate market.
- Appraisal fraud is not a new problem, but the refinancing boom — in which homeowners have cashed out over $450 billion in home equity since 2001 — has created fresh incentives for self-interested parties to collude in the overstatement of property values.
- Up to half of all appraisers have reported feeling pressures from lenders or brokers to overstate property values. Many appraisers go along with these pressures out of fear of losing future work. Appraisers who have not complied with such pressures report not being paid for work and being blacklisted by lenders and brokers.
- The inflation of home prices through appraisal fraud may be helping to push real estate prices up to unsustainable levels and contributing to a housing "bubble." Some observers believe that appraisal fraud helps explain high foreclosure rates in certain parts of the nation.
- Predatory lending targeting minority and sub-prime borrowers often involves appraisal fraud. Low-income aspiring homeowners are also targeted by developers who collude with dishonest appraisers in the aggressive marketing of new homes offered at inflated prices.
- Government oversight of the appraisal process is inadequate. Key participants in the mortgage industry, such as mortgage brokers, are unregulated in many states and oversight of lending institutions is often very weak. State boards that license appraisers and investigate reports of fraud often lack enough resources. New reform steps are urgently needed.

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Assets at Risk

The real estate boom has delivered rising property values to millions of homeowners over the past five years — as well as soaring mortgage burdens for Americans buying homes at record high prices. While the boom has greatly strengthened the financial position of some households, many others face growing financial insecurity. Homeowners are spending a higher percentage of their income on mortgages than ever before and also carry unprecedented levels of credit card debt. The ratio of household debt to income has risen steeply in the past five years to an all-time high, while savings have declined. Average credit card debt among all families increased by 53 percent between 1989 and 2001, with lower income households experiencing even higher increases. In the past few years, larger debt burdens have been aggravated by stagnant or falling wages and rising healthcare costs.[1]

Many Americans have taken on mortgages that exceed the true market value of their homes thanks to appraisal fraud.

In the face of rising financial pressures, many homeowners have tapped the growing equity in their home to meet current living expenses. American households pulled out a record $458 billion worth of equity from their homes between 2001 and 2004, according to data from Freddie Mac.[2] This trend is expected to continue in 2005. As reported in an earlier Demos briefing paper, "House of Cards," a majority of refinancing loans have been used to repay other loans, such as credit card debts, or to cover consumer expenditures. Adjustable rate mortgages accounted for 34 percent of these new loans in 2004, leaving borrowers vulnerable to a rise in interest rates. Today, the homeownership rate stands at a record 69 percent, but Americans actually own less of their homes than they did thirty years ago. Homeowner equity fell to 55 percent in 2004, down from 68 percent in the early 1970s.[3]

Homeowners who refinanced their homes based on current high real estate values face major risks if prices should fall. Also at risk are the millions of homeowners who have purchased their homes in the past few years. Overall, the net effect of the surging real estate market and the accompanying refinancing craze is that the financial well-being of American households hinges as rarely before on the continued strength of property values. And, in an ominous development for both the economy and individuals, many Americans have taken on mortgages that exceed the true market value of their homes thanks to appraisal fraud.

What Is Appraisal Fraud?

The real estate boom in recent years has meant record levels of business — and profits — for banks, mortgage brokers, and others who originate mortgage loans. But this boom has had a dark side. Evidence suggests that property appraisals, perhaps the most critical step in the mortgage process, are not always conducted honestly. Indeed, the financial incentives of those involved in this process often work against securing an honest appraisal of a home's value.

Appraisal fraud can take different forms. When a home is being purchased or refinanced, the lender or broker — as well as the consumer — may seek to have it appraised for more than its actual value. Lenders may look for an appraiser who will appraise the home for the desired value, and even request that an appraiser not appraise a property unless they will confirm that price. In other cases, lenders or brokers may commission several appraisals and use the one that confirms the price they want. Or they may pressure an appraiser to adjust their appraisal upward. They may withhold payment for an appraisal unless this demand is met. The goal of lenders or brokers — who are generally paid on commission based on the value of the mortgage — is to ensure that the loan will close without any problems. An appraisal that comes in below the value of the desired loan amount could jeopardize a completed transaction. Real estate agents have the same interest, and are also known to exert pressures for dishonest appraisals. Developers who directly market new homes may also exert such pressure.

The refinancing boom has aggravated the problem of appraisal fraud by increasing the incentives for dishonesty. Take the example of a homeowner with a house whose true value is $150,000 and who has $140,000 in outstanding mortgage debt, as well as $20,000 in credit card debt. If the homeowner wants to refinance in order to pay off credit card debt, he or she will need a new mortgage loan that is based upon an appraisal of the home that is above its true value. (*See Table 1.*) A lender or broker may encourage the homeowner to believe that the home is worth this money, and find an appraiser who will appraise the property for this value. Without the dishonest appraisal, there will be no basis for refinancing the loan at all.

Table 1. How Appraisal Fraud Puts Homeowners at Risk

	Market Value	*Appraised Value*	*Mortgage Outstanding*	*Loan to Value*
Old Loan	$150,000	$150,000	$140,000	93%
	Market Value	*Fraudulent Appraisal*	*Mortgage Outstanding*	*Loan to Value*
Refinanced Loan With Inflated Appraisal	$150,000	$170,000	$160,000	107%

Another incentive for dishonesty is that, today, those parties who originate mortgage loans are less likely to pay a price if the borrower defaults. In a big change from the past, third-party mortgage brokers play a growing role in originating loans — by some estimates up to 70 percent of all mortgages.[4] Likewise, lenders used to have a greater interest in ensuring that the appraisals were accurate, since they held the mortgage debt extended to borrowers. Now, many mortgages are quickly sold to a large secondary market of debt holders such as quasi-government sponsored entities like Freddie Mac and Fannie Mae. In principle, these secondary holders of mortgage-backed securities can force lenders to buy back loans where property values have been overstated, and many larger lenders have rigorous systems in place to ensure that appraisals are accurate so that this doesn't happen. In practice, the risk of such forced buybacks can seem low and lenders may worry less than they used to about being stuck with a foreclosed property that is worth less than its appraised value.

The financial incentives of those involved in the mortgage process often work against an honest appraisal of a home's value.

Appraisers also have a financial interest in providing appraisals that may not be accurate. Their livelihoods are dependent on a steady stream of work from lenders and mortgage brokers. An appraiser who fails to deliver the desired appraisal, thus torpedoing a loan deal, may find that he or she does not receive future work from that particular lender or broker.

In some jurisdictions, weak government oversight (see below) means there is little risk that a dishonest appraiser will be punished for overstating the price of a property.

Consumers may accentuate the problem of appraisal fraud by not looking out for their long-term interests. Typically, they just want to complete the mortgage or refinancing process as quickly as possible, and may exert pressure on brokers or lenders to get the deal closed without any hitches. When purchasing a home, buyers are likely to assume that the price they are paying reflects "where the market is at" and insomuch as they pay attention to the appraisal process it is with an eye toward having it done quickly and without problems. They may look more critically at this step when refinancing, but their keen desire to pull out low-cost cash from their home — and their hopeful views about the direction of real estate prices — may override any caution about ending up with a mortgage worth more than the home.

Consumers are also prey to aggressive brokers or lenders who have an interest in closing a refinancing deal at the highest loan amount possible. Bombarded by solicitations for refinancing, many of which contain misleading information, consumers are easy targets for manipulation. Unwittingly, consumers put their financial well-being in the hands of two parties — the lender or broker, and a handpicked appraiser — who bring conflicts of interest to the job of assessing the value of their home. Most consumers never consider hiring an independent appraiser.

Evidence of Appraisal Fraud

There is no comprehensive data on the incidence of appraisal fraud, and by its nature this type of fraud can be difficult to prove since real estate prices are often subjective. A large variety of factors determine the price of a home, from trends in a fast-changing market to the condition and location of a property. In cases where an appraisal seems inflated, it can be hard to say whether an appraiser knowingly overstated value. All that said, available evidence suggests that the deliberate manipulation of property values is pervasive.

In 2003, October Research, a private firm, conducted the National Appraisal Survey, which polled 500 appraisers in 44 states about their professional experiences. The findings were startling. The survey found that 55 percent of appraisers reported that they had felt pressures to overstate property values. A quarter of the appraisers surveyed reported feeling such pressures in half of all appraisals that they handled.[5]

Fifty-five percent of appraisers reported that they had felt pressures to overstate property values.

In March 2004, the National Association of Realtors — representing over one million realtors — stated to a Senate subcommittee that the problem of lender pressure and appraisal fraud seemed to have worsened: "Increasingly there is evidence that the use of such pressure is widespread in the appraisal field. These pressures are beginning to erode the independent judgment of appraisers, and are contributing to the ability of unscrupulous individuals to engage in improper loan practices, including property flipping and predatory lending schemes."[6]

Perhaps the most persuasive evidence of the problem is that over 8,000 appraisers have signed a petition to the federal government complaining that the lending industry has "individuals within their ranks, who, as a normal course of business, apply pressure on appraisers to hit or exceed a predetermined value. This pressure comes in many forms and includes the following: the withholding of business if we refuse to inflate values; the withholding of business if we refuse to guarantee a predetermined value; the withholding of business if we refuse to ignore deficiencies in the property; refusing to pay for an appraisal that does not give them what they want; and black listing honest appraisers in order to use 'rubber stamp' appraisers, etc." In signing the petition, many appraisers have posted comments underscoring the severity of the situation. "This is a HUGE problem," reads a typical comment, by Teri Hoke of Mount Holly, North Carolina.

Data collected by the Mortgage Asset Research Institute (MARI) also sheds light on the extent of appraisal fraud. Over the past decade, mortgage lenders, insurers, and other participants in the mortgage industry have reported information to MARI about the problem of mortgage fraud. An April 2004 analysis of data from 2000 through 2003 indicated that while appraisal fraud was not the most common form of mortgage fraud — dishonesty on applications and financial statements topped the list — it was clearly a problem, ranging from a low of 10 percent of fraud cases in 2003 to a high of 38 percent in 2000. However, the authors of the report noted that the actual incidence of appraisal fraud was likely higher than the data indicated.[8]

Appraisers Face Intense Pressures

Testimonials by individual appraisers provide yet more evidence of the endemic nature of appraisal fraud. While the general public remains in the dark about the profound conflicts of interest that surround the mortgage business, this problem is an open topic of discussion among appraisers. The view of many appraisers is that the appraisal process is rife with lender or broker pressures and fraudulent appraisals. For this policy brief, Demos gathered appraiser testimonials from industry newsletters, Internet discussion forums, and direct correspondence with appraisers.

Bob Burnitt is a Texas appraiser who recently quit the profession because of the pervasiveness of fraud. Burnitt commented to the *Realty Times* that "without a shadow of a doubt, real estate appraisal is the most corrupt 'profession' I have ever seen. ... I have lost every single 'good' client I have ever had for the same 'reason.' Sooner or later, I do an appraisal that doesn't 'make value' and that is it, I'm fired. Time and time again. During the so-called 're-fi boom' loan officers absolutely demanded that I either lie or inflate an appraisal for them. When I tell them I can't do that, it is unethical and illegal, they just hang up the phone and call my competition."[9]

Ray Miller, an appraiser from Wisconsin, summed up the problem this way in a recent correspondence with Demos: "You have no clue how the mortgage brokers refuse to pay for appraisals if you don't get the value they need. How they shop around until they find an appraiser who will hit the numbers. How they tell the home owners that if the appraiser does not hit the numbers they are bad appraisers. How they try and force an appraiser to violate USPAP [Uniform Standards of Professional Appraisal Practice] state and federal rules and regs. I would be willing to say that 33 percent of appraisals have been fudged upwards." Miller says lenders or brokers owe him $30,000 for appraisals that did not meet

Destroying Dreams

Appraisal Fraud and Foreclosures in the Poconos

Appraisal fraud is linked to heartbreaking stories of mortgage foreclosure across the nation. Some of the worst abuses have occurred in the Poconos area of Pennsylvania, two hours from New York City, where one in five mortgaged homes has been foreclosed since 1995. Over the past decade, homebuilders have heavily developed the region and have advertised new homes to residents of New York City. Many of the first-time homebuyers in the Poconos have been African-American and Latino families from the Bronx and Brooklyn in search of affordable homes and a better life. What they have found instead is a nightmare.[7]

Unfamiliar with the local real estate market, and subjected to high-pressure and dishonest sales tactics, buyers from the city bought homes at prices that seemed great by New York standards but were far above market value. Many of the homes were shoddy in their construction, at least to a trained eye. But dishonest appraisers, handpicked by developers, signed off on the mortgage loans — mortgages that often consumed more than half of the buyers' monthly incomes. Homeowners who later tried to sell or refinance their homes found that the difference between the price they had paid and market value was as high as $80,000. There have been nearly 6,000 foreclosures in the Poconos county of Monroe since 1995, with many families losing all the down payment equity that they had put into their home purchase.

An independent appraisal process would have prevented many of the Poconos loans from ever being made. But as documented by the *Pocono Record*, appraisers were directly asked by the developers to overstate property values in exchange for high fees. Some went along. Those who didn't were threatened and told they wouldn't get future work. Revelations about the housing scams in the Poconos have resulted in criminal charges for at least one appraiser, as well as for developers. But the conditions under this fraud occurred remain unchanged. Like most states, Pennsylvania does not have any laws that bar lenders or brokers from colluding with appraisers to overstate property values. In addition, as outlined later in this report, Pennsylvania does not always do an effective job of responding to complaints from appraisers about lender pressures. The state is said to be considering tougher laws in this area.

the desired value. An Internet forum that lists "deadbeats" who haven't paid appraisers features a running tally of unpaid bills. As of mid-February 2005, over 1,000 "deadbeats" were listed and owed appraisers nearly $1 million.

Lee Lansford, an appraiser from Illinois, commented in a correspondence with Demos, "I've been appraising residential properties since 1983 and I've seen a significant — major — increase in blatant fraudulent-type behavior in the lending and appraisal arenas. ... There are too many times when either individuals, or entities, with a direct financial stake in seeing to it that a loan transaction closes also has responsibility for the selection and retention of the appraiser who performs the appraisal. This is not a good situation."

In another correspondence with Demos, Pamela Crowley, an appraiser from Florida, commented that mortgage appraisal orders often demand, even in writing, that appraisers ensure that they will meet certain numbers or they will not be sent the appraisal order. Loan originators, mortgage brokers, and real estate agents that demand the use of specific appraisers that will do whatever they're told, she says, "are running the honest and competent appraisers out of business."

Only a few states have laws that prohibit lenders or brokers from pressuring appraisers to overstate values.

In an Internet forum, an appraiser from Denver echoed some of these points, saying that "finding a mortgage broker client who wants a fair market value on one of their deals is like finding a needle in a haystack these days. They'll do anything and everything they can to get a commitment from the appraiser that guarantees the needed value before they'll send an appraisal order. Sadly, plenty of appraisers have their own bills to pay and families to feed, so they play ball." This appraiser goes on to comment on the pressures put upon honest appraisers and how such appraisers are often blackballed from further work. She suggests that the real estate market in Denver was artificially propped up by dishonest appraisal practices following the tech bust and the economic downturn of 2001, with homeowners now paying the price. "Appraisers continued to push values for a solid year after that, using increasingly older comparable sales to justify higher values, in spite of a growing number of homes being put on the market for sale, a clear indicator that the market was stabilizing. ... What we have left now is many homeowners who are upside-down, or close to it, on their mortgages. They can't sell for what they currently owe, so they're left with few choices."

Some of the most vivid evidence of appraiser fraud is found in documents from lenders or brokers that blatantly pressure or threaten appraisers. Several such documents have been collected by appraisers and posted on an Internet site, http://appraisersforum.com. An email from one lender to an appraiser reads: "Unless you can change the appraised value to what I requested, I am going to instruct payroll not to pay for that appraisal." Another email from a lender reads: "Thanks for the appraisal. But dude we ordered this thing at 92K. ... This loan is dead unless we get to 92K."

Weak Laws, Silent Watchdogs

Given how critical an honest appraisal is to the mortgage process, one might think the growing frequency of appraisal fraud would have triggered new regulatory steps in recent years. One would be wrong. Appraisal fraud remains a common problem because, even as evidence of misconduct has mounted, neither the federal government nor most states have taken decisive steps to fix an obviously broken system.

The federal government is the chief watchdog that regulates the banking industry. But federal efforts to prevent appraisal fraud have been ineffective. Recent federal standards issued by the U.S. Treasury clearly call on lenders to respect the independent judgment of appraisers — echoing previous federal statements — but these guidelines do not have the force of regulatory law. Moreover, many loan originators in the mortgage process — such as brokers — are not regulated at all under federal banking statutes. So even if there were a clear federal law preventing pressure on appraisers, such a law would not cover some of the worst offenders. To the extent that federal law enforcement agencies such as the FBI can go after perpetrators of appraisal fraud, it by using other laws (e.g., mail fraud laws) to build a case that illegal activity has occurred.

States have also done a poor job in this area. Only a few states have laws that prohibit lenders or brokers from applying inappropriate pressure on appraisers. Many states do not regulate mortgage brokers or mortgage originators through a licensing process. This means that, in much of the nation, neither the federal nor state government has leverage over those actors who play the biggest role in today's mortgage industry — and who are responsible for most of the pressure on appraisers.

Regulators lack the resources to investigate and punish illegal behavior.

In contrast, the appraisal profession is governed by various federal and state regulations, most of which focus on standards for conducting appraisals and ensuring that appraisers are qualified to do their jobs. Appraisers complain that this regulatory apparatus is cumbersome and overreaching (a "bureaucratic nightmare," according one appraiser) even as the biggest problem around appraisals — lender pressure to overstate values — goes unaddressed. Appraisers also complain that appraisers are most exposed to possible punitive action in cases of appraisal fraud — such as losing their license — while lenders face few possible consequences. Meanwhile, appraisers who are subjected to pressure from lenders or brokers often don't know where to file a complaint. Because pressures on appraisers can come from various actors — banks, mortgage brokers, real estate agents — and each of these actors is regulated by a different agency, or not regulated at all, it can be hard for an appraiser to determine where to seek redress. As the Appraisal Institute notes, "This difficulty in deciphering the proper reporting mechanism allows many instances to go unreported."

Disciplinary action for those involved in appraisal fraud can vary widely across jurisdictions. In some states, such as Florida, state appraisal licensing and certification boards regularly take action against dishonest appraisers. Penalties include fines, suspensions, and license revocations. The FBI and Justice Department have also been active in investigating appraisal fraud in various states. According to an article in *Realty Times*, appraisers increasingly turn to the Bureau for redress in cases of lender pressure.[10]

Appraisers who are subjected to pressure often don't know where to file a complaint.

One big reason for an absence of aggressive enforcement is that regulators lack adequate resources for investigating and disciplining illegal behavior. According to a 2003 study by the General Accounting Office on oversight of the real estate appraisal industry, state agencies overseeing appraisers only have an average of three staff members. The report, which surveyed all states, found that "about two-thirds of the states said that they needed additional funding to conduct investigations, and over three quarters said they needed additional staff."[11]

Why aren't there more resources available to government watchdogs? Good question. Key policymakers and legislators are clearly aware of the pervasive nature of appraisal fraud, thanks to efforts by appraisers to raise awareness about the problem and press for reform. For example, the Appraisers Petition (http://appraiserspetition.com) mentioned earlier calls for more ethical practices in the mortgage industry. The petition, begun in 1999, is a plea to the Appraisal Subcommittee of the Federal Financial Institutions Examination Council, a federal agency, for stronger accountability in the mortgage industry around appraisal matters. The 8,100 signatures gathered so far are testament

Complaints Go Ignored

Many appraisers report frustration with state regulators. When complaints are filed, action may not be taken by regulators, even when action would seem to be clearly called for. David Wilson (not his real name), an appraiser in Pennsylvania, recounted such an episode in a message to an Internet forum. "I was told I was not getting paid [for an appraisal] after I submitted my report which was below the value they needed to make the loan. An office assistant called and told me they were not paying me for my report because they found another appraiser 24 miles out of town who could come up with the value they needed."

The other appraiser's value was $45,000 over what Wilson had estimated. Wilson also learned that the appraiser had not even made an inspection of the property and was able to ensure the value the lender wanted, sight unseen.

Wilson complained to the Consumer Services Division of the Pennsylvania Department of Banking about the incident. The lender responded by claiming that Wilson had undertaken the appraisal without being asked to, and even though Wilson had an appraisal order from the lender, this excuse was accepted by the Department of Banking. Wilson was told that if he wanted to make a complaint against the lender, he should hire legal counsel.

After the incident, Wilson commented, "I hear many complaints like mine against lenders and I want to know who enforces this type of behavior by these lenders who walk all over us. ... I ask, again, who do we report these illegal acts to?"

to the strong desire among appraisers for reform in the industry.

Beyond this initiative, individual appraisers have pushed for reform. Bob Burnitt, the Texas appraiser, tells of his efforts to make change happen. "I have met face-to-face with my Congressman and supplied him with plenty of documentation that loan fraud and inflated, fraudulent appraisal practices are rampant, and his reply was, 'Oh, that's just human nature, I can't do anything about that.'"

"My State Representative ... is equally aware of this situation. Same reaction, 'can't do anything about it.' My State Senator ... has also been advised of the situation as well." Burnitt comments further about the failure of key agencies and associations in Texas, including the Texas Appraiser Licensing and Certification Board, the Texas Real Estate Commission, the Texas Savings and Loan Department, and the Texas Association of Realtors. "All these agencies and associations are aware of the situation and are simply looking the other way."[12]

While some legislators do take the problem of appraisal fraud seriously, so far they are a small minority. At the federal level, proposed congressional legislation to address this problem — introduced on several occasions in recent years by Representative Jan Schakowsky of Illinois — has failed to garner much support. Likewise, there has been little action at the state level.

Fixing the Problem

The conflicts of interest around real estate appraisal practices pose serious risks to homeowners and new homebuyers. In most parts of the country, these risks have been masked by continually rising real estate prices. However, if there is a leveling off or decline in property values, the consequences of appraisal fraud could be devastating for millions of Americans. The experience of trapped homeowners in Denver, as discussed earlier, may provide a glimpse of the heartache that lies ahead in other parts of the United States. It is imperative to reform the mortgage industry now, while real estate prices remain strong. Given the considerable body of regulation that already surrounds the appraisal profession, new reform efforts must be developed carefully. *The principal recommendation of this policy report is that there should be an independent and thorough investigation of the scope and causes of appraisal fraud by an appropriate federal agency. Such an investigation should be mounted in collaboration with state regulators, with input from a range of actors in the mortgage industry. A set of reform proposals should be developed from this process.*

It is clear that several kinds of reforms will be needed to reduce appraisal fraud: New rules to ensure the independence of appraisers, stronger sanctions on appraisers who overstate property values, tougher punishment of lenders or brokers who pressure appraisers, streamlined processes for filing complaints in cases of lender or broker pressure, additional government enforcement capacity, and new efforts to educate consumers. These and other reforms should be achieved through a combination of industry self-regulation and more effective government oversight. Each approach is discussed below.

- *Ensure Appraiser Independence.* New rules are needed to ensure that appraisers can act with independence. Currently, lenders and brokers have wide latitude in choosing who to ask to appraise a property. This creates an obvious potential for abuse, allowing lenders or brokers to choose appraisers known to be dishonest or "shop" for an appraiser who will hit their number. The remedy for this problem is to greatly reduce or eliminate contact between appraisers and lenders or brokers. Echoing the sentiments of many in her profession, appraiser Pamela Crowley commented in correspondence with Demos that appraisal fraud wouldn't stop "until/unless the people pushing the appraisers to inflate the values are no longer able to have anything to do with ordering or paying for the appraisal." Exactly how such a critical reform might be enacted and enforced is a question that must be studied carefully.
- *Punish Lenders, Brokers, and Real Estate Agents Who Pressure Appraisers.* Loan originators and others, like real estate agents, who pressure appraisers to overstate property values should face stiffer punishment. There needs to be greater deterrence of wrongdoing across the range of entities involved in originating mortgage loans. At least two steps are needed to accomplish this goal: First, both the federal government and all states should expressly prohibit the pressuring of appraisers. Second, all actors in the mortgage process should be accountable to a regulatory authority — and, in particular, all states should require the licensing of mortgage brokers and other loan originators.

Those who pressure appraisers should face stiffer punishment.

- *Sanction Dishonest Appraisers.* Even as appraisers agree that most of the burden for changed behavior lies with lenders and brokers, there is also some agreement that there should be tougher sanctions of those appraisers who go along with requests to inflate property values. Currently, honest appraisers may find themselves at a competitive disadvantage in their profession because of lax punishment of dishonest appraisers. This must change. If dishonest appraisers truly feared losing their licenses, they would be more reluctant to give in to lender pressures. In turn, lenders or brokers would have a harder time finding dishonest appraisers. The implicit threat that lenders or brokers can now invoke — "If you don't hit the number I want, another appraiser will" — would carry less weight as more appraisers refuse these requests on the grounds that "I might lose my license if I do that." Exactly how tougher sanctions of appraisers might work should be determined by the study recommended above.
- *Streamline the Complaint Processes.* Appraisers who are subjected to lender or broker pressures — or denied payment for an appraisal that comes in too low — often find it difficult to file a complaint about such behavior because different agencies regulate different kinds of loan originators. There should be more formalized and effective means for filing complaints. In 2003, the Appraisal Institute and several other groups called on federal financial institution regulators to formulate an

appraiser complaint policy. Such a policy would provide a point of contact in each agency for appraisers to submit complaints, explain how such complaints should be submitted, and clarify how complaints would be investigated. This recommendation should be acted upon.

- *Increase Enforcement Capacity.* Regardless of what new regulations are enacted, there must be more capacity to enforce the law. As noted earlier, most state licensing boards lack the resources to fulfill their responsibilities. Some federal agencies engaged in oversight of various actors involved in the mortgage process also lack enough capacity. New investments in oversight are urgently needed.
- *Educate Consumers.* A further solution is to better educate consumers about the problem of appraisal fraud and, more generally, about the potential downsides of home buying and refinancing. As the real estate market has boomed in recent years, lenders, brokers, and developers have invested heavily in selling a one-sided story about how Americans can improve their financial future. Consumers have been urged to buy into new housing developments while the new homes last, to treat their home equity like a bottomless ATM, and to exchange high-interest credit card debt for low-interest mortgage debt. In an atmosphere of what some experts have called "panic" home buying and refinancing, many Americans have unwittingly encouraged appraisal fraud by pressuring lenders to wrap up deals quickly, by paying no attention to the appraisal step, and by readily accepting higher levels of financial risk than is prudent.

  The real estate boom has granted windfalls to millions of Americans. But many Americans, also, have made rash and uninformed decisions in this area that will haunt them financially for the rest of their lives. Major lenders can play a leading role in consumer education by better explaining what an appraisal is and how it is done. Consumers should be told, for example, that they have the right to see the appraisal, along with the data that it was based upon. The option of an independent appraisal, and the benefits of such a step, should be explained. Government agencies can play an important role here. In the best case, state agencies would compel lenders and brokers to engage in more extensive and honest efforts to educate consumers about the mortgage process. Agencies at all levels of government that work with first-time home buyers should also take direct steps to educate them about the role that the appraisal plays in getting a mortgage and the potential for unethical conduct. At the very least, some agencies can play an active role in education by publicizing the problem of appraisal fraud and drawing attention to major incidents of such fraud. The media can play a constructive role in the same fashion.

There must be more capacity to enforce the law.

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Notes

1. For a full analysis of recent trends in credit card debt, and the causes of these trends, see: Tamara Draut and Javier Silva, "Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the '90s," Demos, 2004.
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7. This account is based on news reports, including a three-part series by the *Pocono Record* and several articles by *The New York Times*. See: Matthew Birkbeck, "I'm Going to Lose Everything," *Pocono Record*, April 8, 2001; and Michael Moss and Andrew Jacobs, "Blue Skies and Green Yards, All Lost to Red Ink," *The New York Times*, April 11, 2004, p. 1.
8. In those cases where one kind of fraud is present, such as false financial statements, the lender has no incentive to investigate further to see if other forms of fraud, such as appraisal fraud, were also involved. William Matthews, et. al., "Annual Case Report to National Home Equity Mortgage Association," Mortgage Asset Research Institute, Inc., April 2004.
9. Blanche Evans, "Sickened by Fraud, a Real Estate Appraiser Turns In His Pencil," *Realty Times*, January 17, 2005.
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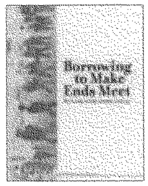
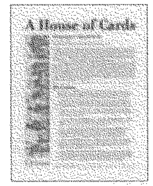
by Tamara Draut and Javier Silva



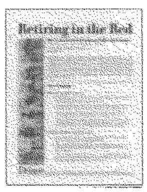
Using new data, this report illustrates how families are increasingly using credit cards to meet their basic needs. Also examines the factors driving this record-setting debt and the impact of financial services industry deregulation on the cost, availability and marketing of credit cards.

House of Cards: Refinancing the American Dream
by Javier Silva



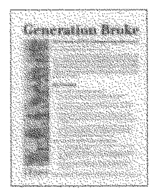
This report looks at the new financial insecurities facing homeowners as Americans cash out billions of dollars of home equity to cover rising living expenses and credit card debt.

Retiring in the Red: The Growth of Debt Among Older Americans
by Tamara Draut and Heather McGhee



This briefing paper documents the rise of credit card and mortgage debt of older Americans since 1992 and also delves into what is driving this disturbing trend.

Generation Broke: The Growth of Debt Among Younger Americans
by Tamara Draut and Javier Silva



This briefing paper documents the rise in credit card and student loan debt between 1992 and 2001 and examines the factors contributing to young adults' increased reliance on credit cards.

For more information about Dēmos' work on debt and assets, please contact:
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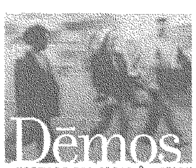
To access any of Dēmos' reports online, visit www.demos-usa.org.



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