

GAO

Report to the Chairman and Ranking
Minority Member, Special Committee on
Aging, U.S. Senate

January 2004

CONSUMER PROTECTION

Federal and State Agencies Face Challenges in Combating Predatory Lending



G A O

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Highlights of [GAO-04-280](#), a report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate

Why GAO Did This Study

While there is no universally accepted definition, the term “predatory lending” is used to characterize a range of practices, including deception, fraud, or manipulation, that a mortgage broker or lender may use to make a loan with terms that are disadvantageous to the borrower. No comprehensive data are available on the extent of these practices, but they appear most likely to occur among subprime mortgages—those made to borrowers with impaired credit or limited incomes. GAO was asked to examine actions taken by federal agencies and states to combat predatory lending; the roles played by the secondary market and by consumer education, mortgage counseling, and loan disclosure requirements; and the impact of predatory lending on the elderly.

What GAO Recommends

GAO suggests that Congress consider providing the Federal Reserve Board with the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of financial and bank holding companies to ensure compliance with federal consumer protection laws applicable to predatory lending. Congress should also consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

www.gao.gov/cgi-bin/getrpt?GAO-04-280.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at 202-512-8678 or woodd@gao.gov.

CONSUMER PROTECTION

Federal and State Agencies Face Challenges in Combating Predatory Lending

What GAO Found

While only one federal law—the Home Ownership and Equity Protection Act—is specifically designed to combat predatory lending, federal agencies have taken actions, sometimes jointly, under various federal consumer protection laws. The Federal Trade Commission (FTC) has played the most prominent enforcement role, filing 19 complaints and reaching multimillion dollar settlements. The Departments of Justice and Housing and Urban Development have also entered into predatory lending-related settlements, using laws such as the Fair Housing Act and the Real Estate Settlement Procedures Act. Federal banking regulators, including the Federal Reserve Board, report little evidence of predatory lending by the institutions they supervise. However, the nonbank subsidiaries of financial and bank holding companies—financial institutions which account for a significant portion of subprime mortgages—are subject to less federal supervision. While FTC is the primary federal enforcer of consumer protection laws for these entities, it is a law enforcement agency that conducts targeted investigations. In contrast, the Board is well equipped to routinely monitor and examine these entities and, thus, potentially deter predatory lending activities, but has not done so because its authority in this regard is less clear.

As of January 2004, 25 states, as well as several localities, had passed laws to address predatory lending, often by restricting the terms or provisions of certain high-cost loans; however, federal banking regulators have preempted some state laws for the institutions they supervise. Also, some states have strengthened their regulation and licensing of mortgage lenders and brokers.

The secondary market—where mortgage loans and mortgage-backed securities are bought and sold—benefits borrowers by expanding credit, but may facilitate predatory lending by allowing unscrupulous lenders to quickly sell off loans with predatory terms. In part to avoid certain risks, secondary market participants perform varying degrees of “due diligence” to screen out loans with predatory terms, but may be unable to identify all such loans.

GAO’s review of literature and interviews with consumer and federal officials suggest that consumer education, mortgage counseling, and loan disclosure requirements are useful, but may be of limited effectiveness in reducing predatory lending. A variety of factors limit their effectiveness, including the complexity of mortgage transactions, difficulties in reaching target audiences, and counselors’ inability to review loan documents.

While there are no comprehensive data, federal, state, and consumer advocacy officials report that the elderly have disproportionately been victims of predatory lending. According to these officials and relevant studies, older consumers may be targeted by predatory lenders because, among other things, they are more likely to have substantial home equity and may have physical or cognitive impairments that make them more vulnerable to an unscrupulous mortgage lender or broker.

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Abbreviations

CRA	Community Reinvestment Act
DOJ	Department of Justice
ECOA	Equal Credit Opportunity Act
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FTC	Federal Trade Commission
GAO	General Accounting Office
GSE	government-sponsored enterprise
HMDA	Home Mortgage Disclosure Act
HOEPA	Home Ownership and Equity Protection Act
HUD	Department of Housing and Urban Development
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RESPA	Real Estate Settlement Procedures Act
TILA	Truth in Lending Act

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United States General Accounting Office
Washington, D.C. 20548

January 30, 2004

The Honorable Larry E. Craig
Chairman
The Honorable John Breaux
Ranking Minority Member
Special Committee on Aging
United States Senate

This report responds to your request that we evaluate issues related to predatory home mortgage lending. As you requested, this report reviews (1) federal laws related to predatory lending and federal agencies' efforts to enforce them, (2) actions taken by states to address predatory lending, (3) the secondary market's role in facilitating or inhibiting predatory lending, (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending, and (5) the relationship between predatory lending activities and elderly consumers. This report includes a Matter for Congressional Consideration.

As agreed with your office, we plan no further distribution of this report until 30 days from its issuance date unless you publicly release its contents sooner. We will then send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member of the House Committee on Financial Services; the Secretary of the Department of Housing and Urban Development; the Secretary of the Department of the Treasury; the Chairman of the Federal Trade Commission; the Chairman of the Board of Governors of the Federal Reserve System; the Chairman of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Chairman of the National Credit Union Administration; and other interested parties. Copies will also be made available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

This report was prepared under the direction of Harry Medina, Assistant Director. Please contact Mr. Medina at (415) 904-2000 or me at (202) 512-8678 if you or your staff have any questions about this report. Major contributors to this report are listed in appendix VI.

David G. Wood

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Executive Summary

Purpose

Each year, millions of American consumers take out mortgage loans through mortgage brokers or lenders to purchase homes or refinance existing mortgage loans. While the majority of these transactions are legitimate and ultimately benefit borrowers, some have been found to be “predatory”—that is, to contain terms and conditions that ultimately harm borrowers. Loans with these features, often targeted at the elderly, minorities, and low-income homeowners, can strip borrowers of home equity built up over decades and cause them to lose their homes.

The Chair and Ranking Minority Member of the Senate Special Committee on Aging asked GAO to examine the efforts under way to combat predatory lending. GAO reviewed (1) federal laws related to predatory lending and federal agencies’ efforts to enforce them, (2) actions taken by states to address predatory lending, (3) the secondary market’s role in facilitating or inhibiting predatory lending, (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending, and (5) the relationship between predatory lending activities and elderly consumers. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans. To address these objectives, GAO reviewed data and interviewed officials from federal, state, and local agencies and from industry and consumer advocacy groups; examined federal, state, and local laws; and reviewed relevant literature. At GAO’s request, federal agencies identified enforcement or other actions they have taken to address predatory lending. GAO also obtained data from publicly available databases; the data were analyzed and found to be sufficiently reliable for this report. Chapter 1 provides the details of the scope and methodology of this report. The work was conducted between January 2003 and January 2004 in accordance with generally accepted government auditing standards.

Background

While there is no uniformly accepted definition of predatory lending, a number of practices are widely acknowledged to be predatory. These include, among other things, charging excessive fees and interest rates, lending without regard to borrowers’ ability to repay, refinancing borrowers’ loans repeatedly over a short period of time without any economic gain for the borrower, and committing outright fraud or deception—for example, falsifying documents or intentionally

misinforming borrowers about the terms of a loan.¹ These types of practices offer lenders that originate predatory loans potentially high returns even if borrowers default, since many of these loans require excessive up-front fees. No comprehensive data are available on the incidence of these practices, but banking regulators, consumer advocates, and industry participants generally agree that predatory loans are most likely to occur in the market for “subprime” loans. The subprime market serves borrowers who have limited incomes or poor or no credit histories, in contrast with the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. Originators of subprime loans most often are mortgage and consumer finance companies but can also be banks, thrifts, and other institutions.

Serious data limitations make the extent of predatory lending difficult to determine. However, there have been a number of major settlements resulting from government enforcement actions or private party lawsuits in the last 5 years that have accused lenders of abusive practices affecting large numbers of borrowers. For example, in October 2002, Household International, a large home mortgage lender, agreed to pay up to \$484 million to homeowners to settle states’ allegations that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and fees. In addition, the rate of foreclosures of subprime loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. Some consumer groups and industry observers have attributed this development, at least in part, to an increase in abusive lending, particularly of loans made without regard to borrowers’ ability to repay. Additionally, groups such as legal services agencies have reported seeing an ever-greater number of consumers, particularly the elderly and minorities, who are in danger of losing their homes as a result of predatory lending practices.

Results in Brief

Federal agencies have addressed predatory lending under a variety of federal laws, including the Home Ownership and Equity Protection Act (HOEPA), which was an amendment to the Truth in Lending Act (TILA) designed specifically to combat predatory lending, and other consumer protection laws such as the Federal Trade Commission Act (FTC Act), TILA generally, and the Real Estate Settlement Procedures Act (RESPA). The

¹Throughout this report, the terms “predatory lending” and “abusive lending” are used to refer to such practices.

Federal Trade Commission (FTC) has played a prominent role because it is responsible for implementing and enforcing certain federal laws among lending institutions that are not supervised by federal banking regulators. As of December 2003, FTC reported that it had taken 19 enforcement actions against mortgage lenders and brokers for predatory practices, including some actions that have resulted in multimillion dollar settlements. The Department of Housing and Urban Development's (HUD) enforcement activities related to abusive lending have focused on criminal fraud in its Federal Housing Administration (FHA) loan insurance program. The federal banking regulators—the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (the Board), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA)—report little evidence of predatory lending by the depository institutions that they supervise. However, concerns exist about nonbank mortgage lending companies that are owned by financial or bank holding companies, which have been involved in several notable enforcement actions involving allegations of abusive lending practices. While FTC has clear authority to conduct investigations and enforce consumer protection laws among these nonbank mortgage lending companies, as a law enforcement agency its role is to investigate possible violations rather than to act as a supervisory agency with routine monitoring and examination responsibilities. The Board may be better equipped to monitor and examine these subsidiaries' compliance with federal consumer protection laws and thus to deter predatory lending, but it does not have clear authority to do so.

According to a database that tracks state and local legislation, 25 states, 11 localities, and the District of Columbia have passed their own laws addressing predatory lending.² While these laws vary, most of them restrict the terms or provisions of mortgage loans originated within their jurisdictions. In addition, some states have strengthened the regulation and licensing of mortgage lenders and brokers, and state law enforcement agencies and banking regulators have taken a number of enforcement actions under state consumer protection and banking laws. Some federal regulators have asserted that federal law preempts some state predatory

²Information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation, and is current as of January 9, 2004. These laws only include state and local laws that placed actual restrictions on lending. For example, they do not include local ordinances that consisted solely of a resolution that condemned predatory lending.

lending laws for the institutions they regulate, stating that federally chartered lending institutions should be required to comply with a single uniform set of national regulations. Many state officials and consumer advocates, however, maintain that federal preemption interferes with the states' ability to protect consumers.

The secondary market for mortgage loans—which allows lenders and investors to sell and buy mortgages and mortgage-backed securities—provides lenders with an additional source of liquidity and may benefit borrowers by increasing access to credit and lowering interest rates. But the secondary market may also inadvertently serve to facilitate predatory lending, both by providing a source of funds for unscrupulous originators to quickly sell off loans with predatory terms and by reducing incentives for these originators to ensure that borrowers can repay their loans. Secondary market participants may use varying degrees of “due diligence”—a review and appraisal of legal and financial information—to avoid purchasing loans with abusive terms. Fannie Mae and Freddie Mac—which are relatively recent entrants in the subprime market—have due diligence processes that are designed, in part, to avoid purchasing loans that may have been harmful to consumers. Other firms may use due diligence not necessarily to avoid loans that may have harmed consumers but to avoid loans that are not in compliance with applicable law or that present undue financial or reputation risks. Some states have passed laws making secondary market buyers liable for violations by loan originators, although such laws may have the unintended consequence of reducing the availability of legitimate credit to consumers.

A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. GAO's review of literature and interviews with consumer and federal officials suggest that while tools such as consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending. For instance, consumer education is hampered by the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers and counselors' lack of access to relevant loan documents can hamper the effectiveness of mortgage counseling efforts, while the sheer volume of mortgage originations each year makes providing universal counseling difficult. And while efforts are under way to improve the federally required disclosures associated with mortgage loans, the complexity of mortgage transactions

also hinders these efforts, especially given the lack of financial sophistication among many borrowers who are targeted by predatory lenders.

While there are no comprehensive data, government officials and consumer advocacy organizations have reported that elderly consumers have been disproportionately targeted and victimized by predatory lenders. According to these officials and organizations, elderly consumers appear to be favored targets for several reasons—for example, because they may have substantial equity in their homes or live on limited incomes that make them susceptible to offers for quick access to cash. Further, some seniors have cognitive or physical impairments such as poor eyesight, hearing, or mobility that may limit their ability to access competitive sources of credit. Most consumer financial education efforts seek to serve the general consumer population, but a few education initiatives have focused specifically on predatory lending and the elderly. Most legal assistance related to predatory lending aims at assisting the general population of consumers, although some is focused on elderly consumers in particular.

Principal Findings

Federal Agencies Have Taken Enforcement and Other Actions to Address Predatory Lending, but Face Challenges

Federal agencies and regulators have used a number of federal laws to combat predatory lending practices. Among the most frequently used laws—HOEPA, the FTC Act, TILA, and RESPA—only HOEPA was specifically designed to address predatory lending. Enacted in 1994, HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization. However, HOEPA covers only loans that exceed certain rate or fee triggers, and although comprehensive data are lacking, it appears that HOEPA covers only a limited portion of all subprime loans. The FTC Act, enacted in 1914 and amended on numerous occasions, authorizes FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. TILA and RESPA are designed in part to provide consumers with accurate information about the cost of credit.

Other federal laws that have been used to address predatory lending practices include criminal fraud statutes that prohibit certain types of fraud sometimes used in abusive lending schemes, such as forgery and false

statements. Also, the Fair Housing Act and Equal Credit Opportunity Act—which prohibit discrimination in housing-related transactions and the extension of credit, respectively—have been used in cases against abusive lenders that have targeted certain protected groups.

Using these or other authorities, federal agencies have taken a number of enforcement actions and other steps, such as issuing guidance and revising regulations.

- Among federal agencies, FTC has a prominent role in combating predatory lending because of its responsibilities in implementing and enforcing certain federal laws among lending institutions that are not depository institutions supervised by federal banking regulators. FTC has reported that it has filed 19 complaints—17 since 1998—alleging deceptive or other illegal practices by mortgage lenders or brokers and that some actions have resulted in multimillion dollar settlements. For example, in 2002 FTC settled a complaint against a lender charged with engaging in systematic and widespread deceptive and abusive lending practices. According to FTC staff, close to 1 million borrowers will receive about \$240 million in restitution under the settlement.
- DOJ, which is responsible for enforcing certain federal civil rights laws, has filed an enforcement action on behalf of the FTC and identified two additional enforcement actions it has taken that are related to predatory mortgage lending practices. The statutes DOJ enforces only address predatory lending practices when they are alleged to be discriminatory.
- HUD has undertaken enforcement activities related to abusive lending that primarily focus on reducing losses to the FHA insurance fund, most notably violations of criminal fraud statutes and FHA regulations through “property flipping” schemes, which in some cases can harm borrowers by leaving them with mortgage loans that may far exceed the value of their homes.³ HUD has also taken three enforcement actions in abusive mortgage lending cases for violations of RESPA’s prohibitions on certain types of fees.

³HUD’s FHA mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

- Federal banking regulators have stated that their monitoring and examination activities have uncovered little evidence of predatory lending in federally regulated depository institutions. Four of the five federal banking regulators reported taking no formal enforcement actions involving predatory mortgage lending against the institutions they regulate, while the fifth—OCC—reported that it has taken one formal enforcement action against a bank engaged in abusive mortgage lending. Regulators noted that they have taken informal enforcement actions to address questionable practices raised during the examination process and required their institutions to take corrective action.
- The banking regulators have also issued guidance to the institutions they supervise on avoiding direct or indirect involvement in predatory lending. In addition, the Board has made changes to its regulations implementing HOEPA that, among other things, increase the number of loans HOEPA covers. The Board also made changes to its regulations implementing the Home Mortgage Disclosure Act that make it easier to analyze potential patterns of predatory lending.

Federal agencies and banking regulators have coordinated their efforts to address predatory lending on certain occasions through participation in interagency working groups and through joint enforcement actions. For example, FTC, DOJ, and HUD coordinated to take an enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws within its jurisdiction.

Issues related to federal oversight and regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Nonbank mortgage lending companies owned by financial or bank holding companies (nonbank mortgage lending subsidiaries), such as finance and mortgage companies, account for an estimated 24 percent of subprime loan originations, according to HUD, and some have been the target of notable federal and state enforcement actions involving allegations of abusive lending.⁴ FTC is the primary federal enforcer of consumer protection laws for these nonbank subsidiaries, but it is a law enforcement rather than supervisory agency. Thus, FTC's mission and resource allocations are focused on conducting investigations in response to consumer complaints and other information rather than on routine monitoring and examination

⁴These nonbank subsidiaries are owned by the financial holding companies or bank holding companies and are not the direct operating subsidiaries of the bank itself.

responsibilities. In contrast, the Board conducts periodic examinations of financial and bank holding companies and, under the Bank Holding Company Act, is authorized to monitor and examine the subsidiaries of a bank holding company under certain circumstances. However, this authority does not clearly extend to routine examinations of nonbank subsidiaries of these holding companies with regard to laws pertinent to predatory lending. In addition, the Board does not have specific authority under pertinent federal consumer protection laws to institute an enforcement action against a nonbank subsidiary of a financial or bank holding company. Granting the Board concurrent enforcement authority with the FTC for these nonbank subsidiaries of holding companies could help deter some predatory lending.

Many States Have Passed Laws Addressing Predatory Lending, but Federal Agencies Have Preempted Some Statutes

In response to concerns about the growth of predatory lending and the limitations of existing laws, 25 states, the District of Columbia, and 11 localities have passed their own laws addressing predatory lending practices, according to a database that tracks such laws. Most of these laws regulate and restrict the terms and characteristics of high-cost loans—that is, loans that exceed certain rate or fee thresholds. While some state statutes follow the thresholds for covered loans established in HOEPA, many set lower thresholds in order to cover more loans than the federal statute. The statutes vary, but they generally cover a variety of predatory practices, such as balloon payments and prepayment penalties, and some include restrictions on such things as mandatory arbitration clauses that can restrict borrowers' ability to obtain legal redress through the courts.

Some states have also increased the regulation of and licensing requirements for mortgage lenders and brokers, in part to address concerns that some unscrupulous lenders and brokers have been responsible for lending abuses and that these entities have not been adequately regulated. For example, some states have increased the educational requirements that lenders and brokers must meet in order to obtain a license. In recent years, state law enforcement agencies and banking regulators have also taken a number of actions against mortgage lenders involving predatory lending. For example, an official from Washington State's Department of Financial Institutions reported that the department had taken several enforcement actions to address predatory lending, including one that resulted in a lender being ordered to return more than \$700,000 to 120 Washington borrowers for allegedly deceiving them and charging prohibited fees.

Three federal banking regulators—NCUA, OCC, and OTS—have issued opinions stating that federal laws preempt some state predatory lending laws for the institutions that they regulate. The regulators note that such preemption creates a more uniform regulatory framework, relieves lending institutions of the burden of complying with a hodgepodge of state and federal laws, and avoids state laws that may restrict legitimate lending activities. State officials and consumer advocates that oppose preemption argue that federal laws do not effectively protect consumers against predatory lending practices and that federal regulators do not devote sufficient resources toward enforcement of consumer protection laws for the institutions they oversee.

The Secondary Market May Benefit Consumers but Can Also Facilitate Predatory Lending

In 2002, an estimated 63 percent of subprime loans, worth \$134 billion, were securitized and sold on the secondary market.⁵ The existence of a secondary market for subprime loans has benefited consumers by increasing the sources of funds available to subprime lenders, potentially lowering interest rates and origination costs for subprime loans. However, the secondary market may also inadvertently facilitate predatory lending by providing a source of funds for unscrupulous originators, allowing them to quickly sell off loans with predatory terms. Further, originators of subprime mortgage loans generally make their profits from high origination fees, and the existence of a secondary market may reduce the incentive for these lenders to ensure that borrowers can repay.

Purchasers of mortgage loans undertake a process of due diligence designed to avoid legal, financial, and reputational risk. Prior to the sale, purchasers typically review electronic data containing information on the loans, such as the loan amount, interest rate, and credit score of the borrower. Purchasers also often physically review a sample of individual loans, including such items as the loan application and settlement forms. However, the degree of due diligence purchasers undertake varies. Fannie Mae and Freddie Mac—which are estimated to account for a relatively small portion of the secondary market for subprime loans—told us that they undertake a series of measures aimed at avoiding the purchase of

⁵Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them on the secondary market. Secondary market purchasers may then hold the loans or pool together a group of loans and issue a security that is backed by a pool of mortgages (a “mortgage-backed security”).

loans with abusive characteristics that may have harmed borrowers. In contrast, according to some market participants, the due diligence of other secondary market purchasers of residential mortgages may be more narrowly focused on the creditworthiness of the loans and on their compliance with federal, state, and local laws. However, even the most stringent efforts cannot uncover some predatory loans. For example, due diligence by secondary market purchasers may be unable to uncover fraud that occurred during the loan underwriting or approval process, some excessive or unwarranted fees, or loan flipping.

Under some state and local legislation, purchasers of mortgages or mortgage-backed securities on the secondary market may be liable for violations committed by the originating lenders—referred to as “assignee liability” provisions. HOEPA contains such a provision for loans above certain thresholds, as do the antipredatory lending laws in at least eight states and the District of Columbia, according to a database that tracks state predatory lending laws. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders. However, according to some secondary market participants, assignee liability can also discourage legitimate lending activity. Secondary market purchasers that are unwilling to assume the potential risks associated with assignee liability provisions have stopped purchasing, or announced their intention to stop purchasing, mortgages originated in areas covered by such provisions. Credit rating agencies—whose decisions influence securitizers’ ability to sell the securities—have asserted that assignee liability provisions can make it difficult for them to measure the risk associated with pools of loans. Assignee liability provisions of the Georgia Fair Lending Act were blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

In response to widespread concern about low levels of financial literacy among consumers, federal agencies have conducted and funded financial education for consumers as a means of improving consumers’ financial literacy and, in some cases, raising consumers’ awareness of predatory lending practices. For example, FDIC sponsors a financial literacy program, MoneySmart, which is designed for low- and moderate-income individuals with little banking experience. Other federal agencies, including the Board, FTC, HUD, and OTS, engage in activities such as distributing educational literature, working with community groups, and

providing institutions they regulate with guidance on encouraging financial literacy. Federal agencies have also taken some actions to coordinate their efforts to educate consumers about predatory lending. For example, in October 2003, the Interagency Task Force on Fair Lending, which consists of 10 federal agencies, published a brochure that alerts consumers to the potential pitfalls of home equity loans, particularly high-cost loans. A number of states, nonprofits, and trade organizations also conduct consumer financial education activities, which sometimes focus specifically on raising awareness about predatory lending.

While representatives of the mortgage lending industry and consumer groups have noted that financial education may make some consumers less susceptible to abusive lending practices, GAO's review of literature and interviews with consumer and federal officials suggest that consumer education by itself has limits as a tool for deterring predatory lending. First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, provisions of the loan, and situation of the borrower—determine whether a loan is in a borrower's best interests. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms. Second, predatory lenders and brokers tend to use aggressive marketing tactics that are designed to confuse consumers. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to such tactics. Finally, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information.

Prepurchase mortgage counseling—which can offer a “third party” review of a prospective mortgage loan—may help borrowers avoid predatory loans, in part by alerting consumers to predatory loan terms and practices. HUD supports a network of approximately 1,700 HUD-approved counseling agencies across the country and in some cases provides funding for their activities. While beneficial, the role of mortgage counseling in preventing predatory lending is likely to be limited. Borrowers do not always attend such counseling, and when they do, counselors may not have access to all of the loan documents needed to review the full final terms and provisions before closing. In addition, counseling may be ineffective against lenders and brokers engaging in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents.

Finally, disclosures made during the mortgage loan process, while important, may be of limited usefulness in reducing the incidence of predatory lending practices. TILA and RESPA have requirements covering the content, form, and timing of the information that must be disclosed to borrowers. However, industry and consumer advocacy groups have publicly expressed dissatisfaction with the current disclosure system. HUD issued proposed rules in July 2002 intended to streamline the disclosure process and make disclosures more understandable and timely, and debate over the proposed rules has been contentious. Although improving loan disclosures would undoubtedly have benefits, once again the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices. Moreover, even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Finally, as with mortgage counseling, revised disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of loans in the disclosure documents themselves.

Predatory Lenders May Target Elderly Consumers

Consistent observational and anecdotal evidence, along with some limited data, indicates that, for a variety of reasons, elderly homeowners are disproportionately the targets of predatory lending. Abusive lenders tend to target homeowners who have substantial equity in their homes, as many older homeowners do. In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who may have limited incomes but require funds for major home repairs or medical expenses. Moreover, diseases and physical impairments associated with aging—such as declining vision, hearing, or mobility—can restrict elderly consumers' ability to access financial information and compare credit terms. Some older persons may also have diminished cognitive capacity, which can impair their ability to comprehend and make informed judgments on financial issues. Finally, several advocacy groups have noted that some elderly people lack social and family support systems, potentially increasing their susceptibility to unscrupulous lenders who may market loans by making home visits or offering other personal contact.

Because the elderly may be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some of their education efforts on this population. For example, the

Justice Department offers on its Web site the guide “Financial Crimes Against the Elderly,” which includes references to predatory lending. The Department of Health and Human Services’ Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory lending practices targeting older consumers. The AARP, which represents Americans age 50 and over, sponsors a number of financial education efforts, including a borrower’s kit that contains tips for avoiding predatory lending.

Consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons, although the Equal Credit Opportunity Act does prohibit unlawful discrimination on the basis of age in connection with any aspect of a credit transaction. Federal and state enforcement actions and private class-action lawsuits involving predatory lending generally seek to provide redress to large groups of consumers. Little comprehensive data exist on the age of consumers involved in these actions, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than \$60 million. An estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans. In addition, some nonprofit groups—such as the AARP Foundation Litigation, the National Consumer Law Center, and South Brooklyn Legal Services’ Foreclosure Prevention Project—provide legal services that focus, in part, on helping elderly victims of predatory lending.

Matters for Congressional Consideration

To enable greater oversight of and potentially deter predatory lending from occurring at certain nonbank lenders, Congress should consider making appropriate statutory changes to grant the Board of Governors of the Federal Reserve System the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices. Also, Congress should consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

Agency Comments and Our Evaluation

GAO provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated where appropriate. In addition, the Board, DOJ, FDIC, FTC, HUD, and NCUA provided general comments, which are discussed in greater detail at the end of chapter 2. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V.

The Board commented that, while the existing structure has not been a barrier to Federal Reserve oversight, the approach recommended in our Matter for Congressional Consideration would likely be beneficial by catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would pose tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on whether or not they are part of a holding company, and additional costs. Because nonbank mortgage lenders that are part of a financial or bank holding company currently can be examined by the Board in some circumstances, they are already subject to a different supervisory scheme than other such lenders. We agree that the costs to the lenders and the Board would increase to the extent the Board exercised any additional authority to monitor and examine nonbank lenders, and believe that Congress should consider both the potential costs and benefits of clarifying the Board's authorities.

The FTC expressed concern that our report could give the impression that we are suggesting that Congress consider giving the Board sole jurisdiction—rather than concurrent jurisdiction with FTC—over nonbank subsidiaries of holding companies. Our report did not intend to suggest that the Congress make any change that would necessarily affect FTC's existing authority for these entities, and we modified the report to clarify this point.

DOJ commented that the report will be helpful in assessing the department's role in the federal government's efforts to develop strategies to combat predatory lending. DOJ disagreed with our inclusion in the report of "property or loan flips," which it said was a traditional fraud scheme but not a type of predatory lending. As we noted in our report, there is no precise definition of predatory lending. We incorporated a discussion of property flipping—quick resales of recently sold FHA properties—because HUD officials characterize some of these schemes as involving predatory practices that can harm borrowers. We included loan

flipping—the rapid and repeated refinancing of a loan without benefit to the borrower—in our report because this is widely characterized in the literature and by federal, state, and nonprofit agency officials as a predatory lending practice.

FDIC noted that our Matter for Congressional Consideration focuses on nonbank subsidiaries of holding companies even though these entities comprise, according to HUD, only about 20 percent of all subprime lenders. We recognize that our Matter does not address all subprime lenders or other institutions that may be engaging in predatory lending, but believe it represents a potential step in addressing predatory lending among a significant segment of mortgage lenders. NCUA said that the report provides a useful discussion of the issues and the agency concurs with our Matter for Congressional Consideration. HUD, in its comment letter, described a variety of actions it has taken that it characterized as combating predatory lending, particularly with regard to FHA-insured loans.

Introduction

In recent years, abuses in home mortgage lending—commonly referred to as “predatory lending”—have increasingly garnered the attention and concern of policymakers, consumer advocates, and participants in the mortgage lending industry.¹ Once relatively rare, government enforcement actions and private party lawsuits against institutions accused of abusive home mortgage lending have increased dramatically in the last 10 years. In 2002 alone, there were dozens of settlements resulting from accusations of abusive lending. In the largest of these, a major national mortgage lender agreed to pay up to \$484 million to tens of thousands of affected consumers.

The Nature and Attributes of Predatory Lending

Predatory lending is an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower. While there is no universally accepted definition, predatory lending is associated with the following loan characteristics and lending practices:

- *Excessive fees.* Abusive loans may include fees that greatly exceed the amounts justified by the costs of the services provided and the credit and interest rate risks involved. Lenders may add these fees to the loan amounts rather than requiring payment up front, so the borrowers may not know the exact amount of the fees they are paying.
- *Excessive interest rates.* Mortgage interest rates can legitimately vary based on the characteristics of borrowers (such as creditworthiness) and of the loans themselves. However, in some cases, lenders may charge interest rates that far exceed what would be justified by any risk-based pricing calculation, or lenders may “steer” a borrower with an excellent credit record to a higher-rate loan intended for borrowers with poor credit histories.
- *Single-premium credit insurance.* Credit insurance is a loan product that repays the lender should the borrower die or become disabled. In the case of single-premium credit insurance, the full premium is paid all at once—by being added to the amount financed in the loan—rather than on a monthly basis. Because adding the full premium to the

¹Throughout this report, the terms predatory lending and abusive lending are used interchangeably.

amount of the loan unnecessarily raises the amount of interest borrowers pay, single-premium credit insurance is generally considered inherently abusive.

- *Lending without regard to ability to repay.* Loans may be made without regard to a borrower's ability to repay the loan. In these cases, the loan is approved based on the value of the asset (the home) that is used as collateral. In particularly egregious cases, monthly loan payments have equaled or exceeded the borrower's total monthly income. Such lending can quickly lead to foreclosure of the property.
- *Loan flipping.* Mortgage originators may refinance borrowers' loans repeatedly in a short period of time without any economic gain for the borrower. With each successive refinancing, these originators charge high fees that "strip" borrowers' equity in their homes.
- *Fraud and deception.* Predatory lenders may perpetrate outright fraud through actions such as inflating property appraisals and doctoring loan applications and settlement documents. Lenders may also deceive borrowers by using "bait and switch" tactics that mislead borrowers about the terms of their loan. Unscrupulous lenders may fail to disclose items as required by law or in other ways may take advantage of borrowers' lack of financial sophistication.
- *Prepayment penalties.* Penalties for prepaying a loan are not necessarily abusive, but predatory lenders may use them to trap borrowers in high-cost loans.
- *Balloon payments.* Loans with balloon payments are structured so that monthly payments are lower but one large payment (the balloon payment) is due when the loan matures. Predatory loans may contain a balloon payment that the borrower is unlikely to be able to afford, resulting in foreclosure or refinancing with additional high costs and fees. Sometimes, lenders market a low monthly payment without adequate disclosure of the balloon payment.

Predatory lending is difficult to define partly because certain loan attributes may or may not be abusive, depending on the overall context of the loan and the borrower. For example, although prepayment penalties can be abusive in the context of some loans, in the context of other loans they can benefit borrowers by reducing the overall cost of loans by reducing the lender's prepayment risk.

According to federal and industry officials, most predatory mortgage lending involves home equity loans or loan refinancings rather than loans for home purchases. Homeowners may be lured into entering refinance loans through aggressive solicitations by mortgage brokers or lenders that promise “savings” from debt consolidation or the ability to “cash out” a portion of a borrower’s home equity. Predatory lending schemes may also involve home improvement contractors that work in conjunction with a lender. The contractor may offer to arrange financing for necessary repairs or improvements, and then perform shoddy work or fail to complete the job, while leaving the borrower holding a high-cost loan. Abuses in loan servicing have also increasingly become a concern. Abusive mortgage lenders or servicing agents may charge improper late fees, require unjustified homeowner’s insurance, or not properly credit payments. In November 2003, the Federal Trade Commission (FTC) and the Department of Housing and Urban Development (HUD) reached a settlement with a large national mortgage servicer, Fairbanks Capital, after the company was accused of unfair, deceptive, and illegal practices in the servicing of mortgage loans. The settlement will provide \$40 million to reimburse consumers.

Originating lenders or brokers that engage in abusive practices can make high profits through the excessive points and fees that they charge, particularly when borrowers make their payments regularly. Even when a loan enters foreclosure, the originator of a predatory loan may still make a profit due to the high up-front fees it has already collected. Moreover, a lender that sells a loan in the secondary market shortly after origination no longer necessarily faces financial risk from foreclosure.² Similarly, a mortgage broker that collects fees up front is not affected by foreclosure of the loan.

According to HUD and community groups, predatory lending not only harms individual borrowers but also can weaken communities and neighborhoods by causing widespread foreclosures, which reduce property values. Predatory lending also serves to harm the reputation of honest and legitimate lenders, casting them in the same suspicious light as those making unfair loans and thus increasing their reluctance to extend credit to the traditionally underserved communities that are often targeted by abusive lenders.

²As discussed in chapter 4, the secondary market is where existing mortgage loans and mortgage-backed securities are sold and purchased.

Emergence of Subprime Mortgage Market

The market for mortgage loans has evolved considerably over the past 20 years. Among the changes has been the emergence of a market for subprime mortgage loans. Most mortgage lending takes place in what is known as the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. In contrast, the subprime market serves borrowers who have poor or no credit histories or limited incomes, and thus cannot meet the credit standards for obtaining loans in the prime market.³ It is widely accepted that the overwhelming majority of predatory lending occurs in the subprime market, which has grown dramatically in recent years. Subprime mortgage originations grew from \$34 billion in 1994 to more than \$213 billion in 2002 and in 2002 represented 8.6 percent of all mortgage originations, according to data reported by the trade publication *Inside B&C Lending*. Several factors account for the growth of the subprime market, including changes in tax law that increased the tax advantages of home equity loans, rapidly increasing home prices that have provided many consumers with substantial home equity, entry into the subprime market by companies that had previously made only prime loans, and the expansion of credit scoring and automated underwriting, which has made it easier for lenders to price the risks associated with making loans to credit-impaired borrowers.

Originating lenders charge higher interest rates and fees for subprime loans than they do for prime loans to compensate for increased risks and for higher servicing and origination costs. In many cases, increased risks and costs justify the additional cost of the loan to the borrower, but in some cases they may not. Because subprime loans involve a greater variety and complexity of risks, they are not the uniformly priced commodities that prime loans generally are. This lack of uniformity makes comparing the costs of subprime loans difficult, which can increase borrowers' vulnerability to abuse.

However, subprime lending is not inherently abusive, and certainly all subprime loans are not predatory. Although some advocacy groups claim that subprime lending involves abusive practices in a majority of cases, most analysts believe that only a relatively small portion of subprime loans

³There is no uniform definition across the lending industry for what characterizes a loan as subprime. Subprime loans are generally given to borrowers with credit scores that are below a certain threshold, but that threshold can vary according to the policies of the individual lender.

contain features that may be considered abusive. In addition, according to officials at HUD and the Department of the Treasury, the emergence of a subprime mortgage market has enabled a whole class of credit-impaired borrowers to buy homes or access the equity in their homes. At the same time, however, federal officials and consumer advocates have expressed concerns that the overall growth in subprime lending and home equity lending in general has been accompanied by a corresponding increase in predatory lending. For example, lenders and brokers may use aggressive sales and marketing tactics to convince consumers who need cash to enter into a home equity loan with highly disadvantageous terms.

Originators of subprime loans are most often mortgage and consumer finance companies, but can also be banks, thrifts, and other institutions. Some originators focus primarily on making subprime loans, while others offer a variety of prime and subprime loans. According to HUD, 178 lenders concentrated primarily on subprime mortgage lending in 2001. Fifty-nine percent of these lenders were independent mortgage companies (mortgage bankers and finance companies), 20 percent were nonbank subsidiaries of financial or bank holding companies, and the remainder were other types of financial institutions. Only 10 percent were federally regulated banks and thrifts.⁴

About half of all mortgage loans are made through mortgage brokers that serve as intermediaries between the borrower and the originating lender. According to government and industry officials, while the great majority of mortgage brokers are honest, some play a significant role in perpetrating predatory lending. A broker can be paid for his services from up-front fees directly charged to the borrower and/or through fees paid indirectly by the borrower through the lender in what is referred to as a “yield spread premium.”⁵ Some consumer advocates argue that compensating brokers this way gives brokers an incentive to push loans with higher interest rates and fees. Brokers respond that yield spread premiums in fact allow them to reduce the direct up-front fees they charge consumers.

⁴HUD annually identifies a list of lenders that specialize in either subprime or manufactured home lending. HUD occasionally updates data related to past years. The information provided here was based on data available as of November 7, 2003.

⁵A “yield spread premium” is a payment a mortgage broker receives from a lender based on the difference between the actual interest rate on the loan and the rate the lender would have accepted on the loan given the risks and costs involved. The higher the actual loan rate compared with the acceptable loan rate, the higher the yield spread premium.

The Extent of Predatory Lending Is Unknown

Currently no comprehensive and reliable data are available on the extent of predatory lending nationwide, for several reasons. First, the lack of a standard definition of what constitutes predatory lending makes it inherently difficult to measure. Second, any comprehensive data collection on predatory lending would require access to a representative sample of loans and to information that can only be extracted manually from the physical loan files. Given that such records are not only widely dispersed but also generally proprietary, to date comprehensive data have not been collected.⁶ Nevertheless, policymakers, advocates, and some lending industry representatives have expressed concerns in recent years that predatory lending is a significant problem. Although the extent of predatory lending cannot be easily quantified, several indicators suggest that it may be prevalent. Primary among these indicators are legal settlements, foreclosure patterns, and anecdotal evidence.

In the past 5 years, there have been a number of major settlements resulting from government enforcement actions and private party lawsuits accusing lenders of abusive lending practices affecting large numbers of borrowers. Among the largest of these settlements have been the following:

- In October 2002, the lender Household International agreed to pay up to \$484 million to homeowners across the nation to settle allegations by states that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and charges.
- In September 2002, Citigroup agreed to pay up to \$240 million to resolve charges by FTC and private parties that Associates First Capital Corporation and Associates Corporation of North America (The

⁶One of the few studies that sought to quantify the extent of predatory lending was “Quantifying the Economic Cost of Predatory Lending,” E. Stein, Coalition for Responsible Lending, July 25, 2001 (revised Oct. 30, 2001). We were not able to verify the reliability of the study’s data, which were based on several sources. Other empirical data appears in a study by Freddie Mac on its automated underwriting system, “Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America’s Families,” September 1996. The company evaluated a sample of 15,000 subprime mortgage loans originated by four financial institutions and provided preliminary estimates that between 10 and 35 percent of the borrowers who received these loans could have qualified for a loan in the prime market. Some consumer advocates have said these data suggest that some borrowers may be “steered” to high-cost loans even though they qualify for conventional loans with better terms. A Freddie Mac official told us that the data are insufficient to necessarily draw that conclusion.

Associates) engaged in systematic and widespread deceptive and abusive lending practices.⁷ According to FTC staff, under the settlement close to 1 million borrowers will receive compensation for loans that misrepresented insurance products and that contained other abusive terms.

- In response to allegations of deceptive marketing and abusive lending, First Alliance Mortgage Company entered into a settlement in March 2002 with FTC, six states, and private parties to compensate nearly 18,000 borrowers more than \$60 million dollars.

Further, between January 1998 and September 1999, the foreclosure rate for subprime loans was more than 10 times the foreclosure rate for prime loans.⁸ While it would be expected that loans made to less creditworthy borrowers would result in some increased rate of foreclosure, the magnitude of this difference has led many analysts to suggest that it is at least partly the result of abusive lending, particularly of loans made without regard to the borrower's ability to repay. Moreover, the rate of foreclosures of subprime mortgage loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. A study conducted for HUD noted that while the increased rate in subprime foreclosures could be the result of abusive lending, it could also be the result of other factors, such as an increase in subprime loans that are made to the least creditworthy borrowers.⁹

In the early 1990s, anecdotal evidence began to emerge suggesting that predatory lending was on the rise. Legal services agencies throughout the country reported an increase in clients who were facing foreclosure as a result of mortgage loans that included abusive terms and conditions. These agencies noted that for the first time they were seeing large numbers of

⁷Citigroup acquired Associates First Capital Corporation and Associates Corporation of North America in November 2000 and merged The Associates' consumer finance operations into its subsidiary, CitiFinancial Credit Company.

⁸See HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report* (June 2000), 34-35. The report noted that from January 1998 through September 1999, foreclosure rates averaged 0.2 percent for prime mortgage loans and 2.6 percent for subprime mortgage loans.

⁹Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, and Randall M. Scheessele, "Subprime Foreclosures: The Smoking Gun of Predatory Lending?" Paper presented at the U.S. Department of Housing and Urban Development conference "Housing Policy in the New Millennium," Crystal City, VA, October 2000.

consumers, particularly elderly and minority borrowers, who were facing the loss of homes they had lived in for many years because of a high-cost refinancing. Similar observations were also reported extensively at forums on predatory lending sponsored by HUD and the Department of the Treasury in five cities during 2000, at hearings held in four cities during 2000 by the Board of Governors of the Federal Reserve System (the Board), and at congressional hearings on the issue in 1998, 2001, 2002, and 2003.¹⁰

Federal officials and consumer advocates maintain that predatory lenders often target certain populations, including the elderly and some low-income and minority communities. Some advocates say that in many cases, predatory lenders target communities that are underserved by legitimate institutions, such as banks and thrifts, leaving borrowers with limited credit options. According to government officials and legal aid organizations, predatory lending appears to be more prevalent in urban areas than in rural areas, possibly because of the concentration of certain target groups in urban areas and because the aggressive marketing tactics of many predatory lenders may be more efficient in denser neighborhoods.¹¹

Emergence of Predatory Lending As Policy Issue

The federal government began addressing predatory home mortgage lending as a significant policy issue in the early 1990s. In 1994, the Congress passed the Home Ownership and Equity Protection Act (HOEPA), an amendment to the Truth in Lending Act that set certain restrictions on “high-cost” loans in order to protect consumers.¹² In 1998, as part of an

¹⁰Hearing on “Equity Predators: Stripping, Flipping and Packing Their Way to Profits,” Special Committee on Aging, U.S. Senate, March 16, 1998. Hearing on “Predatory Mortgage Lending: The Problem, Impact and Responses,” Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 26 and 27, 2001. Hearing on “Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums,” Committee on Banking, Housing, and Urban Affairs, U.S. Senate, January 8, 2002. Hearing on “Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit,” Subcommittees on Financial Institutions and Consumer Credit and Housing and Community Opportunity, Committee on Financial Services, House of Representatives, November 5, 2003.

¹¹A Rural Housing Institute report found that predatory lending did not appear to have infiltrated rural counties in Iowa as much as urban counties. However, the institute also noted there have been reports of many cases of predatory lending in rural areas of the country overall, with comparably severe effects on rural victims. See *Rural Voices*, Vol. 7, No. 2, Spring 2002, 4-5.

¹²See Pub. L. 103-325 §§ 151-158, 108 Stat. 2190-2198.

overall review of the statutory requirements for mortgage loans, HUD and the Board released a report recommending that additional actions be taken to protect consumers from abusive lending practices.¹³ HUD and the Department of the Treasury formed a task force in 2000 that produced the report *Curbing Predatory Home Mortgage Lending*, which made several dozen recommendations for addressing predatory lending.^{14, 15}

As discussed in chapters 2 and 3, a variety of federal, state, and local laws have been used to take civil and criminal enforcement actions against institutions and individuals accused of abusive lending practices. Various federal agencies have responsibilities for enforcing laws related to predatory lending. In addition, some state or local enforcement authorities—including attorneys general, banking regulators, and district attorneys—have used state and local laws related to consumer protection and banking to address predatory lending practices. In addition, many private attorneys and advocacy groups have pursued private legal actions, including class actions, on behalf of borrowers who claim to have been victimized by abusive lending.

Objectives, Scope, and Methodology

Our objectives were to describe (1) federal laws related to predatory lending and federal agencies' efforts to enforce them; (2) the actions taken by the states in addressing predatory lending; (3) the secondary market's role in facilitating or inhibiting predatory lending; (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending; and (5) the relationship between predatory lending activities and elderly consumers. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans.

To identify federal laws and enforcement activities related to predatory lending, we interviewed officials and reviewed documents from HUD, the

¹³Board of Governors of the Federal Reserve System and Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act*, July 1998.

¹⁴HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000.

¹⁵During 2003, there were at least two bills introduced in Congress that addressed predatory or abusive lending practices—the Responsible Lending Act (H.R. 833, Feb. 13, 2003) and the Predatory Lending Consumer Protection Act of 2003 (S. 1928, Nov. 21, 2003).

Department of Justice (DOJ), the Department of the Treasury, the Federal Deposit Insurance Corporation (FDIC), FTC, the Board, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). We asked each agency to provide us with the enforcement actions they have taken that—in their assessment—were related to predatory home mortgage lending. We compiled and reviewed data on these enforcement actions and other steps these agencies have taken to address abusive lending practices. We also reviewed and analyzed federal laws that have been used to combat these practices.

To identify actions taken by states and localities, we reviewed and analyzed a publicly available database maintained by the law firm of Butera & Andrews that tracks state and municipal antipredatory lending legislation. We reviewed information related to this database and conducted interviews with the person who maintains it. In order to identify gaps in the completeness or accuracy of data, we compared data elements from this database and from three similar databases maintained by Lotstein Buckman, the National Conference of State Legislatures, and the Mortgage Bankers Association of America. We determined that the data were sufficiently reliable for use in this report. We also interviewed officials representing a wide range of state and local government agencies, lending institutions, and advocacy groups in a number of states and municipalities. In order to illustrate approaches taken in certain states with regard to predatory lending, we collected and analyzed additional information from two states, North Carolina and Ohio. We chose these states to illustrate the differing characteristics of two states' approaches to addressing predatory lending—particularly with regard to legislation restricting high-cost loans and tightening regulation of mortgage lenders and brokers. We also conducted meetings with the Conference of State Bank Supervisors and the National Association of Attorneys General that included representatives from several states. Additionally, we conducted interviews with OCC, OTS, and NCUA to understand their policies and processes on federal preemption of state antipredatory lending laws.

To describe the secondary market's role, we interviewed officials and reviewed documents from the Bond Market Association, the Securities Industry Association, Fannie Mae, Freddie Mac, a due diligence contractor, and two credit rating agencies. We also spoke with officials representing federal and state agencies, and with representatives of the lending industry and consumer groups. In addition, we reviewed and analyzed several local and state laws containing assignee liability provisions.

To describe the role of consumer education, mortgage counseling, and disclosures in deterring predatory lending, we interviewed officials from entities that engage in consumer financial education, including several federal and state agencies, industry trade groups, and local nonprofit organizations such as the Long Island Housing Partnership, the Greater Cincinnati Mortgage Counseling Service, and the Foreclosure Prevention Project of South Brooklyn Legal Services. We also reviewed and analyzed the materials these entities produce. Additionally, we conducted a literature review of studies that have evaluated the effectiveness of consumer education and homeownership counseling.

To describe the impact on older consumers, we conducted a literature review on predatory lending and the elderly and examined studies on financial exploitation of the elderly. We also examined certain enforcement activities and private party lawsuits in which elderly consumers may have been targeted by abusive lenders. We interviewed federal and state agencies that have addressed issues of financial abuse of the elderly, including the Department of Health and Human Services' Administration on Aging and the National Institute on Aging, as well as nonprofit groups that have addressed this issue, including AARP (formerly known as the American Association of Retired Persons).

In addressing all of the objectives, we met with a wide range of organizations that represent consumers, among them the National Community Reinvestment Coalition, the Coalition for Responsible Lending, the National Consumer Law Center, the Association of Community Organizations for Reform Now, and AARP. We also met with organizations representing various aspects of the mortgage lending industry, among them the American Financial Services Association, the Consumer Mortgage Coalition, the Coalition for Fair and Affordable Lending, America's Community Bankers, the National Association of Mortgage Brokers, the Mortgage Bankers Association of America, and the National Home Equity Mortgage Association.

We provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated, as appropriate, as well as general comments that are discussed at the end of chapter 2. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V. We conducted our work between January 2003 and January 2004 in accordance

with generally accepted government auditing standards in Atlanta, Boston, New York, San Francisco, and Washington, D.C.

Federal Agencies Have Taken Steps to Address Predatory Lending, but Face Challenges

While HOEPA is the only federal law specifically designed to combat predatory mortgage lending, federal agencies, including federal banking regulators, have used a number of federal consumer protection and disclosure statutes to take actions against lenders that have allegedly engaged in abusive or predatory lending.¹ These statutes have enabled agencies to file complaints on behalf of consumers over issues such as excessive interest rates and fees, deceptive lending practices, and fraud. FTC, DOJ, HUD, and federal banking regulators have taken steps to address predatory lending practices through enforcement and civil actions, guidance, and regulatory changes. In some cases, agencies have coordinated their efforts through joint enforcement actions and participation in interagency working groups or task forces. However, questions of jurisdiction regarding certain nonbank mortgage lenders may challenge efforts to combat predatory lending. While the Board has authority to examine many such nonbank mortgage lenders under certain circumstances, it lacks clear authority to enforce federal consumer protection laws against them.

Federal Agencies Use a Variety of Laws to Address Predatory Lending Practices

As shown in figure 1, Congress has passed numerous laws that can be used to protect consumers against abusive lending practices. Federal agencies have applied provisions of these laws to seek redress for consumers who have been victims of predatory lending. Among the most frequently used laws are TILA, HOEPA, the Real Estate Settlement Procedures Act (RESPA), and the FTC Act.² Congress has also given certain federal agencies responsibility for writing regulations that implement these laws. For example, the Board writes Regulation Z, which implements TILA and HOEPA, and HUD writes Regulation X, which implements RESPA. Also, in some cases, DOJ has brought actions under criminal fraud statutes based on conduct that can constitute predatory lending.

¹HOEPA amended various provisions of the Truth In Lending Act. In the context of this report, the term “federal banking regulators” refers to the Board, the federal supervisory agency for state-chartered banks that are members of the Federal Reserve System; OCC, which supervises national banks and their subsidiaries; FDIC, the federal regulator responsible for insured state-chartered banks that are not members of the Federal Reserve System; OTS, the primary federal supervisory agency for federally insured thrifts and their subsidiaries; and NCUA, which supervises federally insured credit unions.

²TILA, as amended, is codified at 15 U.S.C. §§ 1601 – 1667f (2000 & Supp 2003). The pertinent consumer protection provisions of the FTC Act are contained in 15 U.S.C. §§ 41 – 58 (2000). RESPA is codified at 12 U.S.C. §§ 2601 – 2617 (2000 & Supp 2003).

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Figure 1: Federal Laws and Statutes Used to Address Lending Practices Generally Considered to be Predatory

Predatory lending practice	Governing federal statute					Enforcing federal agencies			
	TILA	HOEPA ^a	RESPA	FTC Act	Title 18 of U.S. Code	Federal banking regulators	FTC	HUD	DOJ
Failure to disclose actual loan costs	●	●	●			●	●	●	
Prohibited fees and payments			●			●		●	
Lending without regard to ability to repay		●				●	●		
Loan flipping		●				●	●		
Fraud and deception				●	●	●	●		●
Prohibited prepayment penalties		●				●	●		
Prohibited balloon payments		●				●	●		

Source: GAO.

^aHOEPA covers only a limited portion of all subprime loans.

TILA, which became law in 1968, was designed to provide consumers with accurate information about the cost of credit. Among other things, the act requires lenders to disclose information about the terms of loans—including the amount being financed, the total finance charge, and information on the annual percentage rate—that can help borrowers understand the overall costs of their loans. TILA also provides borrowers with the right to cancel certain loans secured by a principal residence within 3 days of closing or 3 days of the time at which the final disclosure is made, whichever is later.³

³See 15 U.S.C. § 1635.

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In 1994, Congress enacted the HOEPA amendments to TILA in response to concerns about predatory lending. HOEPA covers certain types of loans made to refinance existing mortgages, as well as home equity loans, that satisfy specific criteria.⁴ HOEPA covers only a limited portion of all subprime loans, although there is no comprehensive data on precisely what that portion is.⁵ The law is designed to limit predatory practices for these so-called “high-cost” HOEPA loans in several ways. First, it places restrictions on loans that exceed certain rate or fee thresholds, which the Board can adjust within certain limits prescribed in the law. For these loans, the law restricts prepayment penalties, prohibits balloon payments for loans with terms of less than 5 years, prohibits negative amortization, and contains certain other restrictions on loan terms or payments.⁶ Second, HOEPA prohibits lenders from routinely making loans without regard to the borrower’s ability to repay. Third, the law requires lenders to include disclosures in addition to those required by TILA for consumer credit transactions to help borrowers understand the terms of the high-cost loan and the implications of failing to make required payments. Each federal banking regulator is charged with enforcing TILA and HOEPA with respect to the depository institutions it regulates, and FTC is primarily responsible for enforcing the statutes for most other financial institutions, including independent mortgage lenders and nonbank subsidiaries of holding companies. In enforcing TILA and HOEPA, FTC has required violators to compensate borrowers for statutory violations. Under certain

⁴HOEPA covers closed-end refinancing loans and home equity loans with either (i) an annual percentage rate that exceeds the rate for Treasury securities with comparable maturities by more than a specified amount, or (ii) points and fees that exceed the greater of 8 percent of the loan amount or \$400, which is adjusted annually for inflation. 15 U.S.C. § 1602(aa)(1), (3); see 12 C.F.R. § 226.32 (2003). HOEPA does not apply to purchase money mortgages (i.e., loans to purchase or construct a residence), open-end credit (i.e., a line of credit), and reverse mortgages. See, e.g., 15 U.S.C. § 1639.

⁵The Board has cited a study conducted for the American Financial Services Association that estimated that—using current triggers—HOEPA would have covered nearly 38 percent of subprime first mortgage loans originated by nine major national lenders from 1995-2000. See M. Staten and G. Elliehausen, “The Impact of The Federal Reserve Board’s Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans” (July 24, 2001). In the past, the Board has also cited estimates from data from OTS that, using the current triggers, HOEPA would cover roughly 5 percent of all subprime loans, but the Board noted to us that this estimate may be conservative. See 65 Fed. Reg. at 81441.

⁶Negative amortization occurs when loan payment amounts do not cover the interest accruing on a loan, resulting in an increasing outstanding principal balance over time. See 15 U.S.C. § 1639(f).

circumstances, HOEPA provides for damages in addition to the actual damages a person sustains as a result of a creditor's violation of the act.⁷

RESPA, passed in 1974, seeks to protect consumers from unnecessarily high charges in the settlement of residential mortgages by requiring lenders to disclose details of the costs of settling a loan and by prohibiting certain other costs.⁸ Among its provisions is a prohibition against kickbacks—payments made in exchange for referring a settlement service, such as lender payments to real estate agents for the referral of business. RESPA also prohibits unearned fees such as adding an additional charge to a third party fee when no or nominal services are performed. These practices can unjustly increase the costs of loans and the settlement process. HUD enforces RESPA, working closely with federal banking regulators and other federal agencies such as the FTC and the Department of Justice. HUD often brings joint enforcement actions with these agencies, using RESPA and the statutes enforced by the other federal agencies. In addition, the banking regulators may prohibit violations of RESPA in their own regulations.

The FTC Act, enacted in 1914 and amended on numerous occasions, provides the FTC with the authority to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. FTC has used the act to address predatory lending abuses when borrowers have been misled or deceived about their loan terms.⁹

Various criminal fraud statutes prohibit certain types of fraud sometimes used in abusive lending schemes, including forgery and false statements. DOJ and HUD have used these statutes to fight fraudulent schemes that have resulted in borrowers purchasing homes worth substantially less than their mortgage amounts or borrowers being unfairly stripped of the equity in their homes. HUD officials have described some of these fraudulent activities as constituting predatory lending.

⁷See Pub. L. No. 103-325 § 153(a), 15 U.S.C. § 1640(a).

⁸Among other things, RESPA requires the good faith disclosure of estimated settlement costs within 3 days after an application for a mortgage loan and, at or before settlement, a uniform settlement statement (HUD-1) that enumerates the final cost of the loan.

⁹Banking regulators are also authorized to enforce standards imposed pursuant to the FTC Act with respect to unfair or deceptive acts or practices by the institutions they supervise. See 12 U.S.C. § 57a(f).

The following other federal laws have been used to a lesser extent to address abusive lending:

- The Fair Housing Act prohibits discrimination based on race, sex, and other factors in housing-related transactions, and the Equal Credit Opportunity Act (ECOA) prohibits discrimination against borrowers in the extension of credit. Federal agencies have used both laws in cases against lenders that have allegedly targeted certain protected groups with abusive loans.
- The Home Mortgage Disclosure Act (HMDA) requires lenders to make publicly available certain data about mortgage loans. Federal agencies have used the data provided by HMDA to help identify possible discriminatory lending patterns, including those that involve abusive lending practices.
- The Community Reinvestment Act (CRA) requires that banking regulators consider a depository institution's efforts to meet the credit needs of its community—including low- and moderate-income neighborhoods—in examinations and when it applies for permission to take certain actions such as a merger or acquisition. An institution's fair lending record is taken into account in assessing CRA performance. CRA regulations state that abusive lending practices that violate certain federal laws will adversely affect an institution's CRA performance.¹⁰
- Also, federal banking regulators may rely on their supervisory and enforcement authorities under the laws they administer, as well as on the Federal Deposit Insurance Act, to enforce these consumer protection laws and ensure that an institution's conduct with respect to compliance with consumer protection laws does not affect its safety and soundness or that of an affiliated institution.
- Finally, FTC and the banking regulators can also use the Fair Debt Collection Practices Act and Fair Credit Reporting Act in enforcement

¹⁰On January 20, 2004, FDIC announced approval of a joint interagency notice of proposed rulemaking regarding the Community Reinvestment Act. The proposed rule would amend the act's regulations to expand and clarify the provision that an institution's Community Reinvestment Act evaluation is adversely affected when the institution has engaged in specified discriminatory, illegal, or abusive credit practices in connection with certain loans. FDIC said that the Board, OCC, and OTS were expected to announce their approval of the proposed rulemaking shortly.

actions related to predatory lending that involve violations of credit reporting and loan servicing provisions.

Although a number of federal laws have been used to protect borrowers from abusive lending or to provide them redress, not all potentially abusive practices are illegal under federal law. Enforcement officials and consumer advocates have stated that some lenders make loans that include abusive features but are designed to remain below the thresholds that would subject them to the restrictions of HOEPA. For loans not covered under HOEPA, certain lending practices many consider to be abusive are not, depending on the circumstances, necessarily a violation of any federal law. For example, it is not necessarily illegal to charge a borrower interest rates or fees that exceed what is justified by the actual risk of the mortgage loan. Nor is it *per se* illegal under federal law to “steer” a borrower with good credit who qualifies for a prime loan into a higher cost subprime loan.¹¹ Finally, with the exception of loans covered under HOEPA, there are no federal statutes that expressly prohibit making a loan that a borrower will likely be unable to repay.¹²

¹¹Even in instances where charging high interest rates or fees or steering borrowers to subprime loans do not violate federal consumer protection statutes, imposing such rates and fees on a discriminatory basis against groups protected under the Fair Housing Act and ECOA could constitute violations of those laws.

¹²A pattern of making loans without regard to the ability of borrowers to repay can be considered a violation of the safety and soundness requirements imposed on federally insured depository institutions and could also reflect poorly on an institution’s compliance with the Community Reinvestment Act. See OCC Advisory Letter 2003-2 (Guidance for National Banks to Guard Against Predatory and Abusive Lending Practices), February 21, 2003. For loans that are covered under HOEPA, making a loan without regard to a borrower’s ability to repay is not prohibited unless it can be demonstrated that an institution has engaged in a “pattern or practice” of doing so. OCC in its recent rulemaking prohibited national banks or their operating subsidiaries from making consumer loans based predominantly on the foreclosure or liquidation value of a borrower’s collateral. See 69 Fed. Reg. 1904 (Jan. 13, 2004).

**Federal Agencies Have
Taken Some
Enforcement Actions,
but Banking Regulators
Have Focused on
Guidance and
Regulatory Changes**

FTC, DOJ, and HUD have taken enforcement actions to address violations related to abusive lending.¹³ As of December 2003, FTC reported that the agency had taken 19 actions against mortgage lenders and brokers for predatory practices. DOJ has addressed predatory lending that is alleged to be discriminatory by enforcing fair lending laws in a limited number of cases. HUD's efforts have generally focused on reducing losses to the Federal Housing Administration (FHA) insurance fund, including implementing a number of initiatives to monitor lenders for violations of FHA guidelines.¹⁴ HUD reported having taken a small number of actions to enforce RESPA and the Fair Housing Act in cases involving predatory lending.

Federal banking regulators stated that their monitoring and examination activities have revealed little evidence of predatory lending practices by federally regulated depository institutions. Accordingly, most banking regulators reported that they have taken no formal enforcement actions related to predatory mortgage lending abuses by the institutions they supervise. Regulators have addressed predatory lending primarily by issuing guidance to their institutions on guarding against direct or indirect involvement in predatory lending practices and by making certain changes to HOEPA and HMDA regulations. In addition, several federal agencies have coordinated certain efforts to pursue enforcement actions related to predatory lending and have shared information on their efforts to address fair lending and predatory lending.

¹³Most enforcement actions discussed in this chapter were civil judicial actions brought and settled by FTC, DOJ, and HUD.

¹⁴HUD's FHA mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

FTC Has Played the Predominant Federal Role in Enforcement Actions Related to Predatory Lending

FTC is responsible for implementing and enforcing certain federal laws among lending institutions that are not supervised by federal banking regulators. FTC reported that between 1983 and 2003, it filed 19 complaints alleging deceptive or other illegal practices by mortgage lenders and brokers, 17 of them filed since 1998.¹⁵ For a list of these FTC enforcement actions, see appendix I. As of December 2003, FTC had reached settlements in all but one of the cases. In most of these settlements, companies have agreed to provide monetary redress to consumers and to halt certain practices in the future. In some cases, the settlements also imposed monetary penalties that the companies have paid to the government. Among the recent enforcement actions related to predatory lending that the FTC identified are the following:

- *The Associates*. In 2002, FTC settled a complaint against Associates First Capital Corporation and Associates Corporation of North America (collectively, The Associates), as well as their successor, Citigroup. The complaint alleged that the lender violated the FTC Act and other laws by, among other things, deceiving customers into refinancing debts into home loans with high interest rates and fees and purchasing high-cost credit insurance. The settlement, along with a related settlement with private parties, provides for up to \$240 million in restitution to borrowers.¹⁶
- *First Alliance*. In 2002, FTC, along with several states and private plaintiffs, settled a complaint against First Alliance Mortgage Company alleging that it violated federal and state laws by misleading consumers about loan origination and other fees, interest rate increases, and monthly payment amounts on adjustable rate mortgage loans. The company agreed to compensate nearly 18,000 borrowers more than \$60

¹⁵FTC has also recently addressed abuses in the mortgage loan servicing industry. In November 2003, it announced settlements with Fairbanks Capital Holding Corp., its wholly owned subsidiary Fairbanks Capital Corp., and their founder and former CEO (collectively, Fairbanks) on charges that Fairbanks violated the FTC Act, RESPA, and other laws by failing to post consumers' mortgage payments in a timely manner and charging consumers illegal late fees and other unauthorized fees. The settlement will provide \$40 million in redress to consumers. The case was jointly filed with HUD. *United States of America v. Fairbanks Capital Corp. et al.*, Civ. Action No. 03-12219-DPW (D. Mass.)(filed 11/12/03).

¹⁶Citigroup, Inc., acquired The Associates in a merger that was completed in November 2000. The FTC complaint named Citigroup and CitiFinancial Credit Company as successor defendants.

million in consumer redress and to refrain from making misrepresentations about future offers of credit.

- *Fleet Finance and Home Equity U.S.A.* In 1999, Fleet Finance, Inc., and Home Equity U.S.A., Inc., settled an FTC complaint alleging violations of the FTC Act, TILA, and related regulations. These violations included failing to provide required disclosures about home equity loan costs and terms and failing to alert borrowers to their right to cancel their credit transactions. To settle, the company agreed to pay up to \$1.3 million in redress and administrative costs and to refrain from violating TILA in the future.
- *Operation Home Inequity.* In 1999, FTC conducted “Operation Home Inequity,” a law enforcement and consumer education campaign that sought to curb abusive practices in the subprime mortgage lending market. FTC reached settlements with seven subprime mortgage lenders that had been accused of violating a number of consumer protections laws, including the FTC Act, TILA, and HOEPA. Six companies were required to pay \$572,000 in consumer redress, and all lenders were required to adhere to future lending restrictions. FTC staff told us that the operation was intended in large part to increase consumers’ awareness of predatory lending and to provide a deterrent effect by warning lenders that FTC is able and willing to take action against them.

FTC staff expressed their belief that the agency’s enforcement actions over the years have been successful in deterring other lenders from engaging in abusive practices. However, in a congressional hearing in 2000 FTC had requested statutory changes that would improve its ability to enforce HOEPA. For example, FTC recommended that Congress expand HOEPA to prohibit the financing of lump-sum credit insurance premiums in loans covered by HOEPA and to give FTC the power to impose civil penalties for HOEPA violations.¹⁷

¹⁷Prepared statement of the Federal Trade Commission before the House Committee on Banking and Financial Services on “Predatory Lending Practices in the Subprime Industry,” May 24, 2000. Since then, many mortgage lenders have said they are abandoning lump-sum credit insurance.

DOJ Has Enforced Fair Lending Laws in Connection with Predatory Lending

DOJ's Housing and Civil Enforcement Section is responsible for enforcing certain federal civil rights laws, including the Fair Housing Act and ECOA. DOJ identified two enforcement actions it has taken related to predatory mortgage lending practices that it alleged were discriminatory.¹⁸

- *Delta Funding*. In 2000, DOJ, in cooperation with FTC and HUD, brought charges against Delta Funding Corporation, accusing the consumer finance company of violations of the Fair Housing Act, HOEPA, ECOA, RESPA, and related federal regulations.¹⁹ Delta allegedly approved and funded loans that carried substantially higher broker fees for African American females than for similarly situated white males. Delta was also accused of violating certain consumer protection laws by paying kickbacks and unearned fees to brokers to induce them to refer loan applicants to Delta and by systematically making HOEPA loans without regard to borrowers' ability to repay. The settlement placed restrictions on the company's future lending operations and victims were compensated from previously established monetary relief funds.²⁰
- *Long Beach Mortgage*. In 1996 DOJ settled a complaint alleging violations of the Fair Housing Act and ECOA against Long Beach Mortgage Company.²¹ According to the complaint, the company's loan officers and brokers charged African American, Hispanic, female, and

¹⁸In addition to these cases, DOJ filed an amicus curiae brief in a private case, *Hargraves v. Capital City Mortgage Corp.*, Civ. Action No. 98-1021 (JHG/AK) (D DC), in which the department contended that certain alleged predatory lending practices violated the Fair Housing Act and ECOA. The case involved a mortgage lender that allegedly engaged in a pattern or practice of deceiving African American borrowers about the terms of their loans and other information, such as the total amount due. In addition, DOJ filed a complaint in *United States v. Action Loan*, Civ. Action No. 3:00CV-511-H (W.D. KY), which resulted from enforcement efforts by the FTC and HUD and involved allegations of predatory mortgage lending.

¹⁹*United States v. Delta Funding Corp.*, Civ. Action No. CV 00 1872 (E.D. N.Y. 2000).

²⁰Two monetary relief funds totaling over \$12 million were set up under a previous remediation agreement involving Delta and the New York State Banking Department.

²¹*United States v. Long Beach Mortgage Company*, Case No. 96-6159 (1996). Prior to December 1990, Long Beach Bank was a savings and loan association, chartered by the state of California. Between December 1990 and October 1994, Long Beach Mortgage Company operated under the name of Long Beach Bank as a federally chartered thrift institution. In 1999, Washington Mutual, a federally chartered thrift, acquired Long Beach Mortgage Company and owns it at the holding company level.

older borrowers higher loan rates than it charged other similarly situated borrowers. The company agreed to set up a \$3 million fund to reimburse 1,200 consumers who had received Long Beach loans.²²

Representatives from both FTC and DOJ have stated that their enforcement actions can be very resource intensive and can involve years of discovery and litigation. For example, FTC filed a complaint against Capitol City Mortgage Corporation in 1998 that is still in litigation more than 5 years later. FTC staff told us that because cases involving predatory lending can be so resource intensive, the agencies try to focus their limited resources on the cases that will have the most impact, such as those that may result in large settlements to consumers or that will have some deterrent value by gaining national exposure. Similarly, DOJ officials select certain discrimination cases, including those mentioned above, in part because of their broad impact.

HUD's Enforcement Activities Focus on FHA Loans

HUD's enforcement and regulatory activity with regard to abusive mortgage lending comes primarily through its management of the FHA single-family mortgage insurance programs, its rule-making and enforcement authority under RESPA, and its enforcement of the Fair Housing Act.

Most of HUD's enforcement activities related to abusive lending have focused on reducing losses to the FHA insurance fund. Investigators from HUD's Office of the Inspector General have worked with investigators from U.S. Attorneys' Offices and the FBI in a joint law enforcement effort to target fraud in the FHA mortgage insurance program, which can result in defaults and thus in losses to the insurance fund.²³ The fraudulent activities sometimes involve property flipping schemes, which can harm borrowers by leaving them with mortgage loans that may far exceed the

²²DOJ has also taken enforcement actions to address other practices, such as credit repair schemes, that do not involve abusive lending but that nonetheless serve to illegally strip homeowners of their equity.

²³GAO has issued a number of reports on the FHA single-family insurance program, a high-risk program area. For example, see U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Housing and Urban Development*, [GAO-03-103](#) (Washington, D.C.: January 2003).

value of their homes.²⁴ Under certain circumstances, such activity can involve predatory lending practices. To address these crimes, investigators have presented evidence of false statements and other criminal fraud and deception. In addition, representatives from HUD told us that they have processes in place to ensure that lenders adhere to agency guidelines and make loans that satisfy FHA requirements. The Office of Lender Activities and Program Compliance approves, recertifies, and monitors FHA lenders and works with them to ensure compliance. If necessary, the office refers violating lenders to HUD's Mortgagee Review Board, which has the authority to take administrative actions such as withdrawing approval for a lender to make FHA-insured loans. HUD officials told us that the board has taken many administrative actions to address violations that could be indicative of predatory lending, such as charging excessive and unallowable fees, inflating appraisals, and falsifying documents showing income or employment. In an effort to address abusive property flipping schemes involving homes secured by FHA-insured loans, HUD issued a final rule in May 2003 that prohibits FHA insurance on properties resold less than 90 days after their previous sale.

HUD officials say that programs they have in place to improve the monitoring of FHA lenders also serve to deter predatory lending. For example, HUD's Credit Watch Program routinely identifies those lenders with the highest early default and insurance claim rates and temporarily suspends the FHA loan origination approval agreements of the riskiest lenders, helping to ensure that lenders are not making loans that borrowers cannot repay. Also, the Neighborhood Watch program provides information to FHA participants about lenders and appraisers whose loans have high default and FHA insurance claim rates. HUD told us that it has also taken a series of actions to better ensure the integrity of appraisals used to finance FHA insured loans. As of December 2003, HUD was in the final stages of issuing a rule that would hold lenders accountable for appraisals associated with loans they make.

²⁴In property flipping schemes, properties are purchased and quickly resold at grossly inflated values. In some cases the inflated value is established by an interim sale to a "straw buyer" and then flipped to an unsuspecting purchaser. In other cases, first-time buyers who have been turned down for home loans because of poor credit or low income are targeted by flippers who arrange loans well in excess of the real value of the property using fabricated employment and deposit records. These schemes often involve many players, including mortgage lenders, mortgage brokers, underwriters, and home-improvement workers. Almost all flipping schemes involve false appraisals. While HUD categorizes property flipping as a predatory lending practice, not all federal agencies concur with this categorization.

HUD's Office of RESPA and Interstate Land Sales is responsible for handling complaints, conducting investigations, and taking enforcement actions related to RESPA. HUD has taken several enforcement actions related to RESPA's prohibition of kickbacks and referral fees, three of which related directly to abusive mortgage lending, as of December 2003.²⁵ Also, as discussed above, in November 2003 HUD and FTC jointly filed a case against and reached settlement with a mortgage loan servicing company charged with violations of the FTC Act, RESPA, and other laws.²⁶ HUD has also recently hired additional staff to enhance its RESPA enforcement efforts. Finally, in 2002, HUD issued a proposed rule designed to change the regulatory requirements of RESPA to simplify and potentially lower the costs of the home mortgage settlement process. According to HUD, as of December 2003, the final rule had been submitted to the Office of Management and Budget and was being reviewed.

HUD's Office of Fair Housing and Equal Opportunity is responsible for enforcing the Fair Housing Act. HUD identified one action—a letter of reprimand to a financial institution—related to enforcement of this act in a case involving predatory lending.

Federal Banking Regulators Have Issued Guidance and Made Regulatory Changes

According to federal banking regulators and state enforcement authorities, federally regulated depository institutions—banks, thrifts, and credit unions—have not typically engaged in predatory lending practices. Federal banking regulators have systems in place to track customer complaints and reported that they have received few complaints related to predatory lending by the institutions they supervise. The regulators conduct routine examinations of these institutions and have the authority, in cases of suspected predatory lending, to enforce a variety of fair lending and consumer protection laws. Banking regulators noted that the examination process, which involves routine on-site reviews of lenders' activities, serves as a powerful deterrent to predatory lending by the institutions they examine.

²⁵For example, a complaint filed jointly by HUD, FTC, and Illinois authorities against Mercantile Mortgage Company in 2002 alleged that for almost 3 years, a broker referred virtually every one of his loan customers to Mercantile in exchange for a fee as high as 10 percent. The other two cases involving RESPA include Delta Funding (2000) and Action Loan Company (2000).

²⁶*United States of America v. Fairbanks Capital Corp.*, 03-12219-DPW (D. MA, filed Nov. 12, 2003).

Officials of OTS, FDIC, the Board, and NCUA said that they had taken no formal enforcement actions related to predatory mortgage lending against the institutions they regulate.²⁷ Officials at OCC said they have taken one formal enforcement action related to predatory mortgage lending to address fee packing, equity stripping, and making loans without regard to a borrower's ability to pay. In November 2003, the agency announced an enforcement action against Loan Star Capital Bank seeking to reimburse 30 or more borrowers for more than \$100,000 in abusive fees and closing costs that violated the FTC Act, HOEPA, TILA, and RESPA.²⁸ The bank also was required to conduct a comprehensive review of its entire mortgage portfolio and to provide restitution to any additional borrowers who may have been harmed.

While most federal banking regulators stated that they have taken no formal enforcement actions, representatives from some said they had taken informal enforcement actions to address some questionable practices among their institutions. For example, OTS has examined institutions that may have charged inappropriate fees or violated HOEPA and resolved the problems by requiring corrective action as part of the examination process. In addition, most of the banking regulators have taken formal enforcement actions, including issuing cease-and-desist orders, in response to activities that violated fair lending and consumer protection laws but were not necessarily deemed to constitute "predatory lending."

Guidance

Federal banking regulators have issued guidance to their institutions about both predatory lending and subprime lending in general. In February 2003, OCC issued two advisory letters related to predatory lending to the national banks and the operating subsidiaries it supervises. One letter provided specific guidelines for guarding against predatory lending practices during loan originations, and the other alerted institutions to the risk of indirectly

²⁷Banking regulators have broad enforcement powers and can take formal actions (cease and desist orders, civil money penalties, removal orders, and suspension orders, among others) or informal enforcement actions (such as memoranda of understanding and board resolutions). Not all informal actions are publicly disclosed.

²⁸*Matter of Clear Lake National Bank*, AA-EC03-25 (OCC Nov. 7, 2003). The lender that made the loans, Clear Lake National Bank of San Antonio, Texas, merged with another bank in April 2003 to become Lone Star Capital Bank, N.A. OCC brought the action under the enforcement authority provided by Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. 1818.

engaging in predatory lending through brokered or purchased loans.²⁹ The advisory letters described loan attributes that are often considered predatory and established standards for policies and procedures for monitoring loan transactions to avoid making, brokering, or purchasing loans with such attributes. For example, the first letter stated that banks should establish underwriting policies and procedures to determine that borrowers have the capacity to repay their loans. The advisory letter also stated OCC's position that predatory lending will also affect a national bank's CRA rating. The advisories have also clarified ways in which predatory practices can create legal, safety and soundness, and reputation risks for national banks. For example, they laid out ways in which the origination or purchase of predatory loans may constitute violations of TILA, RESPA, HOEPA, the FTC Act, and fair lending laws. In addition, in January 2004, OCC issued a rule adopting antipredatory lending standards that expressly prohibit national banks from making loans without regard to the borrower's ability to repay and from engaging in unfair and deceptive practices under the FTC Act.³⁰

In 1999 and 2001, the Board, FDIC, OCC, and OTS issued joint guidance to their institutions on subprime lending in general.³¹ The guidance highlighted the additional risks inherent in subprime lending and noted that institutions engaging in such lending need to be aware of the potential for predatory practices and be particularly careful to avoid violating fair lending and consumer protection laws and regulations. The NCUA issued similar guidance to insured credit unions in 1999.³² Federal banking

²⁹OCC Advisory Letter 2003-2 (Guidance for National Banks to Guard Against Predatory and Abusive Lending Practices), February 21, 2003; and OCC Advisory Letter 2003-3 (Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans), February 21, 2003.

³⁰69 Fed. Reg. 1904 (Jan. 13, 2004).

³¹The Board, FDIC, OCC and OTS, Interagency Guidance on Subprime Lending, March 1, 1999; and Expanded Guidance for Subprime Lending Programs, January 31, 2001. The 2001 guidance applies to institutions with subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital.

³²NCUA Letter to Credit Unions No. 99-CU-05, Risk Based Lending, June 1999.

Regulatory Changes

regulators have also previously issued guidance about abusive lending practices, unfair or deceptive acts or practices, and other issues related to predatory lending.³³

The Board is responsible for issuing regulations that implement HOEPA and HMDA, two laws that play a role in addressing predatory lending. In December 2001, in response to concerns that HOEPA may not be adequately protecting consumers from abusive lending practices, the Board amended Regulation Z, which implements HOEPA, to

- lower the interest rate “trigger” that determines whether loans are covered under HOEPA in order to bring more loans under the protection of the law,³⁴
- require that fees paid for credit insurance and similar debt protection products be included when determining whether loans are subject to HOEPA,
- prohibit creditors that make HOEPA loans from refinancing the loan within one year of origination with another HOEPA loan, unless the refinancing is in the borrower’s interest, and
- clarify the prohibition against engaging in a “pattern or practice” of lending without regard to borrowers’ ability to repay.³⁵

In February 2002, the Board also made changes to Regulation C, which implements HMDA. The changes, which went into effect in January 2004, require lenders to provide additional data that may facilitate analyses of lending patterns that may be predatory. For example

³³See OCC Advisory Letter 2000-7 (abusive lending practices); OCC Advisory Letter 2000-10, OCC Advisory Letter 2000-11, OTS Chief Executive Officers Letter 131, OTS Chief Executive Officers Letter 132, and NCUA Letter 01-FCU-03 (title loans and payday lending); OCC Bulletin 2001-47 (third-party relationships); and OCC Advisory Letter 2002-3 and FDIC Financial Institution Letter 57-2002 (unfair or deceptive acts or practices).

³⁴The Board adjusted the annual percentage rate (APR) trigger from 10 to 8 percentage points above the rate for Treasury securities with comparable maturities. The change applies only to first lien mortgages; the subordinate lien mortgage APR trigger remained at 10 percent.

³⁵66 Fed. Reg. 65604 (Dec. 20, 2001).

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- if the costs to the borrower of financing a loan exceed a certain threshold determined by the Board, the lender must report the cost of the loan;³⁶
- if an application or loan involves a manufactured home, the lender is required to identify that fact, in part to help identify predatory practices involving these types of homes; and
- if a loan is subject to HOEPA, the lender is required to identify that fact in order to give policymakers more specific information about the number and characteristics of HOEPA loans.³⁷

Because HOEPA expressly grants the Board broad authority to issue rules to regulate unfair or deceptive acts and practices, some consumer advocacy organizations have argued that the Board should use its authority to do more to curb predatory lending.³⁸ For example, some consumer groups have called on the Board to use its rule-making authority to prohibit the financing of single-premium credit insurance—a product that is believed by many to be inherently predatory.³⁹ Under the McCarran Ferguson Act,⁴⁰ unless a federal statute is specifically related to the business of insurance, the federal law may not be construed to invalidate, impair, or supercede any state law enacted to regulate the business of insurance. Board officials say it is not clear the extent to which rules issued by the Board under HOEPA seeking to regulate the sale of single-premium credit insurance would be consistent with that standard. The Board has previously recommended that it would be more appropriate for Congress to address this issue through changes in law. Some consumer groups also have argued that the Board should increase the loan data reporting requirements of HMDA to help detect abusive lending. The

³⁶More specifically, lenders are required to report the difference or spread between a loan's annual percentage rate (a value reflecting both the interest rate and certain fees associated with a loan) and the yield on a Treasury security of comparable maturity, for loans where this spread exceeds certain thresholds set by the Board. See, generally, 67 Fed. Reg. 7222 (Feb. 15, 2002) and 67 Fed. Reg. 43218 (June 27, 2002).

³⁷*Id.*

³⁸See 15 U.S.C. § 1639(1)(2).

³⁹In its 2001 amendments to the HOEPA rules, the Board added single-premium credit insurance to HOEPA's fee trigger.

⁴⁰See 15 U.S.C. § 1012.

Board has added certain loan pricing and other items to the HMDA reporting requirements, effective in January 2004, but did not add other data reporting requirements, such as the credit score of the applicant. Board officials said this is based on the belief that the need for additional loan data to ensure fair lending must be weighed against the costs and burdens to the lender of gathering and reporting the additional information.

Agencies Have Coordinated on Enforcement Actions and Participated in Interagency Groups

Federal agencies have worked together to investigate and pursue some cases involving predatory lending. For example, FTC, DOJ, and HUD coordinated to take enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws under its jurisdiction. DOJ conducted its enforcement action against Long Beach Mortgage Company in coordination with OTS, which investigated the initial complaint in 1993 when the company was a thrift. Federal agencies have also coordinated with state authorities and private entities in enforcement actions. For example, in 2002, FTC joined six states, AARP, and private attorneys to settle a complaint against First Alliance Mortgage Company alleging that the company used deception and manipulation in its lending practices.

Federal regulators have also coordinated their efforts to address fair lending and predatory lending through working groups. For example

- In the fall of 1999 the Interagency Fair Lending Task Force, which coordinates federal efforts to address discriminatory lending, established a working group to examine the laws related to predatory lending and determine how enforcement and consumer education could be strengthened.⁴¹ Because of differing views on how to define and combat predatory lending, the group was unable to agree on a federal interagency policy statement related to predatory lending in 2001. The Task Force then continued its efforts related to consumer education and published a brochure in 2003 to educate consumers about predatory lending practices.
- The five banking regulators have conducted additional coordination activities through the Federal Financial Institutions Examination

⁴¹The agencies that participated in the working group were OCC, OTS, FDIC, the Board, NCUA, DOJ, FTC, HUD, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight.

Council's Task Force on Consumer Compliance.⁴² The task force coordinates policies and procedures for ensuring compliance with fair lending laws and the Community Reinvestment Act, both of which have been identified as tools that can be used to address predatory lending. The council publishes a document that responds to frequently asked questions about community reinvestment, including how examiners should consider illegal credit practices, which may be abusive, in determining an institution's Community Reinvestment Act rating.

- In 2000, HUD and the Department of the Treasury created the National Task Force on Predatory Lending, which convened forums around the country to examine the issue and released a report later in the year.⁴³ The report made specific recommendations to Congress, federal agencies, and other stakeholders that were aimed at (1) improving consumer literacy and disclosure, (2) reducing harmful sales practices, (3) reducing abusive or deceptive loan terms and conditions, and (4) changing structural aspects of the lending market.

Some of the recommendations made in the HUD-Treasury task force report have been implemented. For example, as recommended in the report, the Board has adopted changes to HOEPA regulations that have increased the number of loans covered and added additional restrictions. In addition, as the report recommended, FTC and some states have devoted more resources in the past few years to actively pursuing high-profile enforcement cases. As discussed in chapter 5, federal and state agencies have also worked to improve one of the areas highlighted in the report: public awareness about predatory lending issues. Other recommendations made in the report have not been implemented, however. For example, Congress has not enacted legislation to expand penalties for violations of TILA, HOEPA, and RESPA or to increase the damages available to borrowers harmed by such violations. HUD and the Department of the Treasury told us that they have not formally tracked the status of the recommendations made in the report, although HUD officials said they are

⁴²The Federal Financial Institutions Examination Council is a formal interagency body composed of representatives of each of the five federal banking regulators. The council was established in 1979 and is empowered to (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and (2) make recommendations to promote uniformity in the supervision of financial institutions.

⁴³U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000.

informally monitoring the recommendations in the report that relate to their agency. Officials at both agencies also noted that the report and its recommendations were the product of a previous administration and may or may not reflect the views of the current administration.

In addition to participating in interagency groups, agencies share information related to fair lending violations under statutory requirements and formal agreements. For example, since 1992 HUD and the banking regulators have had a memorandum of understanding stating that HUD will refer allegations of fair lending violations to banking regulators and a 1994 executive order requires that executive branch agencies notify HUD of complaints and violations of the Fair Housing Act. In addition, whenever the banking regulatory agencies or HUD have reason to believe that an institution has engaged in a “pattern or practice” of illegal discrimination, they are required to refer these cases to DOJ for possible civil action.

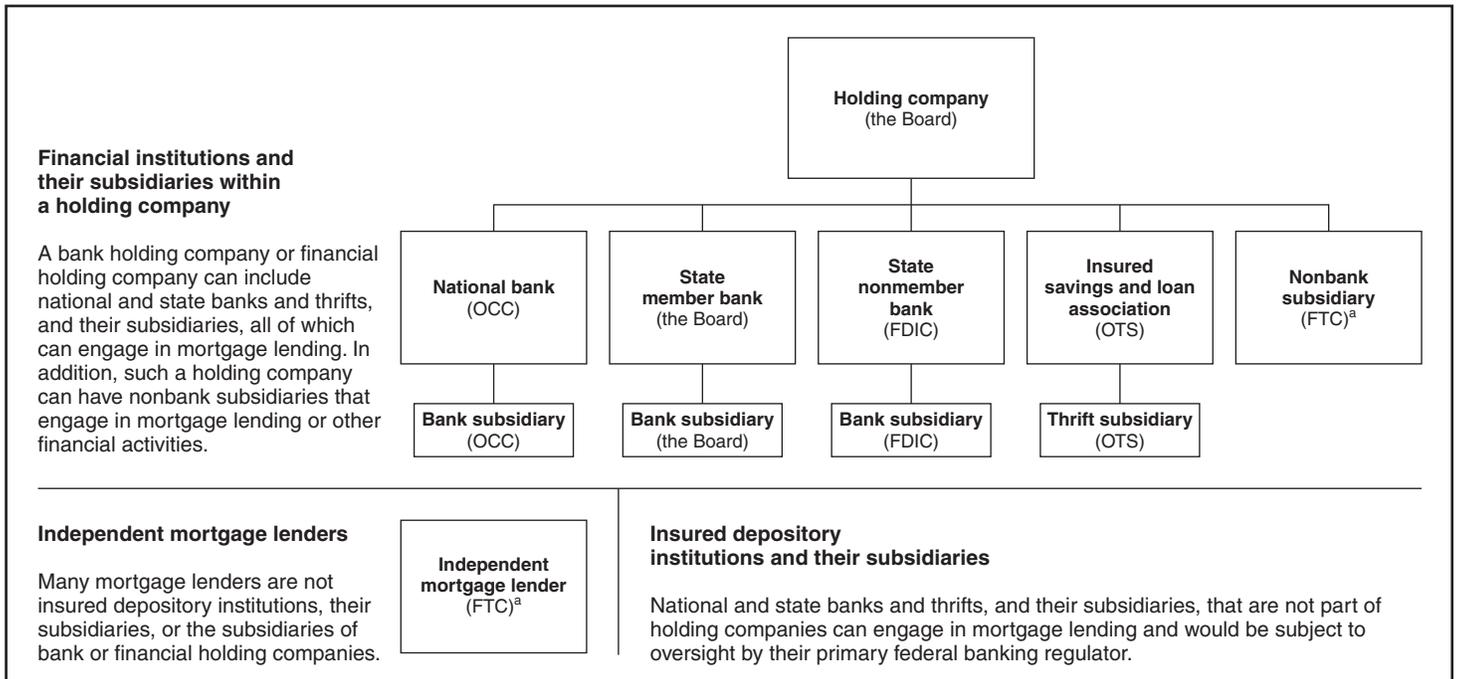
Jurisdictional Issues Related to Nonbank Subsidiaries Challenge Efforts to Combat Predatory Lending

Jurisdictional issues related to the regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Many federally and state-chartered banks and thrifts, as well as their subsidiaries, are part of larger financial holding companies or bank holding companies.⁴⁴ These holding companies may also include nonbank financial companies, such as finance and mortgage companies, that are subsidiaries of the holding companies themselves. These holding company subsidiaries are frequently referred to as affiliates of the banks and thrifts because of their common ownership by the holding company. As shown in figure 2, the federal regulators of federally and state-chartered banks and thrifts also regulate the subsidiaries of those institutions. For example, as the primary regulator for national banks, OCC also examines operating subsidiaries of those banks. On the other hand, federal regulators generally do not perform routine examinations of independent mortgage lenders and affiliated nonbank subsidiaries of financial and bank holding companies engaged in mortgage lending.

⁴⁴A subsidiary of a bank, thrift, or credit union is controlled through partial or complete ownership by the institution. Federal laws and regulations set more specific requirements that dictate whether an institution is a subsidiary. For the purposes of this report, the term holding company refers to both (traditional) bank holding companies and bank holding companies that qualify as financial holding companies as defined by the Board.

**Chapter 2
Federal Agencies Have Taken Steps to
Address Predatory Lending, but Face
Challenges**

Figure 2: Structure and Federal Oversight of Mortgage Lenders



Source: GAO.

Note: The primary federal agency for enforcement of the various federal laws used to combat abusive or predatory lending activities is shown in parentheses.

^aFTC is responsible for enforcing federal laws for lenders that are not depository institutions but it is not a supervisory agency and does not conduct routine examinations.

Some disagreement exists between states and some federal banking regulators over states' authority to regulate and supervise the operating subsidiaries of federally chartered depository institutions. For example, OCC issued an advisory letter in 2002 noting that federal law provides the agency with exclusive authority to supervise and examine operating subsidiaries of national banks and that the states have no authority to regulate or supervise these subsidiaries.⁴⁵ Some representatives of state banking regulators expressed concerns to us about this because of the subsidiaries' potential involvement in predatory lending practices. OCC

⁴⁵OCC Advisory Letter 2002-9 (Questions Concerning Applicability and Enforcement of State Laws: Contacts From State Officials, November 25, 2002.); see also 69 Fed. Reg. 1904 (Jan. 13, 2004).

has stated that the subsidiaries of the institutions it regulates do not play a large role in subprime lending and that little evidence exists to show that these subsidiaries are involved in predatory lending. But some state enforcement authorities and consumer advocates argue otherwise, citing some allegations of abuses at national bank subsidiaries. However, several state attorneys general have written that predatory lending abuses are “largely confined” to the subprime lending market and to non-depository institutions, not banks or direct bank subsidiaries.⁴⁶ OCC officials stated that the agency has strong monitoring and enforcement systems in place and can and will respond vigorously to any abuses among institutions it supervises.⁴⁷ For example, OCC officials pointed to an enforcement action taken in November 2003 that required restitution of more than \$100,000 to be paid to 30 or more borrowers for fees and interest charged in a series of abusive loans involving small “tax-lien loans.”

A second issue relates to the monitoring and supervision of certain nonbank subsidiaries of holding companies. As noted previously, many federally and state-chartered banks and thrifts, as well as their subsidiaries, are part of larger financial or bank holding companies.⁴⁸ These holding companies may also include nonbank subsidiaries, such as finance and mortgage companies, that are affiliates but not subsidiaries of the federally regulated bank or thrift. Although these affiliates engage in financial activities that may be subject to federal consumer protection and fair lending laws, unlike depository institutions they are not subject to routine supervisory examinations for compliance with those laws. While the Board has jurisdiction over these entities for purposes of the Bank Holding Company Act, it lacks authority to ensure and enforce their compliance

⁴⁶See Brief of Amicus Curiae State Attorneys General, *National Home Equity Mortgage Ass'n v. OTS*, Civil Action No. 02-2506 (GK) (D D.C.) (March 21, 2003) at 10-11.

⁴⁷Another jurisdictional issue is uncertainty as to whether the FTC shares jurisdiction with federal banking regulators over bank subsidiaries that are not themselves banks (operating subsidiaries). While OCC maintains it has exclusive regulatory jurisdiction over the operating subsidiaries of national banks, FTC argues that a provision of the Gramm-Leach-Bliley Act provides for the two agencies to share jurisdiction. See Pub. L. No. 106-102 § 133(a). A federal district court has upheld FTC’s interpretation. (See *Minnesota v. Fleet Mortg. Corp.*, 181 F. Supp. 2d 995 (D MN 2001)). We are not aware of any instance in which this matter has interfered with an FTC enforcement action.

⁴⁸In addition to financial and bank holding companies, there are thrift holding companies, which can include thrifts and other financial institutions. Each thrift holding company is regulated and subject to examination by OTS. See 12 USC §1467a (b)(4).

with federal consumer protection and fair lending laws in the same way that the federal regulators monitor their depository institutions.

One reason for the concern about these entities is that nonbank subsidiaries of holding companies conduct a significant amount of subprime mortgage lending. Of the total subprime loan originations made by the top 25 subprime lenders in the first 6 months of 2003, 24 percent were originated by nonbank subsidiaries of holding companies. In addition, of the 178 lenders on HUD's 2001 subprime lender list, 20 percent were nonbank subsidiaries of holding companies. These types of subsidiaries have also been targets of some of the most notable federal and state enforcement actions involving abusive lending. For example, The Associates and Fleet Finance, which were both nonbank subsidiaries of bank holding companies, were defendants in two of the three largest cases involving subprime lending that FTC has brought.⁴⁹

The Associates case illustrates an important aspect of the current federal regulatory oversight structure pertinent to predatory lending. The Board has authority under the Bank Holding Company Act to condition its approval of holding company acquisitions. The Board used this authority in connection with Citigroup's acquisition of European American Bank because of concerns about the subprime lending activities of The Associates, which Citigroup had acquired and merged into its CitiFinancial subsidiary. As a condition of approving the acquisition of European American Bank, the Board directed that an examination of certain subprime lending subsidiaries of Citigroup be carried out to determine whether Citigroup was effectively implementing policies and procedures designed to ensure compliance with fair lending laws and prevent abusive lending practices. However, the Board does not have clear authority to conduct the same type of monitoring outside of the Bank Holding Company Act approval process. Although the Board has the authority to monitor and

⁴⁹Citigroup acquired The Associates in November 2000 and merged The Associates' consumer finance operations into its subsidiary, CitiFinancial Credit Company, a nonbank subsidiary of the holding company. In 1999, Fleet Finance, Inc., and its successor company, Home Equity U.S.A., Inc., agreed to pay \$1.3 million to settle an FTC complaint alleging deceptive disclosures and TILA violations in conjunction with Fleet Finance, Inc., loans. At the time of the settlement, Fleet Finance had become Home Equity U.S.A., Inc. Both Fleet Finance, Inc., and Home Equity U.S.A., Inc., were nonbank subsidiaries of bank holding companies. At the time of the settlement, the bank holding company was Fleet Financial Group, Inc., which has been renamed FleetBoston Financial Corporation. Home Equity U.S.A., Inc., continues to operate as a nonbank subsidiary of FleetBoston Financial Corporation, a bank holding company.

perform routine inspections or examinations of a bank holding company, this authority apparently does not extend to routine examinations of nonbank subsidiaries of bank holding companies with regard to compliance with consumer protection laws. The Bank Holding Company Act, as amended by the Gramm-Leach-Bliley Act, authorizes the Board to examine a nonbank subsidiary for specific purposes, including “to monitor compliance with the provisions of (the Bank Holding Company Act) or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary.” Federal consumer protection laws do not give the Board specific enforcement jurisdiction over nonbank subsidiaries.

For this reason, FTC is the primary federal agency monitoring nonbank subsidiaries’ compliance with consumer protection laws. FTC is the primary federal enforcer of consumer protection laws for these nonbank subsidiaries, but it is a law enforcement rather than supervisory agency. Thus, FTC’s mission and resource allocations are focused on conducting investigations in response to consumer complaints and other information rather than on routine monitoring and examination responsibilities. Moreover, as discussed elsewhere in this report, states vary widely in the extent to which they regulate practices that can constitute predatory lending.

The HUD-Treasury report on predatory lending argued that the Board should take more responsibility for monitoring nonbank subsidiaries of bank holding companies, in part to ensure that consumer protection laws are adequately enforced for these institutions. Similarly, in 1999, GAO recommended that the Board monitor the lending activities of nonbank mortgage lending subsidiaries of bank holding companies and consider examining these entities if patterns in lending performance, growth, or operating relationships with other holding company entities indicated the need to do so.⁵⁰ In its written response to GAO’s recommendation, the Board said that while it has the general legal authority to examine these entities, it has neither the clear enforcement jurisdiction nor the legal responsibility for engaging in such activities, as Congress has directly charged FTC with primary responsibility over enforcement with regard to these entities.

⁵⁰See U.S. General Accounting Office, *Large Bank Mergers: Fair Lending Review Could be Enhanced With Better Coordination*, GAO/GGD-00-16 (Washington, D.C.: Nov. 3, 1999), 20 and 47.

Among federal agencies, the Board is uniquely situated to monitor the activities of the nonbank mortgage lending subsidiaries of financial and bank holding companies by virtue of its role as the regulator of holding companies and its corresponding access to data (such as internal operating procedures, loan level data, and current involvement in subprime lending) that are not readily available to the public. In addition, the Board has extensive experience monitoring and analyzing HMDA data. The recent changes in HMDA reporting requirements will increase the Board's ability to effectively monitor nonbank mortgage lending subsidiaries of holding companies for lending abuses.

In contrast to the specific limits on the Board's examination authority, its authority to enforce the federal consumer protection laws against nonbank subsidiaries is somewhat less clear. The laws themselves specify the institutions subject to enforcement by the Board, but those institutions generally do not include nonbank subsidiaries. The Board has concluded that it must defer enforcement action at least where, as here, a statute specifically prescribes its enforcement jurisdiction to cover only certain entities and specifically grants enforcement authority for other entities to another agency.

Conclusions

Under a number of laws, federal agencies have taken action to protect consumers from abusive lending practices. While FTC has taken a number of significant enforcement actions to battle abuses in the industry, its resources are finite and, as a law enforcement agency, it does not routinely monitor or examine lenders, including the mortgage lending subsidiaries of financial and bank holding companies.

Congress provided banking regulators with the authority to ensure compliance with consumer protection laws by the institutions they regulate, in part because it recognized the efficiencies of having banking regulators monitor for compliance with these laws while examining their institutions for safety and soundness. The Board is in a position to help ensure compliance with federal consumer protection laws by certain subsidiaries of financial and bank holding companies if it were clearly authorized to do so. While concerns about predatory lending extend well beyond the activities of the nonbank subsidiaries of holding companies, these entities represent a significant portion of the subprime mortgage market. Monitoring the mortgage lending activities of the nonbank subsidiaries would help the Board determine when it would be beneficial to conduct examinations of specific nonbank subsidiaries. The Board could

then refer its findings to DOJ, HUD, or FTC or take its own enforcement action if a problem exists. Granting the Board concurrent enforcement authority—with the FTC—for these nonbank subsidiaries of holding companies would not diminish FTC’s authority under federal laws used to combat predatory lending.

The significant amount of subprime lending among holding company subsidiaries, combined with recent large settlements in cases involving allegations against such subsidiaries, suggests a need for additional scrutiny and monitoring of these entities. The Board is in an optimal position to play a larger role in such monitoring but does not have clear legal authority and responsibility to do so for these entities with regard to monitoring compliance of consumer protection laws.

Matters for Congressional Consideration

To enable greater oversight of and potentially deter predatory lending from occurring at certain nonbank lenders, Congress should consider making appropriate statutory changes to grant the Board of Governors of the Federal Reserve System the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices. Also, Congress should consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

Agency Comments and Our Evaluation

GAO provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated, as appropriate. In addition, the Board, DOJ, FDIC, FTC, HUD, and NCUA provided general comments, which are discussed below. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V.

The Board commented that, while the existing structure has not been a barrier to Federal Reserve oversight, the approach recommended in our Matter for Congressional Consideration would likely be beneficial by catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would pose tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on

whether or not they are part of a holding company. Because nonbank mortgage lenders that are part of a financial or bank holding company are already subject to being examined by the Board in some circumstances, they are already subject to a different supervisory scheme than other such lenders. For example, in its comments the Board noted that it may on occasion direct an examination of a nonbank lending subsidiary of a holding company when necessary in the context of applications that raise serious fair lending or compliance issues. Accordingly, we do not believe that clarifying jurisdiction as contemplated in the Matter would result in a significant departure from the current supervisory scheme for nonbank mortgage lenders. The Board also noted that that there could be some additional cost to the nonbank mortgage lending subsidiaries of financial or bank holding companies, as well as to the Board, if the Board were to exercise additional authority. We agree and believe that Congress should consider both the potential costs as well as the benefits of clarifying the Board's authorities.

The FTC expressed concern that our report could give the impression that we are suggesting that Congress consider giving the Board sole jurisdiction—rather than concurrent jurisdiction with FTC—over nonbank subsidiaries of holding companies. Our report did not intend to suggest that the Congress make any change that would necessarily affect FTC's existing authority for these entities and we modified our report to clarify this point. To illustrate the difference in regulatory and enforcement approaches, our draft report contrasted the Board's routine examination authority with the FTC's role as a law enforcement agency. In its comments, FTC noted that it uses a number of tools to monitor nonbank mortgage lenders, of which consumer complaints is only one. The agency also commented that a key difference between the FTC and the Board is that the Board has access to routine information to aid in its oversight as part of the supervisory process. Our report did not intend to suggest that the FTC's actions are based solely on consumer complaints, and we revised the report to avoid this impression.

DOJ commented that the report will be helpful in assessing the department's role in the federal government's efforts to develop strategies to combat predatory lending. DOJ disagreed with our inclusion in the report of "property or loan flips," which it characterized as a traditional fraud scheme rather than an example of predatory lending. As our report states, there is no precise definition of predatory lending. We included a discussion of efforts to combat "property flipping" because HUD officials told us that these schemes sometimes involve predatory practices that can

harm borrowers. As we note in the report, while HUD categorizes property flipping as a predatory lending practice, not all federal agencies concur with this categorization. Distinct from property flipping is “loan flipping”—the rapid and repeated refinancing of a loan without benefit to the borrower. This practice is widely noted in literature and by federal, state, industry, and nonprofit officials as constituting predatory lending.

FDIC noted that our Matter for Congressional Consideration focuses on nonbank subsidiaries of financial and bank holding companies even though these entities comprise, according to HUD, only about 20 percent of all subprime lenders. We acknowledge that our Matter does not address all subprime lenders or institutions that may be engaging in predatory lending, but believe it represents a step in addressing predatory lending among a significant category of mortgage lenders. NCUA said that the report provides a useful discussion of the issues and that the agency concurs with our Matter for Congressional Consideration. HUD, in its comment letter, described a variety of actions it has taken that it characterized as combating predatory lending, particularly with regard to FHA-insured loans.

States Have Enacted and Enforced Laws to Address Predatory Lending, but Some Laws Have Been Preempted

In part because of concerns about the growth of predatory lending and the limitations of existing state and federal laws, 25 states, the District of Columbia, and 11 localities had passed their own laws addressing predatory lending practices as of January 9, 2004.¹ Most of the state laws restrict the terms or provisions of certain high-cost loans, while others apply to a broader range of loans. In addition, some states have taken measures to strengthen the regulation and licensing of mortgage lenders and brokers, and some have used existing state consumer protection and banking laws to take enforcement actions related to abusive lending. However, regulators of federally chartered financial institutions have issued opinions stating that federal laws may preempt some state predatory lending laws and that nationally chartered lending institutions should have to comply only with a single uniform set of national standards. Many state officials and consumer advocates have opposed federal preemption of state predatory lending laws on the grounds that it interferes with the states' ability to protect consumers.

States and Localities Have Addressed Predatory Lending through Legislation, Regulation, and Enforcement Actions

Since 1999, many states and localities have passed laws designed to address abusive mortgage lending by restricting the terms or provisions of certain loans. In addition, states have increased the registration or licensing requirements of mortgage brokers and mortgage lenders and have undertaken enforcement activities under existing consumer protection laws and regulations to combat abusive lending.

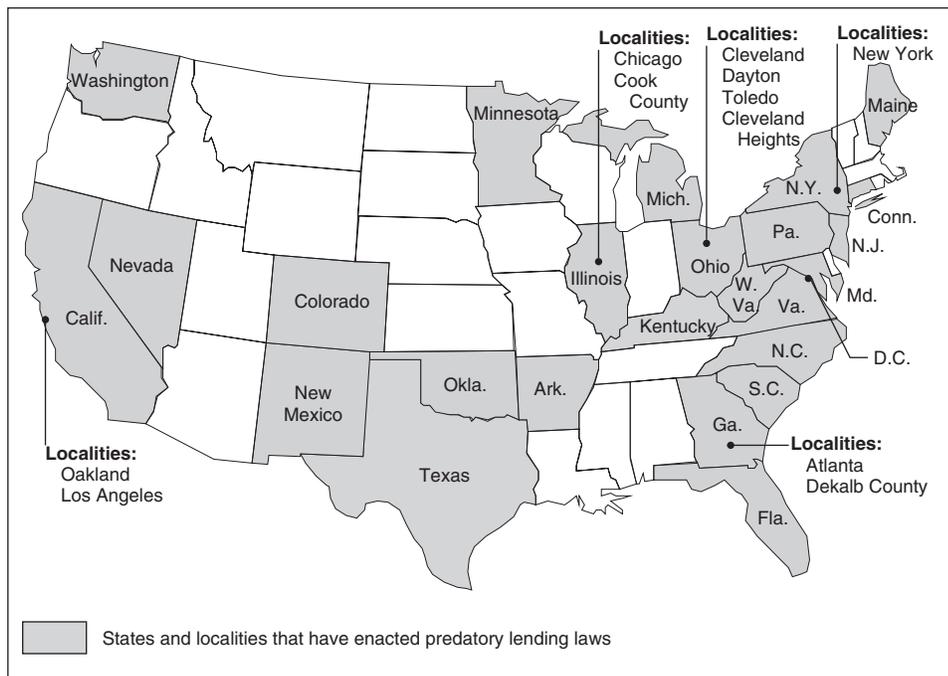
¹Except where citations to provisions of state laws are provided, all information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation. These laws include only state and local laws that place actual restrictions on lending and do not include, for example, local ordinances that consist solely of a resolution that condemned predatory lending. As noted in chapter 1, we took measures to verify the reliability of these data.

Chapter 3
States Have Enacted and Enforced Laws to
Address Predatory Lending, but Some Laws
Have Been Preempted

A Growing Number of
States and Localities Have
Passed Laws to Address
Abusive Lending

According to the database of state laws, as of January 9, 2004, 25 states and the District of Columbia had passed laws that were specifically designed to address abusive lending practices.² (See fig. 3.) These laws were motivated, at least in part, by growing evidence of abusive lending and by concerns that existing laws were not sufficient to protect consumers against abusive lending practices.

Figure 3: States and Localities That Have Enacted Predatory Lending Laws



Source: Butera & Andrews.

²North Carolina enacted the first state law (N.C. Gen. Stat. 24-1.1E[1999]) in 1999; it took effect on July 1, 2000. Nearly all the other state laws were enacted between 2001 and 2003.

Based on our review of the database of state laws, the predatory lending statutes in 20 of the 25 states regulate and restrict the terms and characteristics of certain kinds of “high-cost” or “covered” mortgage loans that exceed certain interest rate or fee triggers.³ Some state laws, such as those in Florida, Ohio, and Pennsylvania, use triggers that are identical to those in the federal HOEPA statute but add provisions or requirements, such as restrictions on refinancing a loan under certain conditions.⁴ Other state laws, such as those of Georgia, New Jersey and North Carolina, use triggers that are lower than those in HOEPA and therefore cover more loans than the federal legislation.⁵ Some states design their triggers to vary depending on the amount of the loan. For example, in New Mexico and North Carolina, covered loans greater than \$20,000 are considered high cost if the points and fees on the loan exceed 5 percent of the total loan amount (North Carolina) or equal or exceed it (New Mexico). In these states, loans for less than \$20,000 are considered high cost if the points and fees exceed either 8 percent of the total or \$1,000.⁶ In the remaining 5 states, the predatory lending laws apply to most mortgage loans; there is no designation of loans as high cost. For example, West Virginia’s law in effect generally prohibits lenders from charging prepayment penalties on any loans and restricts points and fees to either 5 or 6 percent, depending on whether the loan includes a yield spread premium.⁷ Michigan’s law prohibits the financing of single-premium credit insurance into loans.⁸

According to the database, common provisions in state laws are designed to address the following:

- *Lending without regard to the ability to repay.* Restrictions on the making of loans without regard to the borrower’s ability to repay the loan, sometimes referred to as asset-based lending.

³Massachusetts has imposed similar restrictions on high-cost loans, but it was done through regulatory changes rather than legislation.

⁴See, e.g., Fla. Stat. Ann. §§ 494.0079, 494.00791 (2003); Ohio Rev. Code Ann. §§ 1394; Ohio Rev. Code Ann. § 1349.25 (2003); 63 PA Stat. § 456.503 (2003).

⁵See GA Code Ann. § 7-6A-2(2003); N.J. Stat. Ann. § 46:10B-24 (West 2003); N.C. Gen. Stat. § 24-1.1E (2003).

⁶N.C. Gen. Stat. § 24-1-1E; N.M. Stat. Ann § 58-21A-3 (2003).

⁷W. VA. Code §§ 46A-3-110, 31-17-8 (2003).

⁸See Mich. Comp. Laws § 445.1634 (2003).

- *Prepayment penalties.* Limitations on the amount of a prepayment penalty, terms under which a penalty can be assessed, or both.
- *Balloon payments.* Prohibitions on loans with balloon payments or restrictions on their timing.
- *Negative amortization.* Prohibitions on loans where regularly scheduled payments do not cover the interest due.
- *Loan flipping.* Restrictions or prohibitions on the repeated refinancing of certain loans within a short period of time if the refinancing will not benefit the borrower.
- *Credit counseling.* Requirements that borrowers either receive or are notified of the availability of loan counseling.
- *Arbitration clauses.* Restrictions on mandatory arbitration clauses, which limit a borrower's right to seek redress in court. Some laws prohibit mandatory arbitration clauses altogether, while others require compliance with certain standards, such as those set by a nationally recognized arbitration organization.
- *Assignee liability.* Provisions that expressly hold purchasers or securitizers of loans liable for violations of the law committed by the originator, under certain conditions. (See ch. 4 for more information on assignee liability.)

In addition, according to the database we reviewed, 11 cities and counties have passed laws of their own designed to address predatory lending since 2000.⁹ Some local laws are similar to state laws in that they define high-cost loans and restrict their provisions, such as in Los Angeles, California. Other localities, such as Oakland, California, have passed resolutions prohibiting lenders that engage in predatory lending practices from doing business with the locality.

⁹In some cases, these laws were enacted but pending litigation stayed enforcement.

Some States Have Increased
the Regulation of Lenders
and Brokers and
Undertaken Enforcement
Activities to Combat
Predatory Lending

In general, states have regulated mortgage lenders and brokers, although to varying degrees. Some state officials told us that because of concerns that unscrupulous mortgage lenders and brokers were not adequately regulated and were responsible for lending abuses, some states have increased their regulation or licensing requirements of lenders and brokers. As part of their licensing requirements, states sometimes require that these companies establish a bond to help compensate victims of predatory lenders or brokers that go out of business, and some states also require that individuals working for or as mortgage lenders and brokers meet certain educational requirements.

Some states have also reorganized their agencies' operations to better address abuses by lenders and brokers. For example, an official with the Kansas Office of the State Banking Commissioner told us that in 1999 the Kansas legislature created the Division of Consumer and Mortgage Lending, which provides additional staff for examination and enforcement activities. Similarly, an official from the Idaho Department of Finance told us that the state created the Consumer Finance Bureau in 2000 to oversee and conduct routine examinations of mortgage brokers and mortgage lenders.

State law enforcement agencies and banking regulators have also taken a number of actions in recent years to enforce existing state consumer protection and banking laws in cases involving predatory lending. For example, an official from the Washington Department of Financial Institutions reported that it has taken several enforcement actions in recent years to address predatory lending. In one such action, a California mortgage company that allegedly deceived borrowers and made prohibited charges was ordered to return more than \$700,000 to 120 Washington State borrowers. According to officials of the Conference of State Bank Supervisors, states reported that in addressing predatory lending they have usually relied on general state consumer protection laws in areas such as fair lending, licensing, and unfair and deceptive practices. In some states, consumer protection statutes do not apply to financial institutions, so state banking regulators, rather than the attorneys general, typically initiate enforcement activities. Because allegations of predatory practices often involve lending activities in multiple states, states have sometimes cooperated in investigating alleged abuses and negotiating settlements. For example, in 2002 a settlement of up to \$484 million with Household Finance Corporation resulted from a joint investigation begun by the attorneys general and financial regulatory agencies of 19 states and the

District of Columbia. State agencies have also conducted investigations in conjunction with the federal government.

Activities in North Carolina and Ohio Illustrate State Approaches to Predatory Lending

States have varied in their approaches to addressing predatory lending issues. We reviewed legislative and enforcement activities related to predatory lending in two states, North Carolina and Ohio, to illustrate two different approaches.

Impact of North Carolina's Laws on High-Cost Loans and Licensing of Brokers and Originators Remains Uncertain

North Carolina has enacted two separate laws to address concerns about predatory lending. In 1999, the legislature passed a law that attempted to curb predatory lending by prohibiting specific lending practices and restricting the terms of high-cost loans.¹⁰ In 2001, North Carolina supplemented its predatory lending law by adopting legislation that required the licensing of mortgage professionals (mortgage lenders, brokers, and loan officers), defined a number of prohibited activities related to the making of residential mortgages, and enhanced the enforcement powers of the banking commissioner.¹¹

According to the North Carolina Commissioner of Banks, the North Carolina laws applicable to predatory lending were the product of a consensus of banks, mortgage bankers and brokers, nonprofit organizations, and other stakeholders and were intended to address lending abuses that were not prohibited by federal statutes and regulations. Among other things, the 1999 legislation, known as the North Carolina Anti-Predatory Lending Law, imposes limitations specific to both "high-cost"

¹⁰N.C. Session Law 1999-332.

¹¹N.C. Sessions Laws 2001-393 and 2001-399.

loans and other “consumer home loans.”¹² North Carolina’s predatory lending law did not restrict initial interest rates but instead focused on prohibiting specific lending practices and restricting the terms of high-cost loans. In conjunction with other North Carolina laws, the 1999 legislation contains four key features. First, it bans prepayment penalties for all home loans with a principal amount of \$150,000 or less. Second, it prohibits loan flipping—refinancings of consumer home loans that do not provide a reasonable, net tangible benefit to the borrower. Third, it prohibits the financing of single-premium credit life insurance. Finally, it sets a number of restrictions on high-cost loans, including making loans without regard to borrowers’ ability to repay; financing points, fees, and any other charges payable to third parties; or setting up loans with balloon payments. Further, the law prohibits home improvement contract loans under which the proceeds go directly to the contractor, and requires that borrowers receive financial counseling prior to closing.

Although the North Carolina predatory lending law governs the practices of lenders and mortgage brokers, some groups questioned whether it provided for effective enforcement. Specifically, concerns were focused on the lack of state licensing and oversight of all segments of the mortgage lending profession, including mortgage brokers and bankers. Additionally, some critics asserted that the statute provided the state banking commissioner with limited and uncertain authority to enforce the predatory lending provisions. As a result, even before the predatory lending legislation passed, stakeholders worked on a measure to fill the gaps left by the state’s predatory lending law.

¹²The North Carolina predatory lending law defines a high-cost loan as a home loan of \$300,000 or less that has one or more of the following characteristics: (1) points, fees (excluding certain amounts specified in the law), and other charges totaling more than 5 percent of the borrowed amount if the loan is \$20,000 or more, or the lesser of 8 percent of the amount borrowed or \$1,000 if the loan is less than \$20,000; (2) an interest rate that exceeds by more than 10 percent per annum the yield on comparable Treasury bills; or (3) a prepayment penalty that could be collected more than 30 months after closing or that is greater than 2 percent of the amount prepaid. According to the North Carolina Commissioner of Banks, the \$300,000 cap is based on the presumption that those able to borrow \$300,000 or more are able to adequately protect themselves. “Consumer home loans” are loans in which (i) the borrower is a natural person, (ii) the debt is incurred by the borrower primarily for personal, family, or household purposes, and (iii) the loan is secured by a mortgage or deed of trust upon real estate upon which there is located or there is to be located a structure or structures designed principally for occupancy of from one to four families which is or will be occupied by the borrower as the borrower’s principal dwelling.

North Carolina's second statute, the Mortgage Lending Act, was signed into law on August 29, 2001. Prior to the act, some mortgage banking firms and all mortgage brokerages domiciled in the state had been required to register with the state's banking regulator, but individual loan originators were not. The Mortgage Lending Act imposed licensing requirements on all mortgage bankers and brokers, including individuals who originate loans, and added continuing education and testing requirements for mortgage loan officers. The provisions of the act mean that individuals as well as firms are now subject to regulatory discipline. According to the North Carolina Commissioner of Banks, the act has been effective in reducing the number of abusive brokers and individual loan originators. The commissioner noted that a large number of applications for licenses have been denied because the applicants did not meet basic requirements or did not pass the required background check.

Studies on the impact of North Carolina's Anti-Predatory Lending Law have offered conflicting conclusions. For example, one study found an overall decline in subprime mortgages and concluded that any reductions in predatory lending had been attained at the expense of many legitimate loans.¹³ Some have pointed to this evidence as suggesting that the law has reduced legitimate credit to those who most need it. Another study found a reduction in subprime originations but attributed the decline to a reduction in loans with abusive or predatory terms.¹⁴ Consumer advocates and state officials have cited this study as evidence that the law has worked as intended.

Our review of the five studies available on the impact of the North Carolina predatory lending law suggested that data limitations and the lack of an accepted definition of predatory lending make determining the law's impact difficult. For example, information about borrowers' risk profiles, the pricing and production costs of the loans, and the lenders' and borrowers' behaviors was not available to the study researchers. In addition, the extent to which any potential reductions in predatory loans

¹³Elliehausen and Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, Georgetown University School of Business (November 2002).

¹⁴Quercia, Stegman, and Davis, *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment*, Center for Community Capitalism, The Frank Hawkins Kenan Institute of Private Enterprise, University of North Carolina at Chapel Hill (June 25, 2003).

can be attributed to the Mortgage Lending Act as opposed to the Anti-Predatory Lending Law is unclear. Additional experience with the North Carolina laws may be needed in order to properly assess them.

Ohio Has Preempted Local Laws and Taken Action to Regulate Mortgage Brokers

In February 2002, the Ohio legislature enacted a law with the purpose of bringing Ohio law into conformance with HOEPA.¹⁵ Among other things, the legislation preempted certain local predatory lending ordinances. The law was passed in response to an ordinance enacted in the city of Dayton, which was designed to fight predatory lending by regulating mortgage loans originated in that city. Proponents of the state law argued that regulating lenders is a state rather than municipal function and that lending rules should be uniform throughout the state. Some advocates argued that the state law prevents cities from protecting their citizens from abusive lending practices.

The Ohio law imposes certain restrictions on high-cost loans as defined by HOEPA. These include additional restrictions on credit life or disability insurance beyond those imposed by HOEPA. The law also prohibits the replacement or consolidation of a zero-interest rate or other low-rate loan made by a governmental or nonprofit lender with a high-cost loan within the first 10 years of the low-rate loan unless the current holder of the loan consents in writing to the refinancing.¹⁶ Because the purpose of this law was to bring Ohio's law into conformance with HOEPA, the law applies only to loans that qualify as mortgage loans subject to HOEPA. Thus, like predatory lending laws in some other states, the Ohio law applies to relatively few loans.

In May 2002, the Ohio legislature passed another piece of legislation, designed in part to address abusive lending—the Ohio Mortgage Broker Act—that imposed requirements on the state's mortgage brokers and loan officers.¹⁷ Among other things, this law required state examination, education, and licensing of loan officers, and prohibited brokers from engaging in certain deceptive or fraudulent practices. It also required that

¹⁵See Ohio Rev. Code Ann. § 1349.32 (2003).

¹⁶Ohio Rev. Code Ann. § 1349.27 (2002).

¹⁷See Ohio Rev. Code Ann. §§ 1322.01 – 1322.12 (2003).

mortgage brokers and loan officers receive continuing education and take prelicensing competency tests.

In the act adopting HOEPA standards, the Ohio legislature also established a Predatory Lending Study Committee, which was charged with investigating the impact of predatory lending practices on the citizens and communities of Ohio.¹⁸ The study committee consisted of 15 members, including representatives from state agencies, consumer groups, and the lending industry. The act required the committee to submit a report to the governor and legislators by the end of June 2003. The committee reached consensus on two major issues. First, it recommended that all appraisers in the state be licensed and subject to criminal background checks, and second, it recommended increased enforcement of the Ohio Mortgage Broker Act. The Division of Financial Institutions, which is responsible for enforcing the Ohio Mortgage Broker Act, has hired additional staff to ensure compliance with the law. The report and recommendations have been forwarded to the governor and the committee suggested that the Ohio General Assembly consider all recommendations.

Other local ordinances have been passed in Ohio to address predatory lending. One of these ordinances, passed in November 2002 by the Toledo City Council to regulate mortgage lending practices, was challenged, and its enforcement stayed, because of the state HOEPA law passed in February 2002.¹⁹ One provision of that ordinance prohibited making an abusive loan by “taking advantage of a borrower’s physical or mental infirmities, ignorance or inability to understand the terms of the loan.” This provision drew criticism from the mortgage industry, which said the language was vague and difficult to comply with. For example, one secondary market participant noted that it would be nearly impossible to assess borrowers’ mental capabilities for loans they did not originate in the first place. Violating the law was made a criminal offense, and convicted offenders could not receive city contracts or conduct other business with the city.

¹⁸2002 Ohio Laws HB 386 § 5.

¹⁹Ordinance No. 271-03. As of November 17, 2003, the City of Toledo was temporarily enjoined from enforcing application, enforcement, or other effectuation of this ordinance as a result of a lawsuit asserting that the ordinance is preempted by the Home Ownership and Equity Protection Act of Ohio. *AFSA v. City of Toledo, Ohio*, No. C10200301547 (Lucas County).

Regulators Have Determined That Federal Law Preempts Some State Predatory Lending Laws, but Views on Preemption Differ

Significant debate has taken place as to the advantages and disadvantages of state and local predatory lending laws. In several cases, regulators of federally supervised financial institutions have determined that federal laws preempt state predatory lending laws for the institutions they regulate. In making these determinations, two regulators—OCC and OTS—have cited federal law that provides for uniform regulation of federally chartered institutions and have noted the potential harm that state predatory lending laws can have on legitimate lending. Representatives of the lending industry and some researchers agree with the federal banking regulators, arguing that restrictive state predatory lending laws may ultimately hurt many borrowers by reducing the supply of lenders willing to make subprime loans, creating undue legal risks for legitimate lenders, and increasing the costs of underwriting mortgage loans. Moreover, industry representatives have said that most predatory lending practices are already illegal under federal and state civil and criminal laws and that these laws should simply be more stringently enforced. In contrast, many state officials and consumer advocates are opposed to federal preemption of state predatory lending laws. They maintain that federal laws related to predatory lending are insufficient, and thus preemption interferes with their ability to protect consumers in their states, particularly from any potential abuses by the subsidiaries of federally chartered institutions.

OCC, OTS, and NCUA Have Determined That Federal Law Preempts Some State Predatory Lending Laws

Because both the federal and state governments have roles in chartering and regulating financial institutions, questions can arise as to whether a federal statute preempts particular state laws.²⁰ Affected parties may seek guidance from federal agencies requesting their views on whether a particular federal statute preempts a particular state law; in these instances, the agency may issue an advisory opinion or order on the issue. Because the courts are ultimately responsible for resolving conflicts between federal and state laws, these advisory opinions and orders are subject to court challenge and review. As of November 2003, one or more federal regulators had determined that federal laws preempted the predatory mortgage lending laws of the District of Columbia and five

²⁰See U.S. General Accounting Office, *Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law*, [GAO/GGD/OGC-00-51R](#) (Washington, D.C.: Feb. 7, 2000) for additional information on federal preemption of state banking laws.

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states—Georgia, New Jersey, New Mexico, New York, and North Carolina. (See table 1.)

Table 1: Preemption Determinations Issued by OCC, OTS, and NCUA Related to Predatory Mortgage Lending Laws

OCC	OTS	NCUA
Georgia (2003)	Georgia (2003)	Georgia (2002)
	New York (2003)	New York (2000)
	New Mexico (2003)	North Carolina (2002)
	New Jersey (2003)	District of Columbia (2003)

Source: GAO.

Preemption of state law is rooted in the U.S. Constitution’s Supremacy Clause, which provides for the supremacy of federal law. Over the years, the courts have developed a substantial body of precedent that has guided the analysis of whether any particular federal law or regulation overrides or preempts state law. The courts’ analysis of whether federal law preempts state law has fundamentally centered on whether Congress intended for the federal law or regulation to override state law, either from the face of the statute itself (express preemption) or from the structure and purpose of the statute (implied preemption.) In their preemption opinions, OCC, OTS, and NCUA have cited a variety of legislation and legal precedents. Since 1996, OTS has had regulations in place that describe its preemption of state lending laws.²¹ In January 2004, OCC issued a rule amending its regulations in a similar manner, clarifying what types of state laws federal law preempts in the context of national bank lending.²² OCC stated that it issued the rule in response to the number and significance of the questions that have arisen with respect to the preemption of state laws and to reduce uncertainty for national banks that operate in multiple states. In its rulemaking, OCC stated that it was seeking to provide more comprehensive standards regarding the applicability of state laws to lending, deposit taking, and other authorized activities of national banks. The regulations

²¹2 C.F.R § 560.2(a).

²²69 Fed. Reg. 1904 (Jan. 13, 2004).

list examples of the types of state statutes that are preempted (such as laws regulating credit terms, interest rates, and disclosure requirements) and examples of the types of state laws that would not be preempted (such as laws pertaining to zoning, debt collection, and taxation). When OCC first proposed these rules, one news article stated that it “triggered a flood of letters and strong reactions from all corners of the predatory lending debate.” States and consumer groups were critical of the proposal. In contrast, the Mortgage Bankers Association of America and some large national banking companies wrote comment letters in support of OCC’s proposed rules.

Views Differ on the Implications of Federal Preemption of State Predatory Lending Laws

Federal banking regulators point out that preemption of states’ antipredatory lending laws applies only to institutions chartered by the agency issuing the preemption order. For example, OTS’s preemption opinion served to preempt New Jersey’s predatory lending statute for federally chartered thrifts but did not affect the statute’s applicability to independent mortgage companies, national banks, and state-chartered banks and thrifts. In preempting the New Jersey Home Ownership Security Act of 2002, OTS’s Chief Counsel noted that requiring federally chartered thrifts to comply with a hodgepodge of conflicting and overlapping state lending requirements would undermine Congress’s intent that federal savings institutions operate under a single set of uniform laws and regulations that would facilitate efficiency and effectiveness.²³ Federal banking regulators have said that they have found little to no evidence of predatory lending by the institutions they regulate, pointing out that federally supervised institutions are highly regulated and subject to comprehensive supervision.²⁴ They have also noted that they have issued guidance and taken numerous other steps to ensure that their institutions do not engage in predatory lending. Further, OCC has stated that state predatory lending laws, rather than reducing predatory lending among federally supervised institutions, can actually restrict and inhibit legitimate lending activity. The lending industry has generally supported preemption. For example, the Mortgage Bankers Association of America has argued

²³Office of Thrift Supervision, P-2003-5, Preemption of New Jersey Predatory Lending Act (July 22, 2003).

²⁴Several state law enforcement authorities have also said that predatory lending generally occurs outside of banks and direct bank subsidiaries. See Brief of Amicus Curiae State Attorneys General, *National Home Equity Mortgage Ass’n v. OTS*, Civil Action No. 02-2506 (GK) (D D.C.) (March 21, 2003) at 10-11.

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that uniformity in lending regulations is central to an efficient and effective credit market.

In contrast, many state officials and consumer advocates have opposed federal preemption of state predatory lending laws, for several reasons. First, they contend that state predatory lending laws are necessary to address gaps in relevant federal consumer protection laws. For example, one state official said that the predatory lending legislation adopted by his state was more focused and effective than the provisions of the Federal Trade Commission Act. In addition, opponents of preemption claim that federal regulators may not devote the necessary resources or have the willingness to enforce federal consumer protection laws relevant to predatory lending by federally chartered institutions and their subsidiaries. In response to OCC's and OTS's statements that there is no evidence of predatory lending among subsidiaries of federally regulated depository institutions, opponents of preemption noted that there are several cases in which allegations of abusive lending practices involving some of these subsidiaries have been raised.²⁵

²⁵ For example, see *Comments on OCC Working Paper*, Center for Responsible Lending, 7-10, October 6, 2003, <http://www.predatorylending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf>.

The Secondary Market May Play a Role in Both Facilitating and Combating Predatory Lending

By providing lenders with an additional source of liquidity, the secondary market can benefit borrowers by increasing the availability of credit and, in general, lowering interest rates. While a secondary market for prime mortgage loans has existed for decades, a relatively recent secondary market for subprime loans now offers these potential benefits to subprime borrowers as well. However, the secondary market may also serve to facilitate predatory lending, as it can provide a source of funds for unscrupulous originators that quickly sell off loans with predatory terms. Secondary market participants may use varying degrees of due diligence to avoid purchasing loans with abusive terms. In addition, some states have enacted legislation with assignee liability—potentially holding purchasers liable for violations of abusive lending laws that occurred in the loan origination. However, extending liability to secondary market purchasers may cause lenders and other secondary market participants, such as credit rating agencies, to withdraw from the market, as occurred in Georgia.

The Development of a Secondary Market for Subprime Loans Can Benefit Consumers

Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them in the secondary market. Secondary market purchasers may then hold the loans in their own portfolio or may pool together a group of loans and issue a mortgage-backed security that is backed by a pool of such loans. The securitization of mortgage loans became common during the 1980s and, by the 1990s, had become a major source of funding in the prime mortgage market. According to the Office of Federal Housing Enterprise Oversight, by the end of 2002 more than 58 percent of outstanding U.S. single-family residential mortgage debt was financed through securitization. Two government-sponsored enterprises—Fannie Mae and Freddie Mac—represented nearly 40 percent of the amount securitized.¹

The securitization of subprime mortgage loans did not become common until the mid-1990s. The development of a secondary market for these loans has been an important factor in the growth of subprime lending, expanding subprime lenders' access to funds and thus increasing the availability of subprime credit. The trade journal *Inside B&C Lending* estimated that in 2002 approximately 63 percent of new subprime

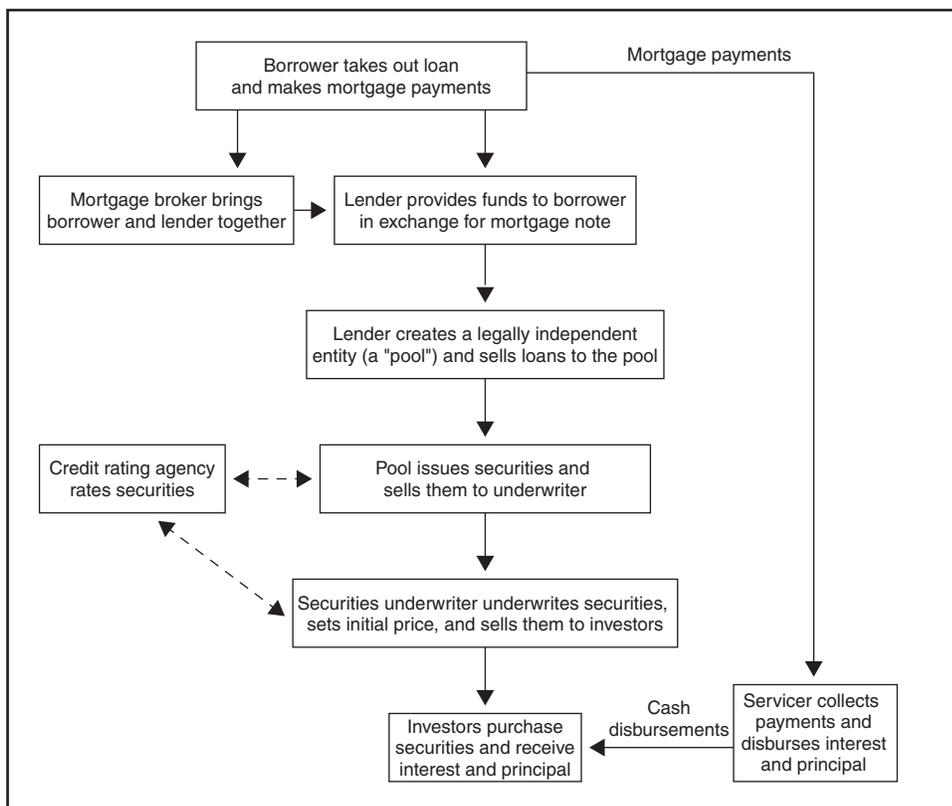
¹A government-sponsored enterprise (GSE) is a congressionally chartered, publicly owned corporation established and accorded favored regulatory treatment to increase access to the capital market for specific economic sectors, including housing.

mortgages, representing \$134 billion, were securitized. The originators of subprime loans are often nonbank mortgage and finance companies. As secondary market participants—such as the Wall Street investment firms that have been the major underwriters for subprime securities—have grown more willing to purchase these instruments, subprime originators have gained access to an important source of liquidity that has allowed them to make more subprime loans.

As shown in figure 4, the process of securitization starts with borrowers obtaining mortgages either directly from a lender or through a broker. The lender then creates a pool—a separate legal entity that purchases the mortgages and issues securities based on them. The lender hires a credit rating agency, which has no direct financial interest in the deal, to confirm the value of the securities based on the expected return and risks of the underlying mortgages. At the same time, the lender hires an underwriter to sell the securities to investors. The value of the securities is based exclusively on the mortgages themselves and is separate from the financial condition of the original lender. Finally, a servicer is hired to collect mortgage payments from the borrowers and disburse interest and principal payments to the investors. The process described above is for securitizations performed via private conduits—that is, without the participation of government-sponsored enterprises.

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Figure 4: Steps in the Securitization of Residential Mortgages



Source: GAO.

Note: This chart represents the process for fully private securitizations and not for government-sponsored enterprises.

Freddie Mac and Fannie Mae are relatively recent entrants into the subprime market; Freddie Mac began purchasing subprime loans in 1997 and Fannie Mae in 1999. Both companies have moved slowly and have limited their purchases to the segment of the subprime market with the most creditworthy of subprime loans. At present, the companies are believed to represent a relatively small portion of the overall secondary market for subprime loans. The exact portion they represent is not clear, but a study conducted for HUD estimated that the companies purchased

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about 14 percent of the subprime loans originated in 2002.² Both Fannie Mae and Freddie Mac have stated publicly that they plan on expanding their role in the subprime market in the future. In part, this may be a result of the affordable housing goals that HUD set for the GSEs in October 2000, which increased the goals for loans made to low- and moderate-income borrowers.³ HUD recommended that the GSEs consider enhancing their roles in the subprime market—which often serves low- and moderate-income borrowers—to help standardize mortgage terms in that market and potentially reduce interest rates for subprime borrowers. While the GSEs are currently believed to represent a small portion of the secondary market for subprime lending, some market observers believe their share will grow.

The growth of the secondary market for subprime loans has potentially benefited some consumers. By providing subprime lenders with a new source of liquidity, these lenders face lower funding costs and reduced interest rate risk, in part because the supply of lenders willing to make loans to borrowers with impaired credit has increased. Many analysts say that, as a result, mortgage loans are now available to a whole new population of consumers and interest rates on subprime loans made by reputable lenders have fallen. In addition, increased securitization of subprime lending may lead to more uniform underwriting of subprime loans, which could further reduce origination costs and interest rates to consumers.

²K. Temkin, J. Johnson, D. Levy, “Subprime Markets, the Role of GSEs, and Risk-Based Pricing,” prepared by The Urban Institute for the U.S. Department of Housing and Urban Development, March 2002. Other estimates of the GSEs’ share of securitization of the subprime market have varied, in part because—as noted earlier—there is no consistent industry definition of what constitutes subprime.

³The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires Fannie Mae and Freddie Mac to meet annual percent-of-business housing goals established by HUD for three categories: low- and moderate-income, underserved, and special affordable. HUD set the following goals for 2001 through 2003: low- and moderate-income—50 percent of the total number of units financed; underserved—31 percent of the total number of units financed; and special affordable—20 percent of the total number of units financed.

The Secondary Market for Subprime Loans Can Facilitate Predatory Lending

While the development of a secondary market for subprime loans may have benefits for borrowers, it can also provide a source of funds for unscrupulous originators that quickly sell off loans with predatory terms. The secondary market can complicate efforts to eliminate predatory lending by separating ownership of a loan from its originator. This separation can undermine incentives to reduce risk in lending and create incentives that may increase the attractiveness of making loans with predatory terms. As noted earlier, some originators of subprime mortgage loans make their profits from high origination fees. The existence of a market that allows originating lenders to quickly resell subprime loans may reduce the incentive these lenders have to ensure that borrowers can repay. Further, lenders often market their products through brokers that do not bear the risks associated with default, as brokers are compensated in up-front fees for the loans they help originate. Some lenders and state officials told us that unscrupulous brokers sometimes deceive originating lenders regarding borrowers' ability to repay. Even if deceived, lenders who originate the loans and then sell them in the secondary market ultimately may not bear the risk of a loan default. Taken together, these circumstances can undermine efforts to combat predatory lending practices.

Market forces provide some incentives to deter secondary market purchasers from purchasing predatory loans because these loans create both credit and reputation risk.⁴ However, predatory loans do not in all cases create unusual financial risks or losses for secondary market purchasers. For example, in most states loan purchasers are generally not liable for damages that may have resulted from the origination of abusive loans that they purchased, mitigating much of the legal risk of buying loans that may have violated laws addressing predatory lending. Moreover, loans with predatory features may carry very high interest rates and have barriers to prepayment, which may more than compensate for the increased credit risks associated with subprime loans.

However, investors' insistence on the use of credit enhancements in the securitization process may offset or mitigate the incentives to engage in predatory lending of originators who sell loans to the secondary market.

⁴Reputation risk is the current and prospective impact on a company's earnings and capital arising from negative public opinion from other market participants. This risk may expose a misbehaving originator or lender to litigation, financial loss, and a decline in its customer base if its behavior injures its customers or clients.

Credit enhancements, which refer to a variety of approaches used to reduce the credit risk of an obligation, are common in securitization transactions, in part because of concerns that originators may try to pass on lower-quality loans. Because the price investors will pay for securities is based on risk as well as return, sellers use the enhancements to lower the risk and thus raise the price of securities. For example, the securities may be overcollateralized by ensuring that the value of the collateral backing the securities—in the case of mortgage backed securities, the face value of the loans—exceeds the value of the securities being offered for sale. The difference provides a “cushion” or reserve against possible credit losses and permits a higher loss rate on the total mortgage pool without endangering payments to the owners of the securities. Securitizers can also include recourse provisions in their loan purchases that require sellers to take back loans in the event of borrower default. As a result of these factors, the degree to which originators of loans sold in the secondary market—including loans with abusive terms—are insulated from credit risks associated with those loans varies, and the profits from selling the loans may vary with the costs of credit enhancement.

Due Diligence Can Help Purchasers Avoid Predatory Loans, but Efforts Vary among Secondary Market Participants

Secondary market purchasers of residential mortgage loans undertake a process of due diligence designed to minimize legal, financial, and reputation risk associated with the purchase of those loans. Due diligence can play an important role in avoiding the purchase of abusive loans, but cannot necessarily identify all potentially abusive loans. Officials of Fannie Mae and Freddie Mac—which, as noted previously, are relatively recent entrants in the subprime market—are also concerned about risks but say that their due diligence processes are also designed to avoid purchasing loans that may have been harmful to consumers. Other firms’ due diligence is not necessarily specifically intended to avoid loans that may have harmed consumers but rather to avoid purchasing loans that are not in compliance with applicable law or that present undue financial or reputation risks.⁵

⁵OCC has issued guidelines stating that national banks are expected to undertake appropriate due diligence to avoid purchasing predatory loans. See OCC Advisory Letter 2003-3 (*Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans*), February 21, 2003.

Due Diligence May Deter the Purchase of Some Predatory Loans but Has Limitations

Loans purchased in the secondary market are usually not purchased individually but rather as a pool of many loans. Purchasers or securitizers of residential mortgage loans try to ensure that the loans in a particular pool are creditworthy and in compliance with law. Purchasers perform a general background and financial review of the institutions from which they purchase loans. In addition, secondary market purchasers of loans nearly always conduct due diligence, or a review and appraisal of confidential legal and financial information related to the loans themselves. Before or after the sale, purchasers may review electronic data containing information on the loans, such as the loan amount, interest rate, and borrower's credit score. Purchasers also may physically review a sample of individual loans, including items such as the loan applications and settlement forms.

Some industry representatives and federal agencies say that appropriate due diligence can play an important role in deterring predatory lending. Participants in the secondary market have an interest in not purchasing loans that may be considered predatory because such loans can create unwarranted legal, financial, and reputation risk. For example, if such loans violate relevant municipal, state, or federal laws, purchasing them could, in some cases, expose the buyers to legal risks such as lawsuits, fines, and penalties. Moreover, predatory loans may be more likely to go into default, increasing financial risk without a commensurate increase in expected returns. In addition, many industry officials told us that reputation risk is a major reason why they want to avoid purchasing predatory loans. Firms involved in the securitization process do not want to be associated with predatory lending activity that could affect their relationships with other firms, community groups, and government agencies.

Due diligence reviews for residential mortgage loans are designed to determine the financial characteristics of the loans and to ensure compliance with applicable federal, state, and municipal laws, including those designed to prohibit predatory lending. The reviews also can be designed to detect loans that have potentially abusive terms but are not necessarily violating any law. For example, an electronic review of loan data can flag characteristics such as interest rates that appear excessive but are nonetheless legal. A loan-level file review, in which a purchaser reviews the physical loan origination documents, offers access to more information and can highlight items such as points and fees and the borrower's capacity to repay. While nearly all purchasers of loans use due

diligence to check for legal compliance, purchasers set their own guidelines for what other loan characteristics meet their standards.

While due diligence in the secondary market is important, the role that it can play in deterring predatory lending by performing due diligence is limited. For one thing, more than one-third of all new subprime loans are not securitized in the first place but are held in the portfolio of the originating lender and thus do not face securitizers' due diligence reviews. In addition, even the most thorough due diligence will not necessarily catch all abusive loans or abusive lending practices. For example:

- Due diligence may not detect fraud in the underwriting or approving of a mortgage. For instance, if a mortgage broker includes false information in a loan application to ensure that a borrower meets an originator's income requirements, the process of due diligence may not detect it.⁶
- The data tapes used for loan reviews do not include point and fee information.⁷ Thus, securitizers typically cannot detect excessive or unwarranted fees prior to purchasing a loan without a loan-level review.
- Loan flipping (repeated refinancings) can be difficult to detect because loan files do not necessarily include information on previous refinancings.

Fannie Mae and Freddie Mac Appear to Perform Extensive Due Diligence to Avoid Buying Loans with Abusive Terms

Fannie Mae and Freddie Mac have relatively strict criteria for the loans they purchase, particularly subprime loans. As noted, both companies limit their purchases to the most creditworthy subprime loans. In April 2000, Fannie Mae issued guidelines to sellers of subprime loans that set criteria designed to help the GSE avoid purchasing loans with abusive features. For example, the guidelines state that Fannie Mae's approved lenders may not "steer" a borrower who qualifies for a standard loan to a higher cost

⁶Some securitizers have begun to use fraud detection software as part of their due diligence of residential mortgage loans. Such software analyzes specific data fields within a loan file and looks for characteristics and inconsistencies that may signal fraud in the appraisal, loan application, or loan itself. In some cases, a fraud review can also be incorporated as part of the regular due diligence process.

⁷A prepurchase financial due diligence review may not look at point and fee data because the risks and returns to the loan purchaser depend not on payments that were made at origination but rather on future payments by the homeowner. However, a review of points and fees is often done during a subsequent loan-level file review.

product, may not make loans without regard to the borrower's ability to repay, and may not in most instances charge more than 5 percent of the loan amount in points and fees. Freddie Mac issued similar guidelines to its sellers and servicers in December 2000. Further, both companies, like other secondary market purchasers, rely on a system of representations and warranties, under which sellers contractually agree to buy back loans they sell that turn out not to meet the terms of the contract.

Fannie Mae and Freddie Mac officials told us that they undertake a series of measures aimed at avoiding the purchase of loans with predatory characteristics. Approved sellers and servicers undergo a background check and operational review and assessment that seeks, in part, to determine whether lenders are able to comply with their guidelines. Fannie Mae and Freddie Mac also require that special steps, such as additional due diligence measures, be taken in purchasing subprime loans. For example, Fannie Mae requires that subprime loans be originated using the company's automated desktop underwriting system, which helps ensure that borrowers are not being steered to a more expensive loan than they qualify for.⁸ Fannie Mae officials say that the automated desktop underwriting system also facilitates traditional lenders that serve subprime borrowers.

In addition, both companies said that they undertake extensive and costly due diligence that goes well beyond simple legal compliance and is aimed at avoiding loans that may potentially be considered abusive or detrimental to the borrower. Both companies use an outside contractor to conduct their loan-level due diligence reviews on subprime loans. The contractor has a standard "script" that reviews a large number of data elements related to legal compliance and creditworthiness. However, the contractor told us that Fannie Mae and Freddie Mac add elements to the script to make the review more stringent with regard to identifying potentially abusive practices. For example, Freddie Mac requires the contractor to check whether the lender has gathered evidence of a borrower's income information directly or relied on self-verification, which can raise uncertainty about a borrower's capacity to repay. In addition, the

⁸Fannie Mae and Freddie Mac officials note that their antipredatory lending policies and compliance measures are only one element in their efforts to fight predatory lending. For example, both companies also have special programs that provide appropriately priced loans to credit-impaired borrowers and other consumers who tend to be targeted by predatory lenders; support homebuyer education and counseling for at-risk individuals; and have special loan programs designed for borrowers who have been targeted or victimized by predatory lenders.

contractor told us that Fannie Mae and Freddie Mac are more likely than other firms to reject or require a repurchase if evidence exists that the loan may involve a predatory practice—even if the loan is otherwise legally compliant.

Other Purchasers Vary in the Extent of Their Due Diligence

According to industry representatives, all purchasers of mortgage loans undertake a process of due diligence, but the process can vary in its degree of stringency and comprehensiveness. For example, while most firms typically pull a sample of loans for a loan-level file review, companies may review anywhere between a few percent and 100 percent of the loans. In addition, companies vary in terms of the data elements they choose to review. Some firms review prior loans made to the borrower in an effort to detect loan flipping, while others do not. Further, some companies may be more willing than others to purchase loans that are considered questionable in terms of legal compliance, creditworthiness, or other factors.

As noted earlier, loans that have harmed consumers and that may be deemed “predatory” by some observers are not necessarily against the law, nor do they necessarily increase the risk of the loan.⁹ Industry officials told us that while securities firms are concerned with the reputation risk that may come with purchasing abusive loans, the primary function of their due diligence is to ensure compliance with the law and to protect investors by ensuring that loans are creditworthy.¹⁰

⁹One example would be steering borrowers to higher-cost loans than is justified by their credit histories. This practice is often considered abusive but is not *per se* a violation of federal law, nor does it necessarily increase credit risk to the lender.

¹⁰Reputation risk can also be an issue for *sellers* of loans to the secondary market. Regularly selling loans that later create risks and costs for secondary market purchasers may close off the seller’s access to the secondary market.

Assignee Liability May Help Deter Predatory Lending but Can Also Have Negative Unintended Consequences

Some states have enacted predatory lending laws that have assignee liability provisions under which purchasers of secondary market loans may be liable for violations committed by the originators or subject to a defense by the borrower against collecting the loan. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders. However, depending on the specific nature of the provision, assignee liability may also have unintended consequences, including reducing access to or increasing the cost of secondary market capital for legitimate loans. For example, assignee liability provisions of a predatory lending law in Georgia have been blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

Several States Hold Secondary Purchasers Liable for Predatory Lending Violations

Antipredatory lending laws in several states have included some form of assignee liability. Typically, with assignee liability, little or no distinction is made between the broker or lender originating a loan that violates predatory lending provisions and the person who purchases or securitizes the loans. Under these provisions, secondary market participants that acquire loans may be liable for violations of the law committed by the original lenders or brokers whether or not the purchasers were aware of the violations at the time they bought the loans. Further, borrowers can assert the same defenses to foreclosure against both originating lenders and entities in the secondary market that hold the loans (the assignees). Depending on the specific provisions of the law, assignees may have to pay monetary damages to aggrieved borrowers.

As of December 2003, at least nine states and the District of Columbia had enacted predatory lending laws that expressly included assignee liability provisions, though the nature of these provisions varies greatly, according to the database of state and local legislation we reviewed. Other states have passed predatory lending laws that do not explicitly provide for assignee liability, but debate has occurred in some of these states about whether assignee liability can be asserted anyway under existing laws or legal principles. The federal HOEPA statute includes an assignee liability provision, but, as noted in chapter 2, only a limited number of subprime loans are covered under HOEPA.

Assignee liability can take a variety of forms. For example, an assignee can be held liable only in defensive claims (defense to foreclosure actions and

to claims regarding monies owed on a loan) or can also be assessed for damages directly, including punitive damages.¹¹ Similarly, some laws include “safe harbor provisions,” under which assignee liability may not arise if the assignee has taken certain measures to avoid obtaining a high-cost loan. For example, under New Jersey law, no assignee liability arises if the assignee demonstrates, by a preponderance of evidence, that a person exercising reasonable due diligence could not determine that the mortgage was a high-cost home loan.¹² However, many secondary market participants told us that the value of these safe harbor provisions is limited, in part because of difficulties in demonstrating compliance with safe harbor standards. For example, some secondary market participants say that the New Jersey law does not adequately define what constitutes “reasonable” due diligence.

Assignee Liability May Help Combat Predatory Lending but May Also Hinder Legitimate Lending

The issue of whether to include assignee liability provisions in state and local predatory lending laws has been highly controversial, because such provisions can potentially both confer benefits and cause problems. Assignee liability has two possible primary benefits. First, holding purchasers and securitizers of loans liable for abusive lending violations provides them with an incentive not to purchase predatory loans in the first place. If secondary market participants took greater action—through policy decisions or stricter due diligence—to avoid purchasing potentially abusive loans, originators of predatory loans would likely see a steep decline in their access to secondary market capital. Second, under some forms of assignee liability, consumers who have been victimized by such lenders may have an additional source of redress. In some cases, originators of abusive loans that have been sold in the secondary market are insolvent or cannot be located, leaving victims dependent on assignees for relief from foreclosure or other redress.

¹¹Under New York’s law, an assignee seeking to enforce a loan against a borrower in default or in foreclosure is subject to the borrower’s claims and defenses to payment that the borrower could assert against the original lender. See NY Banking Law § 6-1 (2003). Under Maine’s law, an assignee may be subject to all claims and defenses that the borrower may assert against the creditor of the mortgage. See Maine Rev. Stat. Ann. Title 9-A § 8-209 (2003).

¹²See, e.g., N.J. Stat. Ann. § 46:10B-27 (West 2003); see also, 815 Ill. Comp. Stat. 137/135 (2003).

However, assignee liability provisions may also have the serious if unintended consequence of discouraging legitimate secondary market activity. Secondary market participants say that because they do not originate the loans they purchase, even the most stringent due diligence process cannot ensure that all loans comply with applicable law. In addition, some secondary market participants state that assignee liability provisions require them to make subjective determinations about whether the loans are in compliance with law, and this ambiguity can create legal and financial risk. These factors, industry participants say, can actually end up harming consumers by raising the costs of ensuring compliance with the law and thus increasing the cost of loans to borrowers. Further, if secondary market participants are not willing to risk having to assume liability for violations committed by originators, they may pull out of the market altogether, reducing the availability and increasing the costs of legitimate subprime credit. Finally, if states' predatory lending laws have different terms and provisions regarding assignee responsibilities, the secondary market as a whole could become less efficient and liquid, further increasing rates on legitimate subprime mortgages.

Credit rating agencies have been among the secondary market players that have expressed concern about assignee liability provisions in state predatory lending laws. When a residential mortgage-backed security is created from a pool of loans, an independent credit rating agency examines the security's underlying loans and assigns it with a credit rating, which represents an opinion of its general creditworthiness. Credit rating agencies need to monetize (measure) the risk associated with the loans underlying a security in order to assign a credit rating. Because assignee liability can create additional legal and financial risks, the major credit rating agencies typically review new predatory lending legislation to assess whether they will be able to measure that risk adequately to rate securities backed by loans covered under the law.

We talked with representatives of two major credit rating agencies, firms that issue mortgage-backed securities, and the GSEs Fannie Mae and Freddie Mac to better understand how specific assignee liability provisions might affect their ability to conduct secondary market transactions. In general, the representatives told us that the most problematic assignee liability provisions for secondary market participants are those with two characteristics:

- *Ambiguous language.* Credit rating agencies and other secondary market players seek clear and objective descriptions of the loans

covered by the statutes and the specific actions or omissions that constitute a violation. For example, some participants cited concerns about an ordinance enacted in Toledo, Ohio, that prohibited taking advantage of a borrower's "physical or mental infirmities" but did not define what constituted such infirmities.¹³ Secondary market participants noted that without objective criteria, there is no way to ensure that an originator has complied adequately with the law.

- *Punitive Damages.* Under some assignee liability provisions, the potential damages a borrower can receive are restricted to the value of the loan, while other provisions allow for punitive damages, which are not necessarily capped. Secondary market participants say that the potential for punitive damages can make it very difficult to quantify the risk associated with a security.

Georgia's Statute Illustrates Possible Effects of Assignee Liability Provisions

According to officials of industry and consumer advocacy organizations, the Georgia Fair Lending Act, which became effective on October 1, 2002, was one of the strictest antipredatory lending laws in the nation.¹⁴ It banned single-premium credit insurance and set restrictions on late fees for all mortgage loans originated in the state and, for a special category of "covered loans," prohibited refinancing within 5 years after consummation of an existing home loan unless the new loan provided a "tangible net benefit" to the borrower. The act also created a category of "high-cost loans" that were subject to certain restrictions, including limitations on prepayment penalties, prohibitions on balloon payments, and prohibitions on loans that were made without regard to the borrower's ability to repay.

¹³City of Toledo Ordinance No. 291-02 (Oct. 4, 2002).

¹⁴The Georgia Fair Lending Act is codified at GA Code Ann. §§ 7-6A-1 *et. seq.* OTS, NCUA, and OCC have determined that the Georgia law does not apply to the institutions they supervise because it is preempted by federal law. See Office of Thrift Supervision, P-2003-1, Preemption of Georgia Fair Lending Act (Jan. 21, 2003); National Credit Union Administration, 02-0649, Applicability of Georgia Fair Lending Act to Federal Credit Unions (July 29, 2002); National Credit Union Administration, 03-0412, NCUA Preemption of the Georgia Fair Lending Act (Nov. 10, 2003); and *OCC Preemption Determination and Order*, Docket No. 03-17 (July 30, 2003). Because Georgia law contains a parity provision under which its state-chartered banks are treated similarly to national banks, Georgia's Commissioner of Banking and Finance ruled that Georgia-chartered banks also are not subject to the Fair Lending Act. See *Declaratory Ruling: Effect of Preemption of Georgia Fair Lending Act by the OCC on July 30, 2003* (Aug. 5, 2003).

The act also included fairly strict assignee liability. Secondary market participants that purchased high-cost loans were liable for violations of the law committed by the originator of the loans they purchased, while purchasers of covered loans were subject to borrower defenses and counterclaims based on violations of the act. The act also expressly made mortgage brokers and loan servicers liable for violations. Remedies available to borrowers included actual damages, rescission of high-cost loans, attorney fees, and punitive damages. Most of the violations were civil offenses, but knowing violations constituted criminal offenses.

Shortly after the Georgia Fair Lending Act took effect, several mortgage lenders announced that they would stop doing business in the state due to the increased risk they would incur. In addition, several secondary market participants stated their intention to cease doing business in Georgia. In January 2003, the credit rating agency Standard & Poor's announced it would stop rating mortgage-backed securities in Georgia because of the uncertainty surrounding potential liability under the act. Standard & Poor's decision extended to securitizations of virtually all loans in the state, not just those of covered or high-cost loans. The company said that because the act did not provide an unambiguous definition of which loans were covered (and therefore subject to assignee liability), it could not adequately assess the potential risk to securitizers. In addition, the company said that it was concerned about an ant flipping provision that did not adequately define what constituted the "net tangible benefit" to borrowers that certain refinancings had to provide. The two other major credit rating agencies, Moody's and Fitch, also said that the law would limit their ability to rate mortgage-backed securities in Georgia.

In response to these events, the Georgia legislature amended the Georgia Fair Lending Act on March 7, 2003. The amendments eliminated the category of "covered home loans" and the restrictions that had existed for that category of loans. In addition, the amendments greatly reduced the scope of assignee liability under the law, restricting such liability to "high-cost" loans, and then only when the assignee is unable to show that it has exercised reasonable due diligence to avoid purchasing them. In addition, the amendments capped the amount of damages an assignee can face and prohibited assignee liability in class-action lawsuits. Once these amendments were passed, credit rating agencies announced that they would once again rate securities backed by mortgage loans originated in Georgia, and lenders said they would continue to do business in the state. Advocates of the original Georgia law argued that the legislature overreacted to actions by some members of the lending industry, and many

activists said that Standard & Poor's and others had engaged in an orchestrated effort to roll back the Georgia Fair Lending Act. Industry representatives said that the response by lenders and others was a reasonable response to a statute that created unacceptable risks of legal liability for lenders and assignees.

Policymakers and industry representatives have frequently cited the events in Georgia as a lesson in what can happen when secondary market participants are held liable for violations by the original lender. Industry representatives assert that assignee liability creates undue risks to the secondary market, or makes assessing risks difficult, and ultimately reduces borrowers' access to credit. In the case of Georgia, however, it is unclear whether the problem was assignee liability itself or the scope and characteristics of the specific assignee liability provisions contained in the original law. Georgia's original law created concern in large part because of perceived ambiguities in defining which loans were subject to assignee liability and because assignees' liability was subject to unlimited punitive damages. Not all states with antipredatory lending statutes that include assignee liability provisions have had lenders and credit agencies threaten to withdraw from the market to the same extent, largely because these laws generally cap an assignee's liability, create a safe harbor, or contain less ambiguous language. The challenge to states that choose to impose assignee liability is to craft provisions that may serve their purpose of deterring predatory lending and providing redress to affected borrowers without creating an undue adverse effect on the legitimate lending market.

The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. While consumer education efforts have been shown to have some success in increasing consumers' financial literacy, the ability of these efforts to deter predatory lending practices may be limited by several factors, including the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers and counselors' lack of access to relevant loan documents can hamper the effectiveness of mortgage counseling efforts, while the sheer volume of mortgage originations each year makes universal counseling difficult. While efforts are under way to improve the federally required disclosures associated with mortgage loans, their potential success in deterring predatory lending is likewise hindered by the complexity of mortgage transactions and by the lack of financial sophistication among many borrowers who are the targets of predatory lenders.

Many Consumer Education and Mortgage Counseling Efforts Exist, but Several Factors Limit Their Potential to Deter Predatory Lending

In response to widespread concern about low levels of financial literacy among consumers, federal agencies such as FDIC, HUD, and OTS have conducted and funded initiatives designed in part to raise consumers' awareness of predatory lending practices. In addition, a number of states, nonprofits, and trade organizations have undertaken consumer education initiatives. Prepurchase mortgage counseling—which can include a third party review of a prospective mortgage loan—may also help borrowers avoid predatory loans, in part by alerting them to the characteristics of predatory loans. In some circumstances, such counseling is required. However, a variety of factors limit the potential of these tools to deter predatory lending practices.

Some Federal Agencies Have Initiatives to Promote Awareness of Predatory Lending

A number of federal agencies and industry trade groups have advocated financial education for consumers as a means of improving consumers' financial literacy and addressing predatory lending. The Department of the Treasury, as well as consumer and industry groups, have identified the lack of financial literacy in the United States as a serious, widespread problem.¹ Studies have shown that many Americans lack a basic knowledge and understanding of how to manage money, use debt responsibly, and make wise financial decisions.² As a result, some federal agencies have conducted or funded programs and initiatives that serve to educate and inform consumers about personal financial matters. For example:

- FDIC sponsors MoneySmart, a financial literacy program for adults with little or no banking experience and low to moderate incomes. FDIC officials told us that the program, in effect, serves as one line of defense against predatory lending. The MoneySmart curriculum addresses such topics as bank services, credit, budgeting, saving, credit cards, loans, and homeownership. MoneySmart is offered free to banks and others interested in sponsoring financial education workshops.
- The Federal Reserve System's Community Affairs Offices issue media releases and distribute consumer education publications to financial institutions, community organizations, and to consumers directly. These offices also have hosted conferences and forums on financial education and predatory lending and have conducted direct outreach to communities targeted by predatory lenders.

¹The Fair and Accurate Credit Transactions Act of 2003 (Pub. L. No. 108-159), which was enacted on December 4, 2003, addresses financial literacy in a number of its provisions. Among other things, it establishes a financial literacy and education commission consisting of representatives of FTC, the federal banking regulators, HUD, the Department of the Treasury, and other federal agencies.

²See National Endowment for Financial Education, "Financial Literacy in America: Individual Choices, National Consequences," report based on the symposium "The State of Financial Literacy in America: Evolutions and Revolutions," October 2002 (Greenwood Village, Colorado, 2002), 1 and 6; Maude Toussaint-Comeau and Sherrie L.W. Rhine, "Delivery of Financial Literacy Programs," Policy Studies, Consumer Issues Research Series, Consumer and Community Affairs Division, Federal Reserve Bank of Chicago (2000), 1; Marianne A. Hilgert, Jeanne M. Hogarth, and Sondra Beverly, "Household Financial Management: The Connection between Knowledge and Behavior," *Federal Reserve Bulletin*, July 2003, 309 and 311.

- OTS and NCUA have worked with community groups on financial literacy issues and have disseminated financial education materials, including literature on predatory lending issues, to their respective regulated institutions.
- HUD has developed and distributed a brochure titled *Don't Be a Victim of Loan Fraud: Protect Yourself from Predatory Lenders*, which seeks to educate consumers who may be vulnerable to predatory lending, especially the elderly, minorities, and low-income homeowners.
- Federal banking regulators give positive consideration in Community Reinvestment Act performance reviews to institutions for providing financial education to consumers in low- and moderate-income communities.
- OCC issued an advisory letter in 2001 providing detailed guidance for national banks, encouraging them to participate in financial literacy initiatives and specifying a range of activities that banks can provide to enhance their customers' financial skills, including support for educational campaigns that help borrowers avoid abusive lending situations.³
- FTC and DOJ disseminate information designed to raise consumers' awareness of predatory lending practices, particularly those involving fraudulent acts. Brochures and other consumer materials are distributed on the agencies' Web sites, as well as through conferences and seminars, local consumer protection agencies, consumer credit counselors, state offices, and schools. FTC has also supported public service announcements on radio and television, including Spanish-speaking media.

Some of these initiatives are general financial education programs that do not specifically address predatory home mortgage lending, some address predatory lending practices as one of a number of topics, and a few focus specifically on predatory lending. Some of these initiatives are directed to a general audience of consumers, while others are directed toward low-income or other communities that are often the targets of predatory lenders. A number of different media have been used to deliver the messages, including print and online materials, speeches and spot

³OCC Advisory Letter 2001-1, Financial Literacy, January 16, 2001.

announcements, and materials for the hearing- and visually impaired. In some cases, consumer financial education materials have been produced in a variety of languages, including Arabic, Chinese, Korean, and Spanish. Federal agencies' consumer education campaigns typically take place in partnership with other entities, including community and nonprofit groups and state and local agencies.

Federal agencies have taken some actions to coordinate their efforts related to educating consumers about predatory lending. For example, in October 2003, the Interagency Task Force on Fair Lending, which consists of 10 federal agencies, published a brochure that alerts consumers to potential pitfalls of home equity loans, particularly high-cost loans. The brochure *Putting Your Home on the Loan Line is Risky Business* describes common predatory lending practices and makes recommendations to help borrowers avoid them.

State Agencies, Nonprofits, and Industry Organizations Have Also Initiated Consumer Education Efforts

Some state agencies have also sponsored consumer education initiatives that address predatory lending. For example, the Connecticut Department of Banking offers an educational program in both English and Spanish that partners with neighborhood assistance groups and others to promote financial literacy and educate consumers on the state's antipredatory lending statute. The Massachusetts Division of Banks maintains a toll-free mortgage hotline to assist homeowners about potentially unethical and unlawful lending practices. The hotline helps consumers determine whether loan terms may be predatory and directs them to other sources of information and assistance. The New York State Banking Department distributes educational materials, including a video, that describe predatory lending practices. The department has also conducted educational outreach programs to community groups on the issue.

Nonprofits provide a significant portion of consumer financial education on predatory lending, sometimes with support from federal, state, or local agencies. These efforts include both general financial literacy programs with a predatory lending component and initiatives that focus specifically on predatory lending issues. For example, the National Community Reinvestment Coalition, with funding support from HUD, distributes a training module to help communities across the country educate consumers about predatory lending.

Some industry trade organizations and companies also have consumer education initiatives related to predatory lending:

- Freddie Mac has developed the CreditSmart program in partnership with universities and colleges. CreditSmart is a curriculum on credit education that is available online and has been used in academic programs and in community workshops, seminars, and credit education campaigns. Freddie Mac also helps fund and promote the “Don’t Borrow Trouble” campaign, a comprehensive public education campaign with counseling services that is designed to help homeowners avoid falling victim to predatory lenders. The campaign uses brochures, mailings, posters, public service announcements, transit ads, and television commercials. Its media toolkit and marketing consultant services have been provided to the U.S. Conference of Mayors for use in local communities.
- Fannie Mae supports financial literacy programs through its Fannie Mae Foundation, which sponsors homeownership education programs that focus on improving financial skills and literacy for adult students and at-risk populations, such as new Americans and Native Americans. Fannie Mae also offers a Web-based tool that allows home-buyers to compare loan products and prices.
- The Jump\$tart Program for Personal Financial Literacy, sponsored by a coalition of corporations, industry associations—such as the Insurance Education Foundation and the American Bankers Association Education Foundation—and several government and nonprofit agencies, includes a series of modules covering topics such as managing debt and shopping for credit that are designed to improve the personal financial literacy of young adults.
- The Mortgage Bankers Association of America, a trade association representing mortgage companies and brokers and the real estate finance industry, disseminates a package of information describing some common warning signs of mortgage fraud and predatory lending, a consumer’s bill of rights, and appropriate contacts for consumers who believe they have been victimized by predatory lenders.
- The National Association of Mortgage Brokers makes presentations to first-time homebuyers to educate them on the mortgage process and credit reports, among other topics.

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- The American Financial Services Association’s Education Foundation develops educational materials designed to improve consumers’ use of credit and overall financial literacy.

Mortgage Counseling Can Warn Borrowers of Predatory Lending and Can Offer a “Third Party” Review of Proposed Mortgage Loans

Mortgage counseling can be part of general “homeownership counseling” for new homeowners but may also be offered prior to a refinancing. It gives borrowers an opportunity to receive personalized advice from a disinterested third party about a proposed mortgage or other loan. In addition to providing general advice about the mortgage process and loan products, counselors typically review the terms of proposed loans for potentially predatory characteristics. Studies evaluating the impact of homeownership counseling have found that it helps homeowners maintain ownership of their homes and avoid delinquencies, particularly when the counseling is provided one on one.⁴ HUD supports a network of approximately 1,700 approved counseling agencies across the country. The agencies provide a wide variety of education and counseling services, including homebuyer education and prepurchase counseling. HUD makes grant funds available to some of these agencies, and a portion of these funds has been earmarked exclusively for counseling for victims of predatory lending.

A number of state antipredatory lending laws, such as those in New Jersey and North Carolina, require some lenders to document that a borrower has received counseling before taking out certain types of high-cost loans. In a few cases, however, borrowers may waive their right to receive such counseling. Several states, including Colorado, New York, and Pennsylvania, require lenders to provide notice to borrowers of certain loans that mortgage counseling is available and encourage them to seek it.

⁴See, for example, Abdighani Hiram and Peter M. Zorn, “A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling,” in *Low-Income Homeownership: Examining the Unexamined Goal*, ed. Nicolas P. Retsinas and Eric S. Belsky (Washington, D.C.: Brookings Institution Press and Harvard University Joint Center on Housing Studies, 2001), 2.

A Variety of Factors May Limit the Effectiveness of Consumer Education and Mortgage Counseling in Deterring Predatory Lending

Limitations of Consumer Education

In testimony before Congress and elsewhere, representatives of the Mortgage Bankers Association, the Consumer Mortgage Coalition, and other industry organizations have promoted the view that educated borrowers are more likely to shop around for beneficial loan terms and avoid abusive lending practices. In searching the literature for studies on the effectiveness of consumer financial education programs, we found evidence that financial literacy programs may produce positive changes in consumers' financial behavior.⁵ However, none of the studies measured the effectiveness of consumer information campaigns specifically on deterring predatory lending practices.

The majority of federal officials and consumer advocates we contacted said that while consumer education can be very useful, it is unlikely to play a substantial role in reducing the incidence of predatory lending practices, for several reasons:

- First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, specific loan terms, and borrower's situation—determine whether the loan is in a borrower's best interests. Mortgage loans can involve dozens of different documents that are written in highly technical language. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a proffered loan contains abusive terms.
- Second, abusive lenders and brokers may use high-pressure or "push marketing" tactics—such as direct mail, telemarketing, and door-to-door contacts—that are unfair, deceptive, or designed to confuse the consumer. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to aggressive sales tactics.
- Third, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information. Victims of predatory lending are often not highly educated or literate and may

⁵See for example, B. Douglas Mernheim, Daniel M. Garrett, and Dean M. Maki, *Education and Saving: The Long-Term Effects of High School Financial Curriculum Mandates* (Cambridge, Mass.: National Bureau of Economic Research, 1997), 29-30.

not read or speak English. Further, they may lack access to information conveyed through the Internet or traditional banking sources, or they may have hearing or visual impairments or mobility problems.

Limitations of Mortgage Counseling

Consumer education campaigns have encouraged borrowers to seek counseling before entering into a mortgage loan, particularly a subprime refinancing loan. However, unreceptive consumers, lack of access to loan documents, fraudulent lending practices, and the uneven quality of counseling services can affect the success of these counseling efforts. For instance, some consumers may simply not respond to counseling. Officials at HUD have noted that not all first-time homebuyers avail themselves of prepurchase counseling, and that some consumers who do attend counseling sessions ignore the advice and information given to them. Further, counselors may not have access to loan documents containing the final terms of the mortgage loan. Although lenders are required to provide a good-faith estimate of the mortgage terms, they are not required to provide consumers with the final and fixed terms and provisions of a mortgage loan until closing.⁶ Moreover, predatory lenders have been known to manipulate the terms of a mortgage loan (sometimes called “bait and switch”) so that the terms of the actual loan vary substantially from that contained in the good faith estimate.

In addition, counseling may be ineffective against lenders and brokers that engage in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents. Finally, the quality of mortgage counseling can vary because of a number of factors. For example, one federal official cited an instance of a mortgage company conducting only cursory telephone counseling in order to comply with mandatory counseling requirements.

Although some states have mandated counseling for certain types of loans, serious practical barriers would exist to instituting mandatory prepurchase mortgage counseling nationally. HUD officials have noted that instituting a mandatory counseling program for most regular mortgage transactions nationwide would be an enormous and difficult undertaking that might not

⁶For example, TILA requires federal lenders to make certain disclosures on mortgage loans within 3 business days after the receipt of a written application. It also requires a final disclosure statement at the time of closing that includes the contract sales price, principal amount of the new loan, interest rate, broker’s commission, loan origination fee, and mortgage and hazard insurance, among other things.

be cost-effective. Lenders originated about 10 million mortgage loans in 2002 in the United States. The cost of providing counseling for all or many of these loans would be high, and it is unclear who would or should be responsible for paying it. In addition, there is a need for trained, qualified counselors, according to federal officials and representatives of consumer and advocacy groups, and currently no system exists for effectively training large numbers of counselors while maintaining quality control.

HUD requires counseling for its reverse mortgages. These mortgages allow homeowners to access the equity in their home through a lender, who makes payments to the owner.⁷ Borrowers who receive a home equity conversion mortgage insured through FHA must attend a consumer information session given by a HUD-approved housing counselor. Mandatory counseling for reverse mortgages may be reasonable because these products are complex and subject to abuse. However, reverse mortgages are also relatively uncommon; only approximately 17,610 HUD-insured reverse mortgages were originated in fiscal year 2003.

Disclosures, Even If Improved, May Be of Limited Use in Deterring Predatory Lending

Federally mandated mortgage disclosures, while helpful to some borrowers, may be of limited usefulness in reducing the incidence of predatory lending practices. TILA and RESPA have requirements concerning the content, form, and timing of information that must be disclosed to borrowers. The goal of these laws is to ensure that consumers obtain timely and standardized information about the terms and cost of their loans. Federal agencies, advocacy groups, and the mortgage industry have said that mortgage disclosures are an important source of information for borrowers, providing key information on loan terms and conditions and enabling borrowers to compare mortgage loan products and costs. Representatives of the lending industry in particular have said that disclosures can play an important role in fighting predatory lending, noting that clear, understandable, and uniform disclosures allow borrowers to understand the terms of their mortgage loans and thus make more informed choices when shopping for a loan.

However, industry and advocacy groups have publicly expressed dissatisfaction with the current scheme of disclosures as mandated by TILA and RESPA. A 1998 report by the Board and HUD concluded that

⁷The loan is not repaid in full until the homeowner permanently moves out of the home, passes away, or other specified events have occurred.

consumers cannot easily understand current disclosures, that disclosures are often provided too late in the lending process to be meaningful, that the information in disclosures may differ significantly from the actual final loan terms, and that the protections and remedies for violations of disclosure rules are inadequate.⁸

Improving the disclosure of pertinent information has been part of efforts under way over the last few years to streamline and improve the real estate settlement process. HUD issued proposed rules in July 2002 to simplify and improve the process of obtaining home mortgages and reduce settlement costs for consumers. HUD stated that the proposed changes to its RESPA regulations would, among other things, “make the good faith estimate [settlement cost disclosure] firmer and more usable, facilitate shopping for mortgages, make mortgage transactions more transparent, and prevent unexpected charges to consumers at settlement.”⁹ Debate over the proposed rules, which as of December 2003 were still under review, has been contentious. Industry groups claim that the proposal would help fight predatory lending by helping consumers understand loan costs up front and thus enable consumers to compare products, or comparison shop. Several advocacy organizations and an industry group say the proposed rules would still allow unscrupulous mortgage originators to hide illegal or unjustified fees.

Although streamlining and improving mortgage loan disclosures could help some borrowers better understand the costs and terms of their loans, such efforts may play only a limited role in decreasing the incidence of predatory lending practices. As noted above, mortgage loans are inherently complex, and assessing their terms requires knowing and understanding many variables, including interest rates, points, fees, and prepayment penalties. Brokers and lenders that engage in abusive practices may target vulnerable individuals who are not financially sophisticated and are therefore more susceptible to being deceived or defrauded into entering into a loan that is clearly not in their interests. Even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Moreover, as with prepurchase counseling, revised

⁸Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform to the Truth In Lending Act and the Real Estate Settlement Procedures Act* (Washington, D.C.: July 1998).

⁹See 67 Fed. Reg. 49134 (Jul. 29, 2002).

Chapter 5
The Usefulness of Consumer Education,
Counseling, and Disclosures in Deterring
Predatory Lending May Be Limited

disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of a loan in the disclosure documents themselves.

Elderly Consumers May Be Targeted for Predatory Lending

Although little data is available on the incidence of predatory lending among the elderly, government officials and consumer advocacy organizations have reported consistent observational evidence that elderly consumers have been disproportionately victimized by predatory lenders.¹ Abusive lenders are likely to target older consumers for a number of reasons, including the fact that older homeowners are more likely to have substantial equity in their homes and may be more likely to have diminished cognitive function or physical impairments that an unscrupulous lender may try to exploit. Most educational material and legal activity related to predatory lending targets the general population rather than elderly borrowers in particular. Some federal agencies and nonprofit organizations provide consumer education materials on predatory lending that specifically target the elderly.

A Number of Factors Make Elderly Consumers Targets of Predatory Lenders

Nearly all federal, state, and consumer advocacy officials with whom we spoke offered consistent observational and anecdotal information that elderly consumers have disproportionately been victims of predatory lending. Little hard data exist on the ages of victims of predatory lending or on the proportion of victims who are elderly. Nonetheless, several factors explain why unscrupulous lenders may target older consumers and why some elderly homeowners may be more vulnerable to abusive lenders, including higher home equity, a greater need for cash to supplement limited incomes, and a greater likelihood of physical impairments, diminished cognitive abilities, and social isolation.

On average, older homeowners have more equity in their homes than younger homeowners, and abusive lenders could be expected to target consumers who have substantial home equity.² By targeting these owners, unscrupulous lenders are more easily able to “strip” the equity from a borrower’s home by including unjustified and excessive fees into the cost

¹No clear agreement exists on the age at which someone is considered “elderly.” While we do not designate any specific age in this report with reference to the terms “older” or “elderly,” we are generally referring to persons over the age of 65.

²For example, a study by the Board found that in 1997, some 55 percent of the homeowners who had fully paid off their mortgage were 65 years of age or older. See Glenn B. Canner, Thomas A. Durkin, and Charles A. Luckett, “Recent Developments in Home Equity Lending,” *Federal Reserve Bulletin*, April 1998, 241-51. Borrowers may have substantial equity in their homes but still not qualify for a prime loan because their capacity to repay the loan is limited or their credit score is beneath a certain threshold.

of the home equity loan.³ Federal officials and consumer groups say that abusive lenders often try to convince elderly borrowers to repeatedly refinance their loans, adding more costs each time. “Flipping” loans in this way can over time literally wipe out owners’ equity in their homes.

In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who have limited cash flows and can use money from a home equity loan for major home repairs or medical expenses. In the overall marketplace it is common, and can be advantageous, to tap into one’s home equity when refinancing. However, unscrupulous brokers and lenders can take advantage of an elderly person’s need for cash to steer borrowers to loans with highly unfavorable terms.

Further, diseases and physical impairments associated with aging can make elderly borrowers more susceptible to abusive lending. For example, declining vision, hearing, or mobility can restrict elderly consumers’ ability to access financial information and compare credit terms. In such situations potential borrowers may be susceptible to the first lender to offer what seems to be a good deal, especially if the lender is willing to visit them at home or provide transportation to the closing. Physical impairments like poor hearing and vision can also make it difficult for older borrowers to fully understand loan documents and disclosures.

Similarly, while many older persons enjoy excellent mental and cognitive capacity, others experience the diminished cognitive capacity and judgment that sometimes occurs with advanced age. Age-related dementias or mental impairments can limit the capacity of some older persons to comprehend and make informed judgments on financial issues, according to an expert in behavioral medicine at the National Institute on Aging. Furthermore, a report sponsored by the National Academy of Sciences on the mistreatment of elderly persons reported that they may be more likely to have conditions or disabilities that make them easy targets for financial abuse and they may have diminished capacity to evaluate proposed courses of action. The report noted that these impairments can

³For example, a loan might be offered to a borrower who owns a home worth \$100,000 and owes \$20,000 from a previous mortgage. An abusive lender might refinance the loan for \$25,000 (providing the borrower with a \$5,000 “cashout”) but then charge fees of \$15,000, which are financed into the loan. The borrower then would owe \$40,000, but might not be aware of the excessive fees that were charged because the monthly repayment schedule had been spread over a much longer period of time.

make older persons more vulnerable to financial abuse and exploitation.⁴ Representatives of legal aid organizations have said that they frequently represent elderly clients in predatory lending cases involving lenders that have taken advantage of a borrower's confusion and, in some cases, dementia.

Finally, both the National Academy of Sciences report and representatives of advocacy groups we spoke with noted that elderly people—particularly those who live alone—may feel isolated and lonely, and may lack support systems of family and friends who could provide them with advice and assistance in obtaining credit. Such individuals may simply be more willing to discuss an offer for a home equity loan made by someone who telephones or knocks on their door, makes personal contact, or makes an effort to gain their confidence. These personalized marketing techniques are common among lenders and brokers that target vulnerable individuals for loans with abusive terms.

Federal officials, legal aid services, and consumer groups have reported that home repair scams targeting elderly homeowners are particularly common. Elderly homeowners often live in older homes and are more likely to need someone to do repairs for them. The HUD-Treasury report noted that predatory brokers and home improvement contractors have collaborated to swindle older consumers. A contractor may come to a homeowner's door, pressure the homeowner into accepting a home improvement contract, and arrange for financing of the work with a high-cost loan. The contractor then does shoddy work or does not finish the agreed-on repairs, leaving the borrower to pay off the expensive loan.

The result of lending abuses, such as losing a home through foreclosure, can be especially severe for the elderly. The National Academy of Sciences report noted that losing financial assets accumulated over a lifetime can be devastating to an elderly person, and that replacing them is generally not viable for those who are retired or have physical or mental disabilities. The financial losses older people can suffer as a result of abusive loans can result in the loss of independence and security and a significant decline in quality of life. Moreover, older victims of financial exploitation may be

⁴Richard J. Bonnie and Robert B. Wallace, eds., "Elder Mistreatment: Abuse, Neglect, and Exploitation in an Aging America," Panel to Review Risk and Prevalence of Elder Abuse and Neglect, National Research Council (Washington, D.C.: National Academies Press, 2003), 393.

more likely to become dependent on social welfare services because they lack the funds to help compensate them for their financial losses.

Elderly consumers represent just one of several classes of people that predatory lenders appear to target. The HUD-Treasury task force report noted that many predatory lenders also specifically target minority communities. Consumer advocacy and legal aid organizations have reported that elderly African American women appear to be a particular target for predatory lenders. This population may be targeted by predatory lenders at least in part because of their relatively low literacy levels—the result of historical inequalities in educational opportunities—which, as discussed earlier, may increase vulnerability to abusive lending.⁵

Some Education and Enforcement Efforts Focus on Elderly Consumers

Because elderly people appear to be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some educational efforts and legal assistance on this population. Several booklets, pamphlets, and seminars are aimed at helping inform elderly borrowers about predatory lending. In addition, while most legal activities related to predatory lending practices are designed to assist the general population of consumers, some have focused on elderly consumers in particular.

Federal and Nonprofit Agencies Sponsor Some Financial Education Efforts Targeted at Older Consumers

Consumer financial education efforts of government and nonprofit agencies and industry associations generally seek to serve the general consumer population rather than target specific subpopulations. However, some federal and nonprofit agencies have made efforts to increase awareness about predatory lending specifically among older consumers. For example:

- DOJ has published a guide entitled *Financial Crimes Against the Elderly*, which includes references to predatory lending. In 2000, the

⁵For example, about 25 percent of elderly black Americans had graduated from high school in 1992, compared with about 58 percent of elderly white Americans, and about 57 percent of elderly black Americans were reported to have had fewer than 9 years of formal education. See Robert Joseph Taylor and Shirley A. Lockery, “Socio-Economic Status of Older Black Americans: Education, Income, Poverty, Political Participation and Religious Involvement,” *African American Research Perspectives* 2 (1): 3-4.

agency cosponsored a symposium that addressed, among other topics, financial exploitation of the elderly.

- OTS has produced an educational training video addressing financial abuse of the elderly.
- The U.S. Department of Health and Human Services' Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory or abusive lending practices against older consumers. Supported activities include senior legal aid programs, projects to improve financial literacy among older consumers, and financial educational materials directed at senior citizens.
- FTC publishes a number of consumer information products related to predatory lending and home equity scams that discuss abusive practices targeted at the elderly.
- AARP, which represents more than 35 million Americans age 50 and over, offers a borrowers' kit containing consumer tips for avoiding predatory lenders, supports a toll-free number to call for assistance regarding lending issues, and distributes fact sheets on predatory lending. Some of these materials are provided in Spanish and in formats accessible to the hearing- and visually impaired. AARP also provides information on its Web site that is designed to educate older Americans on predatory lending issues. In addition, the organization has conducted focus groups of older Americans to gather data on their borrowing and shopping habits in order to better develop strategies for preventing older people from becoming the victims of predatory lending.
- The National Consumer Law Center has developed a number of consumer materials aimed in part at helping elderly consumers recover from abusive loans, including a brochure titled *Helping Elderly Homeowners Victimized by Predatory Mortgage Loans*.

Some Legal Assistance Is Aimed Specifically at Helping Older Victims of Predatory Lending

Federal consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons. For example, age is not a protected class under the Fair Housing Act, which prohibits discrimination in housing-related transactions. In addition, HMDA—which requires certain financial

institutions to collect, report, and disclose data on loan applications and originations—does not require lenders to report information about the age of the applicant or borrower. However, ECOA does specifically prohibit unlawful discrimination on the basis of age in connection with any aspect of a credit transaction. In the case against Long Beach Mortgage Company noted earlier, the lender was accused of violating ECOA by charging elderly borrowers, among other protected classes, higher loan rates than it charged other similarly situated borrowers.

Federal and state enforcement actions and private class-action lawsuits involving predatory lending generally seek to provide redress to large groups of consumers. Little hard data exist on the age of consumers involved in these actions, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than \$60 million. According to AARP, an estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans. The company used a sophisticated campaign of telemarketing and direct mail solicitations, as well as a lengthy sales presentation that FTC said was designed to mislead consumers in general and elderly consumers in particular about the terms of its loans.

Some nonprofit groups provide legal services focused on helping elderly victims of predatory lending:

- The AARP Foundation Litigation, which conducts litigation to benefit Americans 50 years and older, has been party to 7 lawsuits since 1998 involving allegations of predatory lending against more than 50,000 elderly borrowers. Six of these suits have been settled, and the other is pending.
- The National Consumer Law Center has a “Seniors Initiative” that seeks to improve the quality and accessibility of legal assistance with consumer issues for vulnerable older Americans. One focus of the initiative is preventing abusive lending and foreclosure. The center publishes a guide for legal advocates to help them pursue predatory lending cases, and has been involved in litigation related to cases of predatory lending against senior citizens.

-
- Some local legal aid organizations that help victims of predatory lending have traditionally served older clients. For example, the majority of clients assisted by South Brooklyn Legal Services' Foreclosure Prevention Project are senior citizens.

The limited number of education and enforcement efforts related to predatory lending that specifically target older consumers—as opposed to the general population—is not necessarily problematic. Given limited resources, the most efficient and effective way to reach various subpopulations, including the elderly, is often through general education and information campaigns that reach broad audiences. Similarly, enforcement actions and private lawsuits that seek to curb the activities of the worst predatory lenders in general are likely to aid the elderly borrowers that these lenders may be targeting.

FTC Enforcement Actions Related to Predatory Lending

Primary defendant	Date of settlement ^a	Federal laws cited	Alleged unfair or deceptive practices
Capital City Mortgage Corporation ^b	(litigation ongoing)	FTC Act, TILA, ECOA, Fair Debt Collection Practices Act	Using deception/misrepresentation to manipulate borrowers into loans, ECOA recordkeeping and notice violations, unfair and deceptive loan servicing violations
OSI Financial Services, Inc., and Mark Diamond ^c	November 2003	FTC Act	Using deception/misrepresentation to charge excessive loan fees
First Alliance Mortgage Company ^d	March 2002	FTC Act, TILA	Using deception/misrepresentation to charge excessive loan fees
Associates First Capital Corporation, Associates Corporation of North America, Citigroup Inc., and CitiFinancial Credit Company	September 2002	FTC Act, TILA, ECOA, FCRA	Using deception/misrepresentation to manipulate borrowers into loans, packing undisclosed products (insurance) into loans, unfair debt collection
Mercantile Mortgage Company, Inc. ^e	July 2002	FTC Act, TILA, HOEPA, RESPA, Credit Practices Rule	Using deception/misrepresentation to manipulate borrowers into loans, illegal kickbacks, HOEPA disclosure violations, taking unlawful security interests
Action Loan Company, Inc. ^f	August 2000	FTC Act, TILA, RESPA, Credit Practices Rule, ECOA, FCRA	Packing undisclosed products (insurance) into loans, kickbacks for the referral of loans, ECOA violation for failing to meet requirements upon adverse actions, taking unlawful security interest
FirstPlus Financial Group, Inc.	August 2000	FTC Act, TILA	Using deception/misrepresentation to manipulate borrowers into home equity loans, TILA disclosure violations
Nu West, Inc.	July 2000	FTC Act, TILA, HOEPA	HOEPA disclosure violations, right of rescission violations
Delta Funding Corporation and Delta Financial Corporation ^g	March 2000	HOEPA, RESPA, ECOA, Fair Housing Act	Pattern or practice of asset-based lending and other HOEPA violations, paying kickbacks and unearned fees to brokers, intentionally charging African American females higher loan prices than similarly situated white males
Fleet Finance, Inc. and Home Equity USA, Inc.	October 1999	FTC Act, TILA	Failure to provide, or provide accurately, (1) timely disclosures of the costs and terms of home equity loans and/or (2) information to consumers about their rights to cancel their credit transactions
Barry Cooper Properties	July 1999	FTC Act, HOEPA	Pattern or practice of asset-based lending and other HOEPA violations
Capitol Mortgage Corporation	July 1999	FTC Act, TILA, HOEPA	HOEPA disclosure violations, right of rescission violations
CLS Financial Services, Inc.	July 1999	FTC Act, HOEPA	Pattern or practice of asset-based lending and other HOEPA violations
Granite Mortgage, LLC and others	July 1999	FTC Act, TILA, HOEPA	Pattern or practice of asset-based lending and other HOEPA violations

**Appendix I
FTC Enforcement Actions Related to
Predatory Lending**

(Continued From Previous Page)

Primary defendant	Date of settlement ^a	Federal laws cited	Alleged unfair or deceptive practices
Interstate Resource Corporation	July 1999	FTC Act, HOEPA	HOEPA disclosure violations
LAP Financial Services, Inc.	July 1999	FTC Act, TILA, HOEPA	Pattern or practice of asset-based lending and other HOEPA violations, right of rescission violations
Wasatch Credit Corporation	July 1999	FTC Act, TILA, HOEPA	Pattern or practice of asset-based lending and other HOEPA violations, right of rescission violations
R.A. Walker and Associates	July 1991	FTC Act	Using deception/misrepresentation to convince borrowers to transfer title to defendant
Nationwide Mortgage Corporation	May 1988	FTC Act, TILA	Using deception/misrepresentation to manipulate borrowers into unaffordable loans with balloon payments

Source: FTC.

Note: In addition to the cases listed, FTC has also recently addressed abuses in the mortgage loan servicing industry. In November 2003, it announced settlements with Fairbanks Capital Holding Corp., its wholly owned subsidiary Fairbanks Capital Corp., and their founder and former CEO (collectively, Fairbanks) on charges that Fairbanks violated the FTC Act, RESPA, and other laws by failing to post consumers' mortgage payments in a timely manner and charging consumers illegal late fees and other unauthorized fees. The settlement will provide for \$40 million in redress to consumers. The case was jointly filed with HUD. *United States of America v. Fairbanks Capital Corp. et al.*, Civ. Action No. 03-12219-DPW (D. Mass.) (filed 11/12/03).

^aIn some cases, the date of settlement listed is the date of the press release announcing the settlement.

^bDOJ filed an amicus curiae brief in a private suit alleging discrimination in violation of the ECOA and Fair Housing Act, which was joined with the FTC case, but settled separately.

^cThe state of Illinois was also a plaintiff in this case.

^dThe states of Arizona, California, Massachusetts, Florida, New York, Illinois, AARP, and private attorneys were also plaintiffs in this case.

^eHUD and the state of Illinois were also plaintiffs in this case. Violations of Illinois state law were also claimed.

^fHUD was also a plaintiff in this case, and DOJ formally filed the complaint on behalf of FTC and HUD.

^gDOJ and HUD were also plaintiffs in this case.

Comments from the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

EDWARD M. GRAMLICH
MEMBER OF THE BOARD

January 16, 2004

Mr. David G. Wood
Director, Financial Markets and
Community Investment
General Accounting Office
Washington, DC 20548

Dear Mr. Wood:

This is in response to your request for the Federal Reserve Board's comments on the draft GAO report entitled Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending. Predatory mortgage lending has been an important issue of concern to federal and state regulators, consumer advocates, members of Congress and others.¹ The increase in responsible subprime lending in recent years has generally benefited consumers by making credit available to borrowers who may not have otherwise qualified for loans. But as the draft report notes, it is widely accepted that predatory lending occurs most often in connection with subprime loans albeit in a small portion of that market.

As the report notes, there is no precise definition of predatory lending in any federal statute. The term in common parlance, however, is generally used to describe cases in which a broker or lender takes unfair advantage of a borrower, often through deception or fraud to make a loan that is not in the borrower's interest. As the report explains, while there are no Federal statutes that specifically define and address "predatory" lending, a number of consumer protection statutes address various practices that occur in abusive lending.

The draft report contains a number of findings and a recommendation to Congress that focuses on enforcement of these existing Federal consumer protection statutes. To enable greater oversight of, and potentially deter predatory lending at, certain nonbank lenders, the report recommends that the Congress consider making certain statutory changes. The changes would grant the Board the clear authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of bank and financial holding companies for compliance with federal consumer protection laws that may relate to predatory lending practices. Further, the draft report recommends that Congress consider

¹ The scope of the report was limited to home mortgage lending.

Appendix II
Comments from the Board of Governors of
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Mr. David G. Wood
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giving the Board specific authority to undertake enforcement actions under those laws against nonbank mortgage lending subsidiaries of bank and financial holding companies.

The Board currently has the general legal authority to monitor and examine nonbank subsidiaries of bank and financial holding companies, but primary responsibility for enforcement of existing federal consumer protection statutes with respect to these nonbank subsidiaries is specifically granted to the FTC. The report concludes, however, that the FTC's mission and resource allocation are directed primarily at conducting investigations based on consumer complaints rather than routine monitoring. The report finds that the Federal Reserve System is better equipped to monitor and examine the nonbank subsidiaries of bank holding companies, apparently by virtue of our role as holding company regulator, and, thus, potentially deter predatory lending activities; and finds that Congress consider giving the Federal Reserve clear and direct authority to do so.

The Federal Reserve regularly conducts examinations of state member banks for compliance with a number of federal consumer protection laws. Examinations of nonbank subsidiaries for compliance with specific statutes are not routinely conducted. Nevertheless, examiners assess consumer compliance risk across the broad range of a banking organization's activities to determine its impact on the organization's overall risk profile and to identify appropriate supervisory activities. In addition, the Board may on occasion direct an examination of a nonbank lending subsidiary of a holding company when necessary in the context of applications to expand in which serious fair lending or compliance issues are raised.²

Although it may be useful to clarify jurisdictional issues in this area, the existing structure has not been a barrier to Federal Reserve oversight. There could be some value in the approach the report is recommending in that it is likely that some abusive practices could be caught that might not be otherwise; however, the selection of either concurrent or exclusive jurisdiction over this population of nonbank entities poses tradeoffs. Changing the federal law expressly to give the Federal Reserve exclusive or even joint enforcement authority for nonbank mortgage lending subsidiaries would result in one supervisory scheme being applied to that group of entities (with attendant costs) and a different supervisory scheme under the sole jurisdiction of the FTC being applied to the same type of nonbank companies not affiliated with a bank. Providing for concurrent jurisdiction between the Federal Reserve and the FTC would subject these nonbank subsidiaries within holding companies to potentially greater oversight than similar entities that are not holding

² For example, in connection with Citigroup's application to acquire European American Bank (which the Board approved on July 2, 2001), the Board directed that an examination of certain subprime lending subsidiaries of Citigroup be carried out to determine whether Citigroup is effectively implementing policies and procedures designed to ensure compliance with fair lending laws and to prevent abusive lending practices.

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company subsidiaries without any indication that affiliates of a bank act more often in a predatory manner than creditors that are not affiliated with a bank. Moreover, any jurisdictional change contemplated by the report would increase costs to the Federal Reserve and thus to the taxpayer, in much the same way as would increasing the FTC's responsibilities in this regard.

As the report illustrates, the challenges of combating predatory lending are difficult and complex. Finding solutions to these challenges merits careful attention by Congress to a broad range of approaches.

Sincerely,



Comments from the Department of Justice



U. S. Department of Justice

Civil Rights Division

Office of the Assistant Attorney General

Washington, D.C. 20035

JAN 14 2004

Mr. Harry Medina, Assistant Director
Financial Markets and Community Investments
United States General Accounting Office
301 Howard Street, Suite 1200
San Francisco, CA 94105-2252

Dear Mr. Medina:

Thank you for the opportunity to review the draft of the General Accounting Office (GAO) report entitled "*CONSUMER PROTECTION: Federal and State Agencies Face Challenges in Combating Predatory Lending, GAO-04-280.*" Representatives of the Department of Justice's (DOJ) Criminal Division, and the Civil Rights Division reviewed this draft report. This letter constitutes the DOJ's formal comments and I request that it be included in the final report.

The extensive effort that your staff has put into this report and the opportunity to work with them on this important issue is appreciated. The Civil Rights Division would like to comment on several aspects of the draft report as follows.

Highlights one-pager (First paragraph, 8th line):

a reference to the Equal Credit Opportunity Act should be added after the reference to the Fair Housing Act

Executive Summary

(Page 7, second bullet): This truncated explanation is a bit misleading and does not fully summarize the discussion in the text. We would suggest adding the language in bold: "DOJ, which is responsible for enforcing certain federal civil rights laws, **filed two of these enforcement actions on behalf of the FTC and identified two additional enforcement action it has taken that were related to predatory lending practices. The statutes DOJ enforces only address predatory lending practices when they also are** alleged to be discriminatory.

(page 12, first paragraph, line 7): Including DOJ in this list of federal agencies is a bit misleading, because all the other listed agencies have regulatory powers and

we do not. We would suggest omitting DOJ from the list on line 7, and adding a reference to DOJ at the beginning of the next sentence, which would then read "Federal agencies, **including these agencies and the DOJ**, have also taken some actions to coordinate their efforts related to educating consumers about predatory lending.

Body of the Report

(Page 19, 2nd paragraph). The third sentence should be clarified to read as follows: DOJ has addressed predatory lending **that is alleged to be discriminatory** by enforcing fair lending laws in a limited number of cases.

(Page 22, first bullet). Last sentence should be clarified to read: "The settlement placed restrictions on the company's future lending operations and **referred victims were compensated from to** previously established monetary relief funds.

(Page 22, footnote 31). Last sentence should be corrected to read: "In addition, **according to DOJ filed complaints in both U.S. v. Action Loan, Civ. Action No. 3:00CV-511-H (W.D. KY), and U.S. v. Franklin Acceptance Corp., Civil No. 99-CV-2435 (E.D. Pa.), cases involving which involved allegations of predatory mortgage lending that resulted from a joint enforcement efforts between DOJ and by the FTC. HUD was also involved in the Action Loan case.**

(Page 30, bullet at bottom of page): The referenced working group had the dual purpose of strengthening enforcement and consumer education from the beginning and the consumer education subcommittee never stopped meeting, so several clarifications should be made, as follows:

-- In the fourth line, the end of that sentence should read "...determine **where how enforcement and consumer education** could be strengthened."

-- In the seventh line, the phrase "and stopped meeting" should be deleted.

-- In the eighth line, the beginning of that sentence should be changed to read: "The Task Force ~~then focused specifically on issues~~ **continued it efforts** related to consumer education ..."

(Page 72, last bullet): The referenced brochures and consumer materials are also available on our website (www.usdoj.gov/crt/housing), and this fact should be listed, as the website is one of our primary means of distributing information about our work.

The Criminal Division comments are as follows:

The GAO report purports to address the problem of "predatory lending," for which there is no commonly accepted definition. In attempting to define the term,

Page 3

the GAO uses examples of the kinds of practices which it associates with "predatory lending." The problem with this is that some of the GAO's examples are not what is commonly thought of as predatory lending practices. A substantial portion of the report discusses property or loan flips, which is a traditional fraud scheme but not a type of predatory lending that deserves discussion in this report. The Criminal Division's main objection to the report is the misleading way that GAO has defined predatory lending and the DOJ's enforcement efforts.

In conclusion, the Department of Justice would like to commend the GAO analysts who worked on this report. DOJ representatives met with them on several occasions and they worked diligently to analyze all aspects of this issue in a constructive manner. Their observations and conclusions will be most helpful in assessing the Department's role in the federal government's efforts to develop strategies regarding the important issue of predatory lending.

Sincerely,



Wan J. Kim
Deputy Assistant Attorney General

cc: Julie Wellman, Audit Liaison, Criminal Division

Comments from the Department of Housing and Urban Development



ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

January 16, 2004

Mr. David G. Wood
Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. Wood:

The Department appreciates the opportunity to comment on the draft GAO Report entitled: Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending (GAO-04-280). Our substantive comments will cover two areas of particular importance to HUD: the FHA Mortgage Insurance Programs and RESPA.

HUD agrees that there is no common definition of predatory lending in the context of the provision of mortgage credit. However, HUD is aggressively attacking abusive and deceptive lending practices in FHA insured lending, which we feel targets the behavior most indicative of predatory lending. Action by HUD and the Federal Housing Administration (FHA) to eliminate these practices is significant because it impacts over one million loans that FHA insures each year, including a substantial number of first time and minority buyers who use FHA and the exemplary influence FHA exerts on the marketplace.

To protect FHA borrowers and set industry examples, FHA has developed a series of new requirements specifically targeting lending practices indicative of predatory lending. To this end, the following have been published as final rules:

- 24 CFR Part 203, Anti-Flipping Rule. The rule prohibits FHA insurance on a property resold within 90 days of the previous sale and also prohibits sale of a property by anyone other than the owner of record. Effective June 2003.
- 24 CFR Part 200, Appraiser Qualifications for Placement on FHA Single Family Appraiser Roster. The rule establishes the changes designed to strengthen the licensing and certification requirements for placement on the FHA appraiser roster. Effective June 2003.
- 24 CFR Part 5 § 5.801, Electronic Submissions of Audited Financial Statements. The rule allows HUD to accept electronic submissions of lenders' financial audits to identify and remove noncompliant lenders more quickly. Effective September 2002.

www.hud.gov

espanol.hud.gov

- 24 CFR Part 200 and 203, Single Family Mortgage Insurance: Section 203(k) Consultant Placement and Removal Procedures. The rule establishes placement and removal procedures for HUD's roster of 203(k) consultants. Effective September 2002.
- 24 CFR Part 200, Nonprofit Organization Participation in Certain FHA Single Family Activities; Placement and Removal Procedures (Nonprofit Roster). The rule establishes placement and removal procedures for HUD's Nonprofit Organizations Roster. Effective July 2002.

Additional rules for program participants have been proposed. These proposed rules include:

- Lender Accountability for Appraisals. This rule holds lenders accountable for the appraisal validity. (Proposed Rule published January 2003)
- Revision to FHA Credit Watch/Termination Initiative. Revises Credit Watch to capture underwriting lenders; prevents a lender from opening a new branch within the area covered by the proposed termination. (Proposed Rule published April 2003)

The Department is in the process of developing other rules that will tighten the requirements relating to becoming an FHA-approved mortgagee, serving as a loan officer for an FHA insured mortgage, and maintaining approved status as a lender. In addition, rules are being developed to increase HUD control over false and misleading advertising, to limit the number of FHA insured loans a nonprofit may have outstanding, to strengthen the qualifications of owners/officers of FHA-approved lending institutions, and to define the duties and responsibilities of loan correspondents and underwriting lenders.

In addition to establishing more stringent procedures for participating in FHA insured programs, the Department is taking aggressive action concerning mortgagees who demonstrate poor performance through early claim and default rates. The Department has created the Credit Watch Program by which the Department tracks quarterly the default rates for the 25,000 offices that originate FHA loans and terminates those operations where the default rate exceeds twice that of the local jurisdiction. In addition to being used to protect the integrity of the FHA insurance funds and sanction those lenders who demonstrate imprudent or possible abusive lending practices, the default rates of these lenders are published on the Web and thereby serve as a source of information by which other lenders and interested parties can judge a lender's performance.

FHA also produces Neighborhood Watch, a web-based software application, for HUD oversight of lenders and lender self-monitoring. Neighborhood Watch complements the Credit Watch Termination initiative by providing FHA approved lenders with statistical views of their performance. As a self-policing tool it has enabled

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lenders to monitor their performance in comparison to other lenders, take corrective actions within their own organizations, and/or sever relationships with poorly-performing business partners.

FHA has created a companion program for appraisers, known as "Appraiser Watch," to target appraisers for review. Appraiser Watch uses traditional risk factors – such as loan volume, loan performance, and loan type – to compare appraisers across peer groups and identify appraisers for review. There are about 25,000 FHA-approved appraisers (about the same number as lender offices).

As stated before, FHA is aggressively policing its participants and imposing significant sanctions on mortgagees found to be violating procedures or otherwise engaged in abusive or deceptive behavior. To demonstrate the effectiveness of the Department's emphasis on program monitoring and enforcement, the following table shows the increase in activity on recent years:

Sanctions	FY 1998-2000	FY 2001-2003
On-site Monitoring Review	2,297	2,777
Sanctions by MRB	128	137
Withdrawn by MRB	28	36
Civil Money Penalties	\$6.17m	\$6.5m
Lenders Assessed Civil Money Penalties	103	116
Indemnifications	2,906	8,980
Potential Savings from Indemnifications	\$87.2m*	\$209m**
Suspensions/Proposed Debarments/Final Determinations	742	1,384
Referrals to OIG	204	1,101

* The dollar amount is based on the historical average loss of \$30,000

** The dollar amount is based on the more recent average loss of \$23,300

HUD also addresses predatory lending through its Loss Mitigation Program, which is often able to help a victim of predatory lending who has defaulted on the mortgage and faces possible foreclosure. Under this program, lenders have options that may help homeowners stay in their homes or may mitigate the financial consequences of the default if the homeowner does not have the resources to make that possible. FHA regulations require that mortgagees explore all available loss mitigation options prior to proceeding to foreclosure. The success of this program is clear. In 2002 the number of loss mitigation cases resolved by the borrower retaining homeownership exceeded the number of cases resolved through foreclosure.

HUD also supports efforts to provide pre-purchase counseling, at little or no cost to potential homeowners, and consumer education specifically targeting predatory

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lending. Housing awards grants to HUD-Approved Counseling Agencies. During FY 2002, HUD-approved counseling agencies provided assistance to 423,000 homeowners or potential homeowners; HUD provided grant funds to directly support 226,000 of those clients. In addition, HUD has developed a Homeownership Education and Learning Program (HELP) that is offered through sponsoring groups such as nonprofits, community-based organizations, and community colleges. HUD also plans to launch a national advertising campaign specifically warning the public of the dangers of predatory lending, and HUD distributes literature concerning the subject at Homeownership Fairs and other public exhibitions throughout the country.

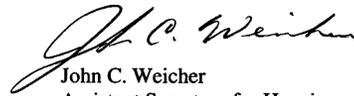
With respect to RESPA, the final rule has been submitted to OMB and is now being reviewed. During that review, the Department cannot comment on the rule. However, the Department recognizes and has stated that RESPA was not intended to eliminate predatory lending, and regulatory reform under RESPA cannot achieve that objective. The Department's rules concerning FHA lenders and appraisers are based on that recognition.

As evidenced by the aforementioned, the Department is strongly committed to curbing the abusive practices associated with predatory lending and would appreciate the final report acknowledging these efforts.

The Department also has several comments specific to the report that we have included as an enclosure to this letter.

Again, we wish to thank the GAO for the opportunity to add our comments to the report prior to finalization.

Sincerely,



John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner

Enclosure

Comments from the National Credit Union Administration



National Credit Union Administration

Office of the Executive Director

January 14, 2004

Harry Medina, Assistant Director
Financial Markets and Community Investments
U.S. General Accounting Office
301 Howard Street, Suite 1200
San Francisco, CA 94105-2252

Re: Predatory Lending Draft Report.

Dear Mr. Medina:

You have asked for our review and comment on the draft report prepared by the General Accounting Office (GAO) discussing challenges faced by federal and state agencies in combating predatory lending (Report). We appreciate the opportunity to comment and offer the following observations.

The Report is a comprehensive treatment of this difficult topic and provides a useful discussion of the issues. While we have no specific experience with non-bank subsidiaries of financial holding companies, we accept the characterization in the Report that these entities frequently escape meaningful regulatory oversight. Thus, we concur in GAO's recommendation that Congress consider providing the Federal Reserve with clearer statutory authority to supervise them.

As the Report notes, NCUA has supervisory responsibility for federally insured credit unions. Consistent with the experience of the other federal banking regulators, we have not observed predatory lending practices among the depository institutions that we regulate. Credit unions are nonprofit cooperatives, owned by their members and democratically controlled, that may only lend and pay dividends to their members and, as such, are disinclined by their nature and structure to engage in the kinds of practices regarded as predatory or abusive.

In Chapter 2 of the Report about guidance issued by the federal regulatory agencies on subprime lending, we request that the following language be added. On page 27, after the first sentence in the second paragraph, insert the following new sentence: "The NCUA issued similar guidance to insured credit unions in 1999." A footnote should be inserted at the end of this sentence, to read as follows: "NCUA Letter to Credit Unions No. 99-CU-05, Risk Based Lending, June, 1999." Inclusion of this language and footnote will help document that NCUA, consistent with the other federal financial institution regulators, has also issued guidance addressing this issue.

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Appendix V
Comments from the National Credit Union
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Harry Medina
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The Report accurately describes NCUA's experience and position on the issue of federal preemption. Given the lack of evidence that federal credit unions are engaging in predatory lending practices, we remain comfortable that enforcement of the Federal Credit Union Act and the other federal laws pertaining to real estate lending provides sufficient safeguards for consumers. We note that state efforts to strengthen licensing and qualification requirements for mortgage broker activity by persons not associated with federally regulated depository institutions may be an effective way to limit predatory and abusive behavior.

While we acknowledge, as described in Chapter 5 of the Report, that there may be limits to the effectiveness of consumer education efforts and enhanced disclosure requirements, NCUA remains committed to promoting and supporting financial awareness and education for consumers. NCUA has been very active in encouraging credit unions to educate and provide service to those with limited access to financial services. Our "Access Across America" is one such example. This program has focused on creating economic empowerment through expanded credit union service into underserved neighborhoods and communities and facilitating the sharing of resource information for credit unions expanding into these areas. As part of "Access Across America" NCUA supported many programs including the "Money Smart" training materials developed by the FDIC, as well as numerous other workshops and training programs developed in collaboration with organizations such as the Neighborhood Reinvestment Corporation and the Department of Housing and Urban Development. We believe that credit unions themselves are part of the solution to predatory lending, and we are committed to helping them present alternatives for their members.

We hope these comments are useful and will be happy to respond to any questions.

Sincerely,


J. Leonard Skiles
Executive Director

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