

Mortgage Banking Commentary



**THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
AND THE DEPARTMENT OF TREASURY
ISSUE JOINT REPORT:
CURBING PREDATORY HOME MORTGAGE LENDING**

July 11, 2000

Over the past year, the issue of “predatory lending” has captured the attention of legislators, regulators and enforcement agencies at both the federal and state levels. Several states have considered or adopted statutes and regulations addressing perceived abuses, bills have been introduced in the U.S. Congress, and both federal and state enforcement agencies have been active in the area. The issue is complicated for lenders because while all agree that “predatory lending” is abhorrent, few agree on what it is. The term is quite elastic and has been used to refer to many practices that are common in the mortgage industry, particularly in the subprime lending arena.

In late March, Department of Housing and Urban Development (“HUD”) Secretary Andrew Cuomo announced the formation of a task force to investigate the existence of “predatory lending” practices in the lending industry. Recognizing the potentially extensive reach of such an inquiry, Secretary Cuomo invited Department of Treasury (“Treasury”) Secretary Lawrence Summers to co-chair the task force. Within weeks of Cuomo’s announcement, HUD and Treasury had convened the National Task Force on Predatory Lending (the “Task Force”).

Comprised of individuals representing, among others, consumer advocacy groups and mortgage lenders and brokers, the Task Force held five meetings across the country. At these meetings, Task Force members both heard and provided testimony in connection with “predatory lending” practices. Relying in large part on the information gathered at these meetings, HUD and Treasury have released a joint report entitled Curbing Predatory Home Mortgage Lending (the “Report”). The Report represents the first comprehensive federal analysis of the issue and undoubtedly will serve as a template for future debate over “solutions” to perceived problems.

I. Summary of the Report

The Report can be divided into two primary sections. The first section provides necessary background information regarding the subprime mortgage market, the existing legal framework (i.e., Truth in



Lending Act, Real Estate Settlement Procedures Act, etc.), and the Task Force's identification of four practices that occur often in the subprime market and may be deemed "predatory" in nature. They are:

- Loan Flipping;
- Loan Packing;
- Asset-Based Lending; and
- Outright Fraud.

Following the discussion of this background material, HUD and Treasury make several recommendations for preventing predatory lending practices from occurring. These recommendations fall along four primary approaches:

1) Increasing consumer literacy. The Report focuses on ways to improve consumer awareness as well as providing greater remedies for the consumer under existing law. Approaches considered by the Task Force include:

- Notification of pre-transaction counseling;
- Providing a guarantee of settlement costs;
- Amending the Annual Percentage Rate;
- Increasing damages available under the Truth in Lending Act ("TILA") and the Real Estate Settlement Procedures Act ("RESPA");

2) Eliminating harmful sales practices. This portion of the Report concentrates on isolating those practices that are considered to be "predatory" in nature and recommends specific action to be taken to either eliminate the opportunity for such practices to occur in the marketplace or increase penalties for those lenders engaged in such practices. Recommendations made by the Report include:

- Prohibiting the refinancing of Home Ownership and Equity Protection Act ("HOEPA") loans within 18 months from the date of the loan;
- Eliminate "pattern and practice" requirement from proof of asset-based lending claims under HOEPA;
- Aggressive enforcement of laws against mortgage brokers;

3) Reducing abusive terms and conditions in high-cost loans. Similar to the recommendations listed above, the Report targets certain loan terms and conditions as providing increased opportunity to engage in predatory lending practices, and makes the following recommendations to reduce the abusive nature of such terms or conditions:

- Expand the types of loans that are covered under HOEPA;
- Prohibit the use of single premium credit insurance;



- Require that lenders offering loans with prepayment fees offer a choice between loans that include such fees and loans that do not;
 - Prohibit loans from having balloon payments that are triggered prior to 15 years; and
- 4) Increasing transparency in the mortgage lending market. The Report primarily focuses on increasing transparency through increasing the usefulness of the data collected under the Home Mortgage Disclosure Act (“HMDA”).

II. What Constitutes a “Predatory Lending” Practice?

While there exist numerous federal statutes and regulations applicable to mortgage lending, none of these laws provide a concrete definition of what action by a lender will constitute a “predatory lending” practice. Despite the ambiguity surrounding this issue, the Report finds that a “predatory” loan is often the result of either fraudulent lending practices or an attempt by the lender to take unfair advantage of the consumer’s lack of sophistication or understanding of the mortgage loan transaction. Although a fraudulent or unfair practice alone could arguably classify a loan as “predatory,” lenders often combine such action with one or more of a variety of loan terms, such as prepayment fees or single premium credit insurance, to further take advantage of the consumer. As indicated in the Report, “predatory lending” does not describe a specific act on the part of the lender, rather it describes the circumstances and terms under which a loan is made. Loan flipping, loan packing, asset-based lending and outright fraud, as described below, were identified by the Task Force as being four of the most prevalent examples of circumstances and terms that together amount to predatory lending practices.

- LOAN FLIPPING: Loan flipping refers to the practice of repeatedly refinancing loans within a short period of time. Borrowers are often misled by lenders into believing that, by refinancing, the borrower will obtain a lower interest rate and a lower monthly payment. Even assuming that the refinancing does result in a lower interest rate, the refinancings are designed to trigger the imposition of high prepayment or other fees. As a result, lenders are able to generate substantial income with ultimately no benefit to the borrower.
- LOAN PACKING: Loan packing has the effect of concealing the true cost of credit to the borrower. By adding such costs as broker fees or single premium credit insurance into the amount of the loan financed, borrowers are not provided with adequate disclosure of the price of such services.
- ASSET-BASED LENDING: Asset-based lending describes those circumstances under which lenders will make loans to borrowers based on the amount of equity the borrower has in the home rather than the borrower’s income or ability to repay the loan. Elderly individuals on fixed incomes but with significant equity in their homes are often the target of this particular practice.



- **OUTRIGHT FRAUD:** While some elements of fraud are present in all three of the above-described predatory lending practices, the Task Force also uncovered instances of “asset flipping” which required appraisers and mortgage brokers (or other originators) to conspire to mislead the consumer to believe that the property securing the loan is worth more than its actual appraised value.

The Report also finds that while predatory lending practices, such as the ones described above, occur more often in the subprime market than in the prime market, subprime loans are not necessarily predatory in nature. Among the most common reasons for borrowers to turn to the subprime market to access necessary credit are: a poor credit history, high monthly debt payments relative to income, variable income sources, or a lack of familiarity with traditional prime lenders. The existence of any one of these factors could cause a borrower to believe that no other credit sources are available, making it easier for an unscrupulous lender to manipulate or mislead the borrower.

The Task Force singled out home improvement contractors and mortgage brokers as being two “significant sources of abusive lending practices” in the subprime market. One theory provided in the Report for the prevalence of predatory lending practices by mortgage brokers is that they do not take on any credit risk associated with the transaction. The Report reasons that mortgage brokers are not concerned with ultimate repayment of the loan, but are concerned with the fee income that can be reaped from the services they provide in connection with making the loan. In light of the heightened attention that the Task Force believed should be paid to the activities of mortgage brokers, the Report makes specific recommendations for increasing the regulation or supervision of mortgage brokers. (See below discussion under Recommendations: Harmful Sales Practices)

Evidence provided in the Report supports a theory that the existence of more lenders or other originators offering similar loan products with similar terms combined with borrowers’ higher degree of financial sophistication acts as a deterrent to the use of predatory lending practices in the prime market. Without the existence of these market forces, the Task Force found that predatory lending practices were likely to occur. With this theory in mind, the Report articulates several recommendations for eliminating the ability and the opportunity for lenders and other intermediaries to engage in predatory lending practices by providing individuals in the subprime market with the skills or information necessary to make an informed choice with respect to their credit options.

III. Recommendations for Reducing Predatory Lending Practices

Stripping the problem of predatory lending down to its barest essentials, the Report identifies four basic areas that, if addressed, would arguably decrease the prevalence of predatory lending practices in the subprime market. They are:

- Consumer literacy and disclosure;
- Harmful sales practices;
- Abusive terms and conditions in high-cost loans; and
- Market transparency.



The Report's recommendations for addressing the above areas are focused on a mix of consumer education, increased enforcement and the modification of existing laws.

A. Consumer Literacy: Education, Disclosures and Remedies

Testimony from each of the nationwide meetings informed the Task Force that the victims of predatory lending practices simply did not understand the terms of the loans they had received. In light of this, the Report suggests a multi-pronged approach for increasing consumer literacy at the most basic level. One way to increase consumer awareness suggested in the Report is to notify consumers about the availability of "pre-transaction" counseling. For high-cost loans¹ the Report recommends that Congress take action to require creditors to provide loan applicants with a list of approved credit counselors prior to closing and urge the applicant to utilize the services of such counselors. The Report contemplates that these counselors would be certified by HUD or another appropriate state or federal housing/financial regulator.

In addition to increased consumer education, the Report recommends that existing consumer disclosures be amended to provide the consumer with more meaningful information in connection with the mortgage loan. At present, a consumer can be presented with as many as 50 documents prior to the closing of a mortgage loan. A mere fraction of these documents contain federally-mandated disclosures of the significant aspects of the loan. The Report theorizes that the disclosure process can be simplified and discusses proposed alternatives for reaching this goal through regulatory or statutory changes in the following areas: settlement costs, the good faith estimate ("GFE"), the annual percentage rate ("APR") and the timing for providing disclosures.

Advocated by various segments of the mortgage industry is a recommendation that creditors provide consumers with a disclosure guaranteeing closing costs. Based on the theory that consumers are primarily interested in the overall price of settlement and would be better equipped to "comparison shop" if all they needed to compare was a single guaranteed price for settlement services, creditors argued to the Task Force in favor of amending RESPA to permit them to enter into volume-based contracts with affiliates and other settlement service providers to create an inclusive "settlement package" for the consumer. The package would include all of the creditor's charges, such as application, origination and underwriting fees, and all third party fees for such items as surveys, appraisals, credit reports and mortgage broker services. Excluded from inclusion in the package would be costs dependent on the choice of the borrower (i.e., hazard insurance) and costs that would have been otherwise imposed in a cash transaction (i.e., taxes). Before such a recommendation could be effectuated, however, Congress would need to provide an exemption from Section 8 of RESPA, which generally prohibits creditors from receiving "kickbacks and unearned fees." (12 U.S.C. § 2607). This exemption would be available only to those creditors that: (i) offer consumers a comprehensive package of the settlement services needed to close a loan, (ii) provide consumers with a simple prescribed disclosure that gives the maximum price for the package through

¹ "High-cost loans" are defined under 12 C.F.R. § 226.32 (Regulation Z) as being closed-end loans made to refinance existing mortgages and closed-end home equity loans that charge either: (i) an annual percentage rate (APR) of more than 10 percentage points above the yield on Treasury securities of comparable maturities (although the Federal Reserve Board may adjust this trigger down to eight percent or up to 12 percent), or (ii) points and fees (including compensation to mortgage brokers, but excluding certain bona fide third party fees) that exceed the greater of 8 percent of the loan amount or \$400 (adjusted for inflation for calendar year 2000 - \$451).



closing, and (iii) disclose the rate and points offered to the consumer for the loan, along with a guarantee that the rates and points will not increase (subject to certain conditions).

Another alternative for increasing consumer awareness discussed in the Report is the creation of an accuracy standard on the GFE. As described in the Report, the format of the GFE would not change. Creditors would, however, be held liable for an increase in charges that were incurred as a result of a choice on the part of the creditor. Changes in loan amounts or additional costs arising from the consumer's decision to make a change would not be counted toward the tolerance. Although this alternative was supported by HUD and the Federal Reserve Board (the "Board") in a report to Congress in 1998 discussing TILA/RESPA reform, the Report abandons this option in favor of guaranteeing settlement costs as discussed above.

In contrast to the "GFE accuracy standard," the Report adopts the HUD/Federal Reserve Board prior recommendation that the APR be retained, provided that it undergo some significant modification. While the existence of one constant number that consumers can utilize to compare loan products offered by different lenders is useful, the APR in its current form falls short. The exclusion of certain charges from the APR leaves consumers uninformed as to the total cost of the credit. In an effort to add more utility to the APR, the Report recommends eliminating the exclusion of certain costs from the APR and taking an "all-in approach" that would reflect the full cost of credit.

Improving the timing of disclosures comprised a significant amount of the Report's recommendations for improving consumer awareness. Generally, the Report supported a system of disclosure that would provide consumers with the information necessary to "shop" for the best mortgage as soon as possible, preferably prior to paying any significant fees. Also recommended in the Report were changes to the timing and content of the HUD-1 settlement statement. Reasoning that consumers needed more time to review the disclosure for discrepancies from prior oral discussions, the Report recommends providing the HUD-1 three days prior to closing rather than one day. In addition, the Report recommends that creditors be required to issue a new HUD-1 in the event that the amount of any of the fees disclosed underwent a material change. If such a change were to occur, the creditor would be unable to close the loan until after the borrower had three days to review the amended disclosure.

While the Report makes some very specific recommendations, as discussed above, it also recommends more general concepts for improving consumer understanding of mortgage loans. This would include the dissemination of educational booklets for refinancings and subordinate-lien loans early in the home-buying process, the combination and simplification of TILA/RESPA disclosures and requiring disclosure of the credit score to the borrower. Even assuming that Congress were to adopt all of the Report's recommendations and make sweeping changes to creditors' disclosure obligations, education of the consumer alone is not enough. In addition to the recommendations made in the Report to increase consumer awareness, the Report also suggests that consumers be provided increased remedies under HOEPA, TILA and RESPA.



Believing that current laws do not sufficiently deter unscrupulous lenders from engaging in predatory lending practices, the Report recommends that Congress amend the types and amounts of damages available to consumers under HOEPA, RESPA and TILA. Among the specific recommendations made, the Report suggests the following:

- An increase in statutory damages available under TILA;
- Authorization of civil penalties in an amount of at least \$2,500 to be collected by the FTC and HUD under HOEPA and RESPA, respectively, for each violation of such laws;
- Permit private causes of action for damages, specific performance, reasonable attorneys fees and costs for violations under RESPA; and
- Update the criminal misdemeanor penalty under Section 8 of RESPA.

B. Harmful Sales Practices

Although there are numerous ways that unscrupulous lenders are able to effect a fraud or take advantage of a borrower's lack of sophistication, the Report remains focused on eliminating or reducing those practices that have previously been identified as "predatory lending" practices, such as loan flipping and asset-based lending. Significant and numerous amendments to HOEPA, or the Board's regulations implementing HOEPA, were recommended in the Report as a means of accomplishing this goal.

1. Loan Flipping

In an effort to reduce instances of "loan flipping" in the marketplace, the Report recommends a strict prohibition on the refinancing of any mortgage loan into a HOEPA loan within the first 18 months of the closing of the mortgage loan. The only exception to this provision would be in those cases where the borrower would receive a "tangible net benefit" from the refinancing. Whether a decrease in the APR, limitations on points and fees or some other consideration constitutes a tangible net benefit would be defined by regulation issued by the Board.

In the event that a permissible refinancing into a HOEPA loan were to occur, the Report recommends that calculation of the amount of points and fees charged for the refinancing be limited to the amount of the new advance (if any), thereby preventing unscrupulous lenders from charging excessive origination fees. On the other hand, if a lender were to engage in a prohibited refinancing into a HOEPA loan, the refinanced loan could potentially be classified as an unfair, deceptive or abusive practice under Regulation Z. The Report recommends that the Board use the authority granted to it under HOEPA (15 U.S.C. § 1639(1)(2)) to categorize such prohibited refinancings as an abusive lending practice. In support for such a classification, the Report cites Congressional Conference Report No. 103-652 indicating that loan flipping "may be [an] appropriate matter[] for regulation under [HOEPA]." (Conf. Rep. No. 103-652, 103d Cong., 2d Sess. (Aug. 2, 1994)).



2. Asset-Based Lending

A significant hurdle when alleging a violation of HOEPA's ban on asset-based lending is the requirement that the borrower show that the lender engaged in a "pattern or practice" of lending without regard to the borrower's ability to repay the loan. Citing the difficulty that borrowers encounter when faced with collecting the empirical evidence necessary to support their claims, the Report encourages Congress to repeal this "pattern and practice" proof requirement. Instead of requiring that the borrower prove that the lender was regularly engaged in the practice of asset-based lending, the Report suggests the creation of a safe harbor for lenders. For purposes of the safe harbor, loans made to borrowers whose total monthly debt-to-income ratio is less than 50% would not be considered an asset-based loan. This exception would not, however, apply if the borrower's residual household income did not meet or exceed the lending guidelines for loans guaranteed by the U.S. Veterans Administration or if the borrower was seriously delinquent or in default on an existing loan.

Even if Congress did not take action to repeal the requirement that consumers show that lenders engaged in a "pattern or practice" of asset-based lending, the Report believes that the Board could amend its interpretation of this phrase to eliminate some of the burden that is placed on consumers. Instead of requiring a statistically valid, random sampling of loans to support a finding that the lender engaged in a pattern or practice of asset-based lending, the Board could find that proof of several instances of such prohibited conduct over a short period of time is sufficient to show a pattern or practice on the part of the lender.

3. Mortgage Broker/Fraud

As noted previously, mortgage brokers were specifically identified in the Report as engaging in predatory lending practices. Specifically, testimony at the nationwide meeting indicated that some mortgage brokers engaged in aggressive marketing or solicitation tactics, which bordered on, if not actually constituted, fraud. Bait and switch tactics, solicitation of fraudulent gift letters, and the use of yield-spread premiums to disguise excessive fees were among the practices identified in the Report as constituting fraud. The Report noted, however, that the imposition of additional regulation on mortgage brokers might not be the solution. Across-the-board impositions of new rules and requirements will impose costs on all mortgage brokers not just those that are engaging in abusive lending practices.

Notwithstanding the hesitancy to subject all mortgage brokers to increased supervision, the Report outlines a number of possible approaches for heightened scrutiny of mortgage brokering activities at both the federal and state levels. At the federal level, it is recommended that Congress take action to require brokers to document the appropriateness of originating HOEPA loans for each borrower. Such documentation could include the broker's review of the borrower's income and credit score as well as full disclosure of all fees received by the broker in connection with the origination of such a loan. Both the borrower and the broker would be required to sign the documentation no less than 3 days prior to closing.



Also contemplated in the Report is a requirement to make lenders liable for illegal action on the part of a broker. Such liability would be limited to instances where: (i) the broker was acting as an agent for the lender, (ii) the broker has an ongoing financial relationship with the lender, or (iii) the lender knew or should have known of the broker's fraud.

At the state level, the Report recommends the development of model state laws for registration, licensing and regulation of mortgage brokers. To illustrate their point, the Report cites some statistics on variations among the state mortgage brokering laws. Of the states reviewed by the Task Force, 39 have laws governing the licensing or registration of mortgage brokers, 29 require that the brokers pay a licensing fee or show proof of a minimum net worth and only six require that mortgage brokers undergo a competency test prior to obtaining a license. The Report also encouraged more aggressive enforcement of existing laws at the state and local levels and the creation of a national database of mortgage brokers to deter unscrupulous brokers from migrating from state to state.

C. Abusive or Deceptive Terms and Conditions

Concerned that lenders would target residents of low-income areas for unfair lending practices, Congress enacted HOEPA as part of the Riegle Community Development and Regulatory Improvement Act. Despite Congress' sweeping intent to enact a law that would limit the incidence of reverse redlining, HOEPA's high trigger thresholds make the law inapplicable to many loans in the subprime market. Anecdotal evidence provided to the Task Force indicates that abuses are prevalent just below HOEPA's trigger levels.

1. HOEPA Reform

Attempting to strike a balance between increasing credit transparency for borrowers and retaining creditors in the subprime marketplace, the Report makes several recommendations for amending HOEPA's provisions. At present, HOEPA's provisions are limited to closed-end loans made to refinance existing mortgages and closed-end home equity loans. However, in light of the Task Force's findings that subprime loans are increasingly occurring in the first-lien market, the Report recommends that HOEPA's reach be extended to include purchase money loans and home equity lines of credit, thereby providing greater protection for homebuyers and homeowners accessing equity in their homes. Although borrowers of reverse loans are already afforded specific protections, the Report indicates that the Task Force has not eliminated the possibility of creating specific regulation or statutory protection for high-cost reverse mortgages. As the average age of the population in America increases, the Report indicates that the need for such specialized regulation will continue to grow.

Based on evidence provided to the Task Force, the Report recommends that HOEPA's interest rate thresholds should be lowered to six percentage points above comparable Treasury securities for first liens and eight percentage points for subordinate-lien loans. Based on these proposed interest rate levels, the Report predicts that HOEPA's protections would be available to one in five subprime borrowers.



In addition to lowering the interest rate threshold, the Report recommends amending the fee threshold to the greater of seven percent of the loan amount or \$1,000. The Report's recommendation, however, would also expand the types of fees that are included in calculating HOEPA's trigger threshold. Fees for purposes of the HOEPA threshold could be expanded to include: (i) certain fees and amounts imposed by third party closing agents, (ii) prepayment penalties that are levied on a refinancing, and (iii) all compensation received by a mortgage broker in connection with the mortgage transaction regardless of whether the mortgage broker originates the loan in his or her own name.

Over 20 percent of mortgage loans that are made in the subprime market are adjustable rate mortgages. HOEPA's APR trigger, however, is based on the rate of the loan at closing notwithstanding the possibility that the APR could increase dramatically after the first few years of the loan. Loans that are subject to low, fixed interest "teaser" rates in the beginning of the loan's term are able to escape HOEPA's triggers even though the loan's later interest rate could significantly exceed HOEPA's APR threshold. In light of this, the Report recommends that, for purposes of the APR threshold, the fully-indexed spread of adjustable rate loans should be taken into consideration for purposes of determining whether the loan should be subject to HOEPA's protections.

2. Single Premium Credit Insurance

Low loss ratios on credit insurance claims and an industry practice of selling such insurance to lenders rather than borrowers make credit insurance policies a reliable income source and an attractive product for insurance companies. Narrative testimony provided to the Task Force, however, indicates that what makes credit insurance attractive to insurers makes it unattractive to borrowers. As the insurance is actually being sold to the lender, with the price of such insurance being passed on to the borrower, the lender has little incentive to seek out low premium credit insurance. Adding to the problem of the potentially high cost of such insurance is the standard in the industry for premiums for credit insurance to be payable in a single payment. This payment is typically financed into the loan leaving borrowers unaware that such insurance is optional or that it has even been included in the loan.

Because of the significant opportunities for abuse with single premium credit insurance, the Report recommends that this product be eliminated entirely from mortgage loans. For those lenders that would still like to offer credit insurance, the Report suggests that it would be acceptable to offer it provided that it is payable on a monthly basis. The Report also articulates a preference for prohibiting the sale of non-mortgage related products such as credit insurance until after the lender has approved the mortgage loan and communicated such approval to the borrower. By delaying the sale of the insurance, borrowers will not be led to believe that a refusal to buy will impair their ability to obtain the loan.

3. Prepayment Penalties

Lenders offering loan products that include prepayment fees are often able to provide borrowers with a choice of products between loans that carry a prepayment fee and ones that have a higher interest rate or other costs but do not have a prepayment fee. Despite the availability of such options in the marketplace, loans carrying prepayment penalties are extremely prevalent in the subprime market. Research provided to the Task Force indicates that 70 percent or more of loans originated in the



subprime market contain a prepayment penalty. Such a high percentage indicates that borrowers in the subprime market are likely unaware that there are alternative mortgage options that could better suit that borrower's needs or that such options even exist.

In an effort to provide greater transparency of the mortgage options that are available to the consumer, the Report recommends that borrowers that are applying for a HOEPA loan be given a choice between a loan with prepayment penalties and one with a higher APR but no prepayment penalties. The Report contemplates that lenders would have an affirmative duty to inform the borrower that such an option exists and that the borrower is eligible to receive either loan.

In the event that a borrower were to choose a loan with a prepayment penalty, the Report recommends that Congress shorten the length of time within which a prepayment penalty may be assessed. Although evidence shows that five years is the typical length of time within which a prepayment fee may be imposed, the Report indicates that a shorter time period would curb predatory lending practices without affecting the availability of credit to borrowers.

4. Balloon Payments

Balloon payments arising within a short period of time from the closing of the loan can be onerous to borrowers, especially those in the subprime market. Borrowers in the subprime market typically require a longer period of time to repair credit, supplement income or reduce debt in order to place themselves in a better bargaining position when it comes time to refinance their loans. The Report anticipates that, by pushing the minimum time at which a balloon payment may be imposed for a HOEPA loan to 15 years, borrowers will have had the time necessary to repair their credit and "graduate" into the prime market.

D. Market Structure

Data regarding the mortgage market is primarily gathered pursuant to the HMDA and the Board's Regulation C, which implements the Act. From this data, information regarding loan purpose, loan amounts, geography, applicant data (sex, race, income, etc.) and loan purchaser is gathered for home purchase and home improvement loans across the country.

While this data has proven to be crucial for policymakers in understanding mortgage lending patterns, the Report finds that additional information is needed, especially information regarding lending activities that occur in the subprime market. In addition to suggesting that more information be collected, such as loan-to-value ratios and the reasons for the denial of loans, the Report recommends that HUD be given authority to assess penalties for HMDA violations for non-federally insured, non-bank affiliated mortgage lenders.

Also, as an incentive to move individuals out of the subprime market and into the prime market, the Report recommends that Community Reinvestment Act ("CRA") credit should be granted for those financial institutions that offer products to assist subprime borrowers to graduate into the prime market. Credit would, however, be either taken away or denied to those entities that support predatory lending practices through loan originations or other activities.



IV. Conclusion

With home ownership rates at a record high of 67 percent, the importance of eliminating predatory lending practices that can strip families of the equity in their homes and eventually lead to foreclosure has become increasingly important. While the Report recommends numerous regulatory and statutory proposals designed to bolster existing consumer protection laws, it is the Report's recommendations with respect to increasing consumer awareness and understanding of mortgage lending that provide the foundation upon which any effort to eliminate or reduce predatory lending practices must be built.

In addition to the Report, HUD, along with several other banking regulatory agencies, has drafted a preliminary policy statement on predatory lending practices. Although this policy has not yet been released in its final form, the summary below provides a good indication of where the agencies are focusing their attention and what loan terms and lending practices to avoid.

I. Draft Policy Statement on Predatory Lending Practices

On May 24, 2000, HUD, Office of Federal Housing Enterprise Oversight, Department of Justice, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve Board (the "Board"), Federal Deposit Insurance Corporation, Federal Housing Finance Board, Federal Trade Commission ("FTC") and National Credit Union Administration (collectively, the "Federal Agencies" or "Agencies") released a draft Policy Statement on Predatory Lending Practices (the "Predatory Lending Policy Statement" or "Policy Statement").

The Policy Statement (i) itemizes the federal fair lending and consumer protection laws over which the Agencies have enforcement authority, (ii) summarizes the federal and state predatory lending initiatives that have occurred over the past several years, (iii) identifies "some of the more harmful practices" that the Agencies believe can constitute predatory lending, and (iv) sets forth examples designed to illustrate the circumstances under which certain lending practices rise to the level of "predatory lending."

The Predatory Lending Policy Statement is intended to articulate the "Agencies' general position on federal fair lending and consumer protection laws, for purposes of administrative enforcement of those statutes." The Policy Statement is not intended to create or confer any rights on third parties that could be enforceable in any administrative or civil proceeding. The Policy Statement is summarized below.

A. Federal Fair Lending and Consumer Protection Laws

The Policy Statement itemizes and briefly summarizes the current federal fair lending and consumer protection laws over which the Agencies have enforcement authority and that could serve as a basis for "predatory lending" claims. These laws are: the Truth in Lending Act ("TILA"), including the Home Ownership and Equity Protection Act ("HOEPA"); Equal Credit Opportunity Act ("ECOA") and Regulation B; Fair Housing Act ("FHA"); Real Estate Settlement Procedures Act ("RESPA"); Federal Trade Commission Act ("FTCA"); and Community Reinvestment Act ("CRA").



B. Past Predatory Lending Initiatives

The Policy Statement also itemizes and briefly summarizes the federal legislative, administrative and judicial activities involving predatory lending that have occurred during the past several years. These are: a series of 1993 Congressional Hearings addressing reverse redlining, protecting home equity through enhanced disclosures and HOEPA; the enactment of HOEPA in 1994; 1998 Congressional Hearings addressing “stripping, flipping and packing,” and TILA/RESPA reform; the U.S. Department of Justice’s (“DOJ”) 1996 settlement with Long Beach Mortgage Company; the FTC’s 1997 settlement with The Money Tree, Inc.; 1997 Congressional Hearings on HOEPA; 1998 Joint Report by HUD and the Board to Congress on TILA and RESPA Reform; 1998 FTC complaint against Capital City Mortgage Company; 1999 FTC settlement with seven subprime lenders and related consumer education campaign; March 2000 HUD/DOJ/FTC settlement with Delta Funding Corporation. The Policy Statement also notes that various state legislatures and agencies have taken action to address predatory lending, and that “several private organizations have accumulated a significant amount of information concerning the existence of predatory lending practices.”

C. Activities That Can Constitute Predatory Lending

Based on the legislative, administrative, judicial and other enforcement and fact-gathering proceedings identified above, the Federal Agencies believe that, depending on the circumstances, the following practices can constitute predatory lending:

- Asset-based lending
- “Packing” unnecessary fees and costs on the loan
- Balloon payments or negative amortization resulting in the need to refinance
- Prepayment penalties that restrict borrower’s ability to refinance
- Targeting protected groups for unlawful, harmful or unsuitable loans
- Flipping and financing additional points and fees each time
- Loan servicing practices that inhibit refinancing with another lender
- Home improvement schemes that involve directing borrowers to high-cost lenders
- Refinancing first-lien loans to generate higher origination fees rather than proposing smaller, second-lien or personal loans
- Providing false, deceptive or incomplete information about loan terms

D. Illustrative Examples

The Policy Statement acknowledges that none of the statutes enforced by the Agencies define “predatory lending,” and indicates that many of the practices described above are not *necessarily* unlawful or harmful. According to the Policy Statement, whether or not such practices constitute unlawful or abusive conduct depends on (i) the Agencies’ understanding of the statutes and regulations they enforce; and (ii) the “totality of the circumstances under which the practices occur.” To help clarify the situations in which certain lending practices “can be unlawful, abusive or both,” the Policy Statement describes a series of scenarios and indicates the extent to which the practices described may violate existing laws and regulations.



For example, **Scenario 1(A)** involves Mrs. Joan Doe, an elderly, African-American widow. Mrs. Doe owns her residence free and clear, lives on a fixed income and is financially unsophisticated. This scenario also involves ABC Improvements Corporation, a home improvement contractor that has an arrangement with XYZ Mortgage Company, a mortgage broker that specializes in making home improvement and home equity loans in the Washington, DC metropolitan area. ABC Contractor actively solicits home improvement contracts with “equity-rich, elderly or unsophisticated homeowners,” and gives XYZ Mortgage Company an exclusive first option to provide financing for the contracts.

The Policy Statement indicates that under state law, ABC Contractor may be deemed XYZ Mortgage Company’s agent. The Policy Statement also provides that if XYZ Mortgage makes HOEPA loans, it could face liability if its loans constituted a pattern or practice of extending credit to persons not likely to be able to make the scheduled payments. HOEPA liability also could arise if XYZ Mortgage paid ABC Contractor directly from the loan proceeds. The Policy Statement further indicates that ABC Contractor aggressively solicits combined home improvement/loan deals in a predominately minority area. Presumably because ABC Contractor is XYZ Mortgage’s agent, the Agencies believe that ABC’s “decision to target neighborhoods for disadvantageous or unlawful loans on the basis of race” violates the FHA. Furthermore, “the targeting of elderly, equity-rich, but lower-income homeowners for predatory loans could have negative CRA rating consequences” for any depository institution that is affiliated with XYZ Mortgage or that seeks to obtain CRA credit by purchasing XYZ’s loans.

Other scenarios in the Policy Statement illustrate reverse redlining in violation of the FHA, asset-based lending in violation of HOEPA, misrepresentations and “bait and switch” tactics that constitute unfair and deceptive trade practices in violation of the FTCA, as well as fraud and other state law violations. The Policy Statement also contains examples of disclosure violations under RESPA, and TILA finance charge and right of rescission violations. Additionally, the Policy Statement provides examples of abusive “equity-stripping” tactics, including the charging of excessive or unnecessary fees, asset-based lending, loan “flipping,” and certain negative amortization and balloon payments. The Policy Statement indicates that equity stripping can violate the FTCA if the lender’s actions are deceptive or unfair, and the ECOA or FHA if the actions are discriminatory. The Policy Statement also indicates that HOEPA prohibits negative amortization and certain balloon payments on high cost loans. Finally, the Policy Statement illustrates circumstances in which “predatory” loans will not be favorably considered in an institution’s CRA evaluation.

The Agencies are soliciting comments to the Policy Statement and intend to supplement it with answers to “common questions as a means of providing further guidance” on the predatory lending issue.

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If you have any questions about the Report or Policy Statement, please give us a call.

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**MORTGAGE BANKING/CONSUMER FINANCE GROUP**

Kirkpatrick & Lockhart LLP practices law both nationally and internationally from offices in Boston, Harrisburg, Los Angeles, Miami, New York, Pittsburgh, San Francisco and Washington. Founded in 1946, the firm is one of the thirty-five largest law firms in the country, with over 560 attorneys. Kirkpatrick & Lockhart LLP represents a broad range of clients in a wide variety of matters, including corporate and securities, e-commerce, investment management, insurance coverage, financial institutions, mortgage banking and consumer finance, creditors rights, intellectual property, tax, labor, environmental, antitrust, health care and government contracts. You can learn more about our firm by visiting our Internet website at <http://www.kl.com>.

Over one half of our lawyers are litigators who practice nationwide in federal and state courts. We have particular experience in class action lawsuits, generally defending financial institutions, broker-dealers, public companies, investment companies and their officers and directors against claims of violations of securities laws, consumer credit laws and common law tort and contract claims.

The Mortgage Banking/Consumer Finance Group provides legal advice and licensing services to the consumer lending industry. It provides legal advice on all aspects of the origination, processing, underwriting, closing, funding, insuring, selling and servicing of residential mortgage loans and consumer loans, from both a transactional and regulatory compliance perspective. Our focus includes both first- and subordinate-lien, residential mortgage loans, as well as open-end home equity, property improvement loans and other forms of consumer loans. We also have substantial experience in multi-family and commercial mortgage loans. Our clients include mortgage companies, depository institutions, consumer finance companies, investment bankers, insurance companies, real estate agencies, home builders, and venture capital funds. Members of the Mortgage Banking/Consumer Finance Group and their telephone numbers and e-mail addresses are listed below:

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