UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

on Predatory Lending Practices in the Home-Equity Lending Market

September 7, 2000

San Francisco, California

I. INTRODUCTION

I am Peggy Twohig, Assistant Director for Financial Practices, of the Federal Trade Commission's Bureau of Consumer Protection.[1] I appreciate the opportunity to appear before you today to discuss the serious problem of abusive lending practices in the subprime lending industry, commonly known as "predatory lending." I will provide an overview of predatory lending practices that are occurring in the growing subprime industry and will discuss the Commission's recent activities in this area. I will also address specific areas about which the Board has sought public comment.[2] First, however, let me briefly speak about the Commission's role in enforcing laws that bear on these problems.

The Commission has wide-ranging responsibilities concerning nearly all segments of the economy, including jurisdiction over most non-bank lenders.[3] As part of its mandate to protect consumers, the Commission enforces the Federal Trade Commission Act ("FTC Act"), which broadly prohibits unfair or deceptive acts or practices in or affecting commerce.[4] The Commission also enforces a number of laws specifically governing lending practices, including the Truth in Lending Act ("TILA"),[5] which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions; the Home Ownership and Equity Protection Act ("HOEPA"),[6] which, as part of the TILA, provides special protections for consumers in certain non-purchase, high-cost loans secured by their homes; and the Equal Credit Opportunity Act ("ECOA"),[7] which prohibits discrimination against applicants for credit on the basis of age, race, sex, marital status, or other prohibited factors. In addition to our enforcement duties, the Commission also responds to many requests for information about credit issues and consumer credit laws from consumers, industry officials, state law enforcement agencies, and the media.[8]

II. THE GROWING PREDATORY LENDING PROBLEM

convened by the Board to examine the issue of predatory lending. The Commission also is educating consumers to help them avoid predatory lending practices.

In the area of loans sold with credit insurance (a practice known as "packing"), the Commission has a long enforcement history. The Commission settled a case in 1997 against The Money Tree, a Georgia-based consumer finance lender, and its president. The case involved, in part, allegations that the company required consumers to purchase credit-related insurance and other "extras" along with their loans, without disclosing to consumers the true cost of their credit. The settlement, among other things, requires The Money Tree to offer refunds of certain insurance premiums to customers whose loans were open at the time the settlement became final. It also mandates that the company approve borrowers' loan applications prior to any discussion with the borrower regarding credit insurance and requires that the company provide expanded disclosures.[(27)] In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans.[(28)] These cases, as well as earlier enforcement actions,[(29)] have provided an important foundation for the Commission in its investigations of potential packing practices in home equity lending. For example, most recently the Commission jointly settled a case, along with HUD, against Action Loan Company, Inc., of

IV. HOW THE BOARD MIGHT FURTHER ADDRESS PREDATORY LENDING PRACTICES

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

Based on our enforcement experience, the Commission recommends that the Board further restrict certain acts and practices under HOEPA and change the HOEPA triggers to expand HOEPA's coverage. These recommendations are interrelated. As discussed below, a very small percentage of subprime mortgage loans are currently covered by HOEPA and the Commission has observed problem lending practices in subprime loans where the rates or fees fall below the

consumers up front to long-term credit insurance precludes them from ever making a separate, fully-informed decision about insurance. And, it requires them to finance the premium, and the points on the premium for the life of the loan.

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

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

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

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

2. Mandatory Arbitration Agreements in HOEPA Loans

Recommendation: The Board Should Ban Mandatory Arbitration Agreements in HOEPA Loans.

Over the last few years, there has been a significant increase in the use of mandatory arbitration clauses in consumer credit contracts, in particular in the subprime industry. In many contexts, alternative dispute resolution, including arbitration, may benefit consumers. However, the Commission is troubled by the use of mandatory arbitration in the context of HOEPA loans. Mandatory arbitration clauses require, as a condition of receiving the loan, that the borrower agree to resolve any dispute arising out of the loan through mandatory arbitration rather than litigation. Consumers may be presented with an arbitration agreement for the first time at loan closing, with no prior notice of the requirement, and among a stack of other complicated loan documents. At that time, even if consumers have an opportunity to read the agreement, consumers are unlikely to inquire about it out of fear they will lose the loan.[(51)] Consumers are focused on getting a loan, and not on the unanticipated event of default. In addition, borrowers may not understand the significance of agreeing to arbitration and various associated terms, such as cost allocation.[(52)] In fact, arbitration may be more costly and inconvenient for the borrower and thus be a disincentive to pursuing legal rights.[(53)]

Moreover, there are significant procedural and substantive distinctions between arbitration proceedings and litigation that might have an adverse effect on a consumer's ability to pursue her remedies for HOEPA violations. By signing a mandatory arbitration agreement, borrowers waive their right to a jury trial and the ability to pursue claims through class action litigation. In arbitration, there is also limited factual discovery and remedies such as punitive damages and injunctive relief are typically unavailable.[54] A decision by an arbitrator in one case has no precedential value; indeed, there is no requirement that the decision-maker give any reasons for the decision. Thus, predatory lenders can shield their abusive practices from public scrutiny. Perhaps most importantly, mandatory arbiel4nng a m 5587.91(ak)-4(e a)-6(gr)3(e)-64m44(n)-10(1, bor)3(r)3()3

mortgage originations; while subprime loans accounted for 45 percent of the foreclosure petitions, the subprime share of mortgage originations was 21 percent in 1998.[62]

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

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

Additional guidance on the meaning of "pattern or practice" is needed. We believe that the appropriate "pattern or practice" standard should be the same as that under the Fair Housing Act ("FHA").[65]

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

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

Further, we have encountered extremely poor documentation by lenders regarding what factors were considered in determining ability to pay. While Regulation B, which implements the

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

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

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

2. The Points and Fees Trigger

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

The Commission has recommended to Congress that credit insurance premiums be included in the HOEPA points and fees trigger.(80) Similarly, the Commission recommends to the Board that lump-sum financed credit insurance premiums (and other loan extras) be included in HOEPA's fees- on1c an H6(n)-8(ua(an)-/CS1 c .332 Tw - .332 Td -28.01)[(f)-1(ees)te

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

facing the possibility of paying significant and unnecessary fees and, in some cases, losing their homes. Using its enforcement authority, the Commission continues to work to protect consumers from these abuses. The Commission supports the Board's efforts to expand HOEPA's protections

17. Id. at 45-46.

18. For example, the Department of Justice announced a settlement in September 1996 with Long Beach Mortgage Company addressing allegations, inter alia, that the company discriminated against the elderly, African Americans,

47. Id.

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

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

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

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

52. The Supreme Court has granted certiorari in a case in which the lower court declared a mandatory arbitration clause unenforceable "because it fails to provide the minimum guarantees required to ensure [the borrower's] ability to vindicate her statutory rights will not be undone by steep filing fees, steep arbitrators' fees, or other high costs of arbitration." Randolph v. Green Tree Fin., 178 F.3d 1149, 1158 (11th Cir. 1999), cert. granted, 68 U.S.L.W. 3629 (U.S. April 3, 2000) (No. 99-1235). See also Johnson v. Tele-Cash Inc., 82 F. Supp. 2d 264, 271 (D. Del. 1999) (order denying motion to compel arbitration citing an "inherent conflict" between compelling arbitration and the underlying purposes of TILA).

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

54. See Overview of Contractual Mandatory Binding Arbitration: Hearings Before the Senate Subcommittee on Administrative Oversight and the Courts of the Senate Judiciary Committee, 106th Cong. (2000) (statement of Patricia Sturdevant, Executive Director and General Counsel, National Association of Consumer Advocates).

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

62. Id. at 48-49.

63. See 15 U.S.C. § 1639(h).

64. See 12 C.F.R. § 226.32(e)(1).

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

66. 42 U.S.C.A. § 3614 (1994).

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

68. United States v. West Peachtree Tenth Corp., 437 F.2d 221, 227 (5()sa2(eT 71Tk21)t9upi.4a96 a4(r)-2(o)-4(v)82e4(i)-5(.16 5f.3()

77. Id. at 82.

78. Id. at 83.

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

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

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

82. See Complaint, Hargraves, supra note 20.

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