unlawful lending practices.

III. THE PROBLEM OF PREDATORY LENDING PRACTICES

The enormous growth of the subprime mortgage industry has enabled many consumers to obtain home loans who previously would have had much more limited access to the credit market. The Commission is aware, however, of predatory lending practices in the subprime mortgage market that affect the most vulnerable consumers. These predatory lending practices often involve lower-income and minority borrowers.[(19)] Elderly homeowners, in particular, are frequent targets of some subprime home equity lenders, because they often have substantial equity in their homes, yet have fixed or declining incomes.[(20)] In many cases, those living in lower-income and minority neighborhoods -- where traditional banking services continue to be in short supply -- tend to turn to subprime lenders regardless of whether they would qualify for less expensive loans. While subprime lenders may expand access to credit to individuals who otherwise would be shut out of the market, unethical lenders are in a position to take advantage of consumers in the weakest bargaining position.

It is critically important for consumers, especially those who live in lower-income communities, to have access to credit. However, this access should not be based on predatory lending practices that take advantage of borrowers. Predatory lending practices hide from consumers essential information they need to make decisions about their single greatest asset -- their home -- and the equity they have spent years building. Predatory lending practices are particularly devastating because these loans usually are sought at a time of great need, when borrowers are most susceptible to practices that can strip them of substantial sums of money and, ultimately, their homes.

Predatory lending in the subprime mortgage market covers a wide range of practices. While the practices are quite varied, there are common traits. They generally aim either to extract excessive fees and costs from the borrower or to obtain outright the equity in the borrower's home. This is often accomplished through a combination of aggressive marketing practices, high-pressure sales tactics, and loan terms, such as prepayment penalties, that inhibit a borrower's ability to go elsewhere for credit.

Among the most harmful of these practices is "equity-stripping."[(21)] This often begins with a loan that is based on equity in a property rather than on a borrower's ability to repay the loan -- a practice known as "asset-based lending." As a general rule, loans made to individuals who do not have the income to repay such loans usually are designed to fail; they frequently result in the lender acquiring the borrower's home equity. The borrower is likely to default, and then ultimately lose her home through foreclosure or by signing over the deed to the lender in lieu of foreclosure. Such a scheme is particularly damaging because these vulnerable borrowers often have no significant assets except the equity in their homes.[(22)]

Another practice of serious concern is "packing," which is the practice of adding credit insurance or other "extras" to increase the lender's profit on a loan.[(23)] Lenders often stand to make significant profits from credit insurance, and therefore have strong incentives to induce consumers to buy it as part of the loan.[(24)]

Typically, the insurance or other extra is included automatically as part of the loan package presented to the borrower at closing, and the premium is financed as part of the loan. The lender often fails to provide the borrower with prior notice about the insurance product [(25)] and then rushes the borrower through the closing. Sometimes, the lender represents that the insurance "comes with the loan," perhaps implying that it is free. Other times, the lender simply may include the insurance in the loan closing papers with no explanation. In such a case, the borrower may not understand that the insurance is included or exactly what extra costs this product adds to the loan. Even if the borrower understands and questions the inclusion of the insurance in the loan, subprime borrowers often are not in a position to negotiate loan terms. They often need to close the loan quickly, due to high debt, limited financial resources, and limited financing options. Therefore, they generally will not challenge the loan at closing if they believe or are told that any changes may cause a problem or delay in getting the loan.

Lenders are not prohibited by federal law from requiring the purchase of credit insurance with a loan, as long as they include the price of the premium in the finance charge and annual percentage rate. As described above, however, sometimes the lender effectively requires the purchase of credit insurance with the loan, but fails to include the premium in disclosures of the finance charge and annual percentage rate, as mandated under the Truth in Lending Act.[(26)] When the lender excludes the required insurance premium from consumer is then pressured to sign the papers as drafted -- especially when faced with the untenable prospect of leaving the improvements unfinished. In another reported scenario, the contractor may receive the loan proceeds directly or indirectly from the lender without providing any services to the homeowner, or without providing services commensurate with the amount of the payment. Nevertheless, the lender may still demand full payment from the homeowner.

Predatory practices by home improvement contractors and their affiliated lenders[(31)] are particularly problematic because the targeted homeowners often start out with no mortgage at all or a market-rate first mortgage that they later are induced to refinance. Because of the home improvement scheme, however, a homeowner with an affordable

Department of Justice ("DOJ") and the Department of Housing and Urban Development ("HUD"), with Delta Funding Corporation, a national subprime mortgage lender. The Commission alleged that Delta engaged in a pattern or practice of asset-based lending, and other practices, in violation of HOEPA. Specifically, Delta allegedly extended high-cost loans to borrowers based on the borrower's collateral rather than considering the borrower's current and expected income, current obligations, and employment status to determine whether the borrower was able to make the scheduled payments to repay the obligation. In these instances, prudent underwriting criteria, such as debt-to-income ratios, residual income, and repayment history, would have indicated that the borrower likely would have had difficulty repaying the loan. The settlement, which provided for nationwide injunctive relief, also resolved claims by DOJ for violations of the ECOA and by HUD for violations of the Real Estate Settlement Procedures Act.[(37)]

In July 1999, as part of "Operation Home Inequity," the Commission settled cases against seven subprime mortgage lenders for violations of HOEPA, TILA, and Section 5 of the FTC Act. The alleged HOEPA violations included failure to provide required disclosures, asset-based lending, and use of prohibited terms (such as balloon payments on loans with less than five-year terms, increased interest rates after default, and prohibited prepayment penalties). The settlement agreements provide for substantial remedies and protections for past and future borrowers, including consumer red their credit. The settlement, in part, requires 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.[(42)] In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans.[(43)]

HOEPA Violations

Under current law, if a lender fails to comply with HOEPA, it is liable under HOEPA for the sum of all finance charges and fees paid by the consumer, unless the lender demonstrates that the failure to comply is not material.(51) In the absence of a specific civil penalty provision under HOEPA, merely having to pay these amounts back, and any other damages, may be viewed as simply a cost of doing business. To provide a more effective deterrent, the Commission recommends amendment of HOEPA to give law enforcement agencies the power to impose civil penalties for HOEPA violations. Inclusion of a specific civil penalty provision has established a compliance incentive and strong enforcement tool in other credit statutes, like the ECOA, and would also be beneficial in HOEPA.

D. Prohibit 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. 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. In the Commission's enforcement experience, 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.(52) 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.(53) In fact, arbitration may be more costly and inconvenient for the borrower and thus be a disincentive to pursuing legal rights.(54)

Moreover, there are significant procedural and substantive distinctions between arbitration proceedings and litigation. 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 dispute resolution, it does not support mandatory arbitration agreements imposed in high cost loans where consumers and their homes are most vulnerable.

VI. CONCLUSION

The Commission recognizes that predatory lending practices are a serious national problem. Due to sharp growth in the subprime mortgage industry, it appears that predatory lending practices are also on the rise. As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers are 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. In addition, the Commission supports the expansion of HOEPA protections to enhance consumer protection in this area.

ENDNOTES

1. The views expressed in this statement represent the views of the Commission. Responses to any questions you have are my own, however, and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

2. See 15 U.S.C. § 45(a).

3. See 15 U.S.C. § 1601 et seq.

4. See 15 U.S.C. § 1639.

5. See 15 U.S.C. § 1691.

6. See, e.g., 15 U.S.C. § 45(a); 15 U.S.C. § 1607.

7. A number of the remarks in this testimony are based on the Commission's administrative and enforcement experience in the area of home equity lending, including consultations with individual consumers, consumer groups, and industry.

8. Credit to "prime" borrowers, borrowers generally with good credit histories, is referred to as "A" credit. "A" mortgage loans are those that conform to the secondary market standards for purchase by the government-sponsored entities, Fannie Mae and Freddie Mac (although Fannie Mae and Freddie Mac recently began purchasing "A minus" subprime loans).

9. See *Top 25 B & C Lenders in 1999,* Inside B & C Lending, Feb. 14, 2000, at 2.

10. See *Top 25 B & C Lenders in 1997*, Inside B & C Lending, Feb. 16, 1998, at 2.

11. See Kathleen Day, *'Subprime' Mortgage Practices by Banks and Finance Firms Draw Federal, State Scrutiny*, Wash. Post, February 6, 2000, at H1, 6.

12. See, e.g., Norma Paz Garcia, Dirty Deeds: Abuses and Fraudulent Practices in Los Angeles' Home Equity Market, Consumers Union, October 1995, at 25; Mike Hudson, *Stealing Home*, Wash. Monthly, June 1992, at 23, 26. Congress preempted many state usury laws on first lien mortgages with passage of

[redacted]utions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7.

[redacted] Lending, Jan. 17, 2000, at 3. As part of Wall Street's expansion in this area, firms are [redacted]aches to securitization that further shield investors from risks associated with [redacted]ed securities. See *New Subprime ABS Structure Helps Subordinate Tranches*, Inside B [redacted]7, 2000, at 9.

[redacted] and Craig Focardi, *The Stampede*, Mortgage Banking, Oct. 1997, at 29. Growth in [redacted]s also has been aided somewhat by the increasing availability of warehouse lines of [redacted](e)L5(o)-TT0

Credit Life Insurance Often Overpriced, Wash. Post, Feb. 9, 1997, at H2.

25. This scenario is known as "bait and switch," because the closing papers differ from the loan package previously discussed with the borrower.

26. See 12 C.F.R. § 226.4(b)(7). Typically, lenders can easily induce borrowers to sign a line in the thick package of complex loan closing papers indicating that the purchase of insurance is voluntary when, in fact, they have little choice if they want to close the loan at that time. Whether credit insurance is in fact required or optional is a factual question. See Federal Reserve Board, Official Staff Commentary to Regulation Z, § 226.4(d)(5).

27. Lenders have incentives to omit required credit insurance premiums from the disclosures of the annual percentage rate and finance charge. First, the appearance of a lower rate may induce the borrower to follow through on the transaction. Se-4(g)8(-16(n)3(h))-1tion. Se--(S)4(e)-12(--(S)4(e)-12(--0(a)-8(nc)-8(e)-8(ir

Third, under current federal law, state usury caps do not apply to first liens. See 12 U.S.C. § 1735f-7.

49. The National Consumer Law Center recently recited the experience of one borrower who paid $2,200 for a credit life insurance policy sold to her in connection with a home-