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I am a professor at the University of Alabama School of Law. In the School of Law I teach courses on contracts, payment systems and business organizations. I also teach a seminar on consumer protection. I have published and lectured in a number of areas of lender liability, consumer finance, sub-prime lending, secured transactions, payment systems and banking law. I served as the reporter for the revision of Articles 3 and 4 of the Uniform Commercial Code in Alabama. In 1996 I served on Governor Fob James' Mini-Code Task Force and have been involved in drafting revisions to Alabama's consumer finance laws. In national and state continuing legal education programs I have spoken on such subjects as the Alabama Mini-Code, federal Truth in Lending, the sub-prime credit market, lender liability based on marketing practices, credit insurance and the practice of flipping.

I have served as a consulting and testifying expert for lenders, credit sellers and borrowers in consumer finance litigation. I have worked for public utilities, retailers and financial institutions in reviewing and revising their deposit agreements, installment sales contracts and extended service agreements. I have conducted several compliance seminars for the Alabama Bankers Association. I serve on the Board of Advisors for a national consumer finance publication.

In the course of my work I have studied pleadings, exhibits, loan files, operating manuals, training manuals, training videos, depositions and other documents used in consumer loans and installment sales. I have studied materials in cases involving over 30 consumer finance companies and other mortgage lenders, many of which operate in the sub-prime market. I have written and lectured extensively on the subjects of sub-prime credit markets, flipping and abuse in the sale of credit insurance products. Loan flipping and abusive credit insurance sales practices are particularly common in sub-prime credit markets.

A. *Why Finance Companies "Flip" (Renew) Loans*--Lawyers representing consumer debtors with finance company loans are often surprised to find that new loans are made and existing loans refinanced several times each year. Although we live in a world of "easy credit terms" and are surrounded by examples of the improvident use of credit, consumer finance company lending practices often surprise even the most hardened advocates of E-Z credit. These lending practices are particularly noteworthy when one considers that many of their borrowers started out as credit risks, having come to the finance company after being bounced by a bank or other depositary institution. In other words, these are people who are in the sub-prime credit market.

Finance companies frequently will contact existing customers, offering a few hundred additional dollars. Some training manuals urge the employees to make solicitations every time the customer comes in to make a payment. If the debtor bites at the apple, the existing loan will be "paid off" and a new loan will start, but with a great deal of the balance being "old money." That is, after rebates (most likely credits on the account) for unearned interest and insurance premiums, the new amount financed will be comprised of the unpaid principal balance from the old loan, the few hundred additional dollars given to the debtor in the new loan, and new credit insurance products (credit life, credit property, nonfiling, credit disability, etc.) that were sold and financed by the creditor. Where a mortgage loan is involved, the debtor's equity declines at an alarming rate, while the debt load mounts.

These frequent loan renewals are rabidly marketed through telephone and mail solicitations. Most of us would stop dealing with a bank or other lender that solicited us for new money nearly every time we made a car payment. However, finance companies are not timid in offering new money to debtors. The mechanics and incentives in establishing the flipping system are described below. The system is a product of several forces at work, including the compensation system for finance company employees, state law which favors creditors in the amounts rebated for unearned interest and insurance premiums, very slick (and at times deceptive) marketing practices, and some borrowers who have no credit discipline. The problems are magnified when a borrower is poorly educated and even illiterate. Many finance company borrowers come to the table with little formal education.

All of us are familiar with the advantages, disadvantages, and the reality of refinancing home mortgages, and even car loans. However, most people are surprised by the system that has been implemented by the consumer finance company lending industry, where debtors often send in regular payments, but make little progress against loan principal. The system resembles the nightmare where one is running hard but making little progress against the tiger that is about to pounce. Finance company loan renewals establish a pattern which makes people indentured servants, working hard but never making progress against debts.

The flipping system also magnifies the harm done in the sale of consumer credit insurance products that are so prevalent in finance company lending. Consumer credit insurance, which is generally a bad bargain by any measure, is especially costly where the rebates for unearned insurance premiums are credited under the Rule of 78ths. The use of the Rule of 78ths works to the creditor's advantage when loans are renewed early in the term.

B. ***Employee Incentives and Marketing Strategies in Loan Renewals***--Commercial banks have never been known for paying overly generous salaries to consumer lending officers who are in the trenches. Finance companies pay even less, and sometimes a great deal less. Additional financial incentives are sometimes offered in a bonus point system that is based on loan volume, with point subtractions for loans made that are late or delinquent. The bonus system may be based on individual branch performance.

In some companies, loan volume is double-counted. That is, monthly loan volume is measured without regard to whether the most recent loan includes a large block that is merely a renewal of an earlier loan. In depositions, some employees have reported that they renew loans in order to increase their loan volume. This is close to the system of "churning" accounts in the securities industry. Some employees have stated that as the end of the month approaches, the pressure to turn loan volume increases and the "quality" of new loans diminishes.

Deposition testimony also includes frank admissions that some loans are renewed in order to remedy the problem of loan delinquency. Thus, a loan looks current for the bonus system, even though the borrower has been having trouble making payments before the loan renewal. Not only testimony, but also training films include passages encouraging renewals for existing delinquent accounts, particularly if new collateral or a co-signer can be added to the loan. The same training video offers advice to employees, encouraging them to use loan renewals to cure delinquent accounts. The pressure to sell credit insurance products is also magnified in such a system because the insurance premiums are financed, thus raising loan volume.

Training manuals and video training tapes also include passages encouraging employees to use expressions such as "line of credit" in soliciting renewals. However, a complete refinancing of an existing loan and a restarting of the clock on the old money is hardly what you get in a true line of credit. A true line of credit--even a home equity loan with an established line--allows for draws without much in the way of transactions costs. However, it is the operation of the Rule of 78ths, new prepaid finance charges, and the other transactions cost that are so expensive for borrowers whose loans are flipped by finance companies.

Other passages in lending manuals include directives that "all efforts are devoted toward motivating individuals to make contact with our office." One manual states that "the bulk of our business is repeat business," and that "renewals are SOLD, NOT BOUGHT." Another noteworthy passage is one that reminds lenders that "the alert employee will map out an effective game plan," and "sell eligible applicants to his maximum worth or high credit." However, a study of loan documents and admissions by employees suggests that high credit limits are sometimes exceeded in order to make a delinquent account look current. As is often the case in commercial and corporate loans, some of the loans become problems because the lender ignores internal directives on approval ratios.

In fairness to lenders, it is a fact of life that financial institutions are in the business of selling money and sales volume is critical in any business. In many ways, selling money is no different than selling shirts. However, the lender-borrower relationship has never been viewed as a place where all bets are off relating to disclosures, sales practices, and complications after the sale is made. Thus, the exceptionally aggressive lending practices of finance companies will not be viewed simply as the sale of the next shirt. When it comes to consumer lending, the dynamic changes, and people expect more than the law of the jungle to prevail.

C. *Add-On Interest and the Rule of 78ths*--The most common methods utilized in the calculation of interest in consumer finance loans are the add-on and actuarial methods. Actuarial Interest is calculated by applying a periodic interest rate to the outstanding balance of the loan principal for each period for the term of the loan. This is the method that is used to amortize real estate mortgage loans. In order to calculate actuarial interest and payments for installment transactions, one generally must resort to formulas or tables which are widely available.

Computing interest by the add-on method is easy and is the method most commonly utilized by consumer finance companies in Alabama. Add-on interest is a method for calculating precomputed interest, where the consumer agrees to pay the total of payments, which includes both principal and the full amount of precomputed interest. Thus, if a consumer agreed to borrow $1,000 at twenty percent interest, to be paid over a twenty-four month period, the calculation for payments would be as follows:

(1) $1,000 x .20 x 2 yrs. = $400 interest

(2) $1,000 principal $400 interest = $1,400/24 mos. = $58.33/mo.

With the add-on system, interest is calculated as though the borrower had full use of the principal for the full period of the loan, but because some principal is being repaid with each installment, the debtor pays a fixed amount of interest on a diminishing principal. Thus, the add-on method understates the true simple interest rate and the real cost of the loan.

It is the actuarial method--not the add-on method--that most closely approximates and will in some cases match (if there are no prepaid finance charges or other complications) the annual percentage rate (APR) that most of us know under the mandates of TILA. Because TILA requires a common method for reporting the true interest rate on loans based on an annual percentage rate (APR), the add-on rates dramatically understate the effective "simple" or actuarial rate on a loan.

Because interest on add-on loans is precomputed, the lender must have some system in place to rebate or credit the account for unearned interest in the event the loan is paid off early or refinanced. The most common method for rebating unearned interest charges (and unearned credit insurance premiums) is under the Rule of 78ths, or the Sum of the Digits Method. The Alabama Code follows a federal mandate requiring the use of some method other than the Rule of 78ths for loans with terms longer than sixty-one months. However, because most consumer finance companies make loans with maturities of five years or less, the Rule of 78ths is widely used to rebate unearned interest and unearned insurance premiums in Alabama.

Although the Rule of 78ths is easy to use, it carries a disadvantage for the borrower. The method used by the Rule of 78ths weighs the early months too heavily and the latter months too lightly in calculating interest earned by the creditor. Thus, if a loan is prepaid (or started over, in the case of a refinancing), the creditor would be credited with more interest earned (and not rebated) than if the interest calculation were made on the actuarial method.

It is readily established mathematically and accepted beyond dispute that the higher the APR for a given indebtedness, the greater is the error in the Rule of 78ths in calculating interest earned by the creditor at certain points in the loan, when compared to the actuarial method. Further, with many consumer loans, the point at which there will be the greatest divergence (error) between the Rule of 78ths and the actuarial method is roughly one-third of the way through the loan term. At any point in the loan, the difference between an actuarial rebate and a Rule of 78ths rebate on any given precomputed loan will vary with loan size, the interest rate on the loan, the loan term, and the time of prepayment.

Observations on Flipping--With regard to both car loans and home mortgages, most of the early payments are largely interest and little is principal. It is only later in the loan that a borrower starts to make serious progress against the principal. Conversely, most of the interest income for lenders is made early in the loan. In depositions, finance company employees and executives readily admit that the companies make more money on "new" loans and that old loans are not profitable. This is no great revelation and holds true whether interest is calculated on an actuarial basis or in a precomputed, add-on arrangement. There is no real "fault" or devious practice here. It is merely mathematics at work.

Many borrowers can grasp the ramifications of restarting an old loan (such as home mortgage refinancing) and know the costs and benefits of doing so. These borrowers can read and write. They also do not receive solicitations for "new money" every time they make a payment or receive a monthly statement. Additionally, they are not met with pitches for credit insurance products at every turn.

The same cannot be said for consumer finance company borrowers, many of whom do not bring much formal education to the table. Among the many consumer finance company loan documents and depositions I have studied over the past several years, only a few borrowers were college graduates and many were people who did not finish high school. Others could not read or write. The data on educational levels, dropout rates and illiteracy among some states makes none of this a surprise. When some of these borrowers are matched against very polished, rehearsed, and high pressure promotional practices, with use of terms such as "line of credit" and representations regarding the value (and even the necessity) of credit insurance products, it is no contest in the negotiation process.

Many finance companies include advertisements for more money in each monthly statement they send to the borrower. Seasonal pitches are common, offering a few hundred additional dollars for Christmas money or a summer vacation. Other pitches included on the monthly statement will congratulate the borrower for making a few timely payments, and offer several hundred more dollars if the debtor will visit the office. However, rather than making a new and second small loan, which is the impression created by the advertising, the creditor will restart the clock on the old money in a consolidation.

When pressed on why the finance company could not make a second, small loan, particularly when the loan request was triggered by the lender's solicitation, the standard answer is "it's company policy." No further explanation is offered.

Accounting firms hired to work in consumer finance litigation have developed excellent models to compare the costs to the borrower of the refinancing (flipping) system that is in place and the costs to the borrower if payments on the old loan were allowed to continue, while a new, second small loan was made. The differences in costs are dramatic in most cases and have not been refuted. Even if the APR on the renewal loan is lower than the APR on the old loan, the actual out of pocket costs for the new refinanced loan may be greater than those that would be paid if a second small loan were made available, while payments on the old loan were continued.

The extra costs to the borrower of the system in place are in part the result of the operation of the Rule of 78ths (as it is applied to interest and unearned credit insurance premiums). In order to induce the borrower to take on more debt, some finance companies extend the loan maturity to a new term. Thus, what was once an initial loan with a twenty-four-or thirty-month maturity will often turn into a new loan at forty-eight or even sixty months. Although the debtor may take this arrangement because the monthly payment stays the same, the mountain of interest builds, particularly in a precomputed, add-on loan scenario. And because the creditor will most likely make a new pitch for a loan renewal (and a few hundred more dollars) several months down the road, the principal amount remains largely undiminished or grows.

To see an illiterate borrower who has had a loan "renewed" five, six, or even eight times in two years, and who is sometimes sold as many as three or four credit insurance products (credit life, credit property, credit disability, "involuntary unemployment insurance," and nonfiling may appear individually or all together in one loan), is enough to make most traditional lenders shake their heads. And in some cases, because of the dismal credit record of the borrower before the first loan was made, the expression "throwing good money after bad" appears to be unknown in selected consumer finance company branches, where loan volume dictates incentives and policies.

The frequency of loan renewals in consumer finance company lending is not merely the result of borrowers who voluntarily go to the well too many times. This practice is designed and encouraged by finance companies, without question. The Committee has been provided with exhibits and excerpts from an industry training tape which describe borrowers as "targets" for loan renewal and the packing of insurance products.

E. ***Packing of Insurance Products***--On the matter of the packing of insurance products, one large national company promotes a system which essentially requires the customer to refuse credit insurance and other add-on products, rather than providing a clear explanation and meaningful choice for the customer. Factors considered by the FTC and other regulators (as well as in case law) examining coerced credit insurance sales include the creditor's penetration rate, the profits and financial incentives in making the sale, and the practice of including insurance in loan payment quotes or on loan documents provided to the consumer prior to offering a choice on credit insurance products.

Material provided to the Committee includes employee testimonials relating to credit insurance. One quote reads, "They especially like the insurance when they realize that it is already included with the payment that they have already been quoted." Another entry in that exhibit under a section on "Handling Concerns" reads "Don't 'shoot yourself in the foot' by addressing objections, concerns or questions you 'think' the customer 'might' have." In all the marketing literature I have reviewed, this is one of the most callous statements I have encountered and is contrary to the literature being sent to customers which suggests that the company cares for the customer.

In one document provided to consumers, the company promises "to recommend only those products and services that fit your needs" and "to explain our loan documents and financial products in non-technical terms that YOU can understand." At the same time, employees are being told not to address concerns you think the customer might have. The depositions of former employees and other documents show that it is a common practice among lenders in the sub-prime market to include credit insurance products in the quotes and documents, and to remove those products from the final deal only when the customer objects or has reached a ceiling on debt load or loan-to-value indicators.

F. ***The Sub-Prime Credit Market--***Although there is no universally accepted industry standard for credit grades, most lenders use categories such as "A," "A-," "B," "C," "D" and "F." Consumers with "A" ratings generally have no late mortgage payments and no credit card payments over 30 days delinquent in the last year. At the other end, consumers with "F" ratings are currently in bankruptcy or foreclosure. Although the term "sub-prime" lending means different things to different people, most lenders use the term when referring to "B," "C" and "D" credit. Consumers with "D" credit ratings are generally described as experiencing problems that are severe.

In recent years there has been a considerable boom in sub-prime lending activity involving automobiles, home mortgages and even credit cards. In the auto industry there were approximately 25 sub-prime lenders in 1991. Today there are more than 150. Mortgage lenders are also vying to make loans to people with shaky credit and sub-prime mortgage loans are being bundled and securitized. According to one industry publication, the securitization of sub-prime mortgages increased by 50% from 1996-1997.

And even in the sale of consumer products such as satellite television reception equipment, private label credit card issuers have established separate programs to identify and market credit cards to customers who were previously turned down. In some cases the credit card issuers created the programs in response to dealer complaints that too many customers were refused credit in an initial application. As one would expect, the risks inherent in sub-prime lending are reflected in higher interest rates. Sub-prime borrowers are described in industry material as borrowers who often do not shop around or haggle over terms. Sub-prime borrowers may be relegated to finding credit at any price.

Lending to sub-prime borrowers was once considered the province of small loan companies, finance companies and "fringe banks." However, the sub-prime market is now also served by large mortgage companies, national banks and credit subsidiaries of automobile manufacturers. Several of the largest national banks provide financing for auto purchasers with impaired credit records, buying used-car loans at a discount from face value. Purchasing the contracts at a discount is also a common practice in sub-prime mortgage lending and even in the acquisition of credit card paper.

Not all sub-prime lenders engage in predatory lending practices and responsible lenders should not be criticized for setting their interest rates at a level that reflects the risk represented by the borrower's credit history. However, the practice of loan flipping and the packing of credit insurance products are common in the sub-prime market, particularly to those people in the "D" range. Some employees have testified in depositions that the more unsophisticated and desperate the borrower, the more likely the company would flip and pack loans. Employees have also testified that in offers for debt consolidation loans, borrowers who were the most desperate were offered additional cash in order to hook the loan. A common outcome among the most predatory lenders in the sub-prime market is that those borrowers who can least afford credit insurance products receive the strongest pitch for the purchase of those products. Those borrowers also are targeted for frequent loan renewals with the lender dangling a few additional dollars as the bait for the loan flip.

Through additional testimony and the other industry material provided, the Committee can get a feel for the predatory lending practices that exist in <u>some parts</u> of the sub-prime market. I will be happy to answer any questions you might have or provide additional material as you study the sub-prime market.