PREPARED STATEMENT OF THE
FEDERAL TRADE COMMISSION
before the
SENATE SPECIAL COMMITTEE ON AGING
on
Home Equity Lending Abuses
in the Subprime Mortgage Industry
March 16, 1998

I. INTRODUCTION

Mr. Chairman and members of the Committee: I am Jodie Bernstein, Director of the Bureau of Consumer Protection of the Federal Trade Commission. I appreciate the opportunity to appear before you today on behalf of the Commission to discuss the serious problem of abusive lending practices in the subprime mortgage lending industry. These comments do not address those lenders within the subprime mortgage industry who play by the rules and provide an important source of capital to various segments of borrowers. I will discuss the recent growth of this industry, abusive lending practices that reportedly are occurring in the industry, and the Commission's recent activities in this area. 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. 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. (1) The Commission also enforces a number of laws specifically governing lending practices, including the Truth in Lending Act ("TILA") which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions, and the Equal Credit Opportunity Act ("ECOA"), which prohibits discrimination against applicants for credit on the basis of age, race, sex, or other prohibited factors. The Commission has jurisdiction over most non-bank lenders. In addition to our enforcement duties, the Commission also satisfies many requests for information about credit issues and consumer credit laws from consumers, industry, state law enforcement agencies, and the media.

We increasingly are hearing reports of problems in the home equity loan business, and the Commission is working in a number of ways to address them. Commission strategies include law enforcement activities, often coordinated with other law enforcement officials, and consumer education. It is crucial that as many consumers as possible have access to capital, but, at the same time, this access must not be hindered by deceptive or other unlawful lending practices.

II. THE SUBPRIME MORTGAGE INDUSTRY

Subprime lending refers to the extension of credit to higher-risk borrowers, a practice also commonly referred to as "B/C" or "nonconforming" credit. Loans to subprime borrowers serve communities that may have been underserved by other lenders in the past. In recent years, subprime mortgage lending has grown dramatically, with over 90% of all subprime mortgage loans made in or after 1993. By the end of 1996, the total value of outstanding subprime mortgage loans exceeded $350 billion. In 1997 alone, subprime lenders originated over $125 billion in home equity loans. Subprime loans have become a significant and growing part of the home equity market. Subprime originations constituted 11.5% of the total home equity lending market in 1996; by the first half of 1997, they had grown to 15.5% of this market. At the same time, the composition of companies involved in the subprime market is evolving. One of the dramatic changes in this market has been the growth in subprime mortgage lending by large corporations that operate nationwide.

The subprime mortgage market has flourished because such lending has been profitable, demand from borrowers has increased, and secondary market opportunities are growing. Lenders typically price subprime loans to consumers at rates of interest and fees higher than conventional loans. Higher rates and points can be appropriate where greater credit risks are involved, as is often the case with subprime loans. Critics assert, however, that the interest rates and fees charged by some subprime lenders are excessive, and much higher than necessary to cover increased risks, particularly since these loans are secured by the value of a home. Some attribute lenders' high rates on first mortgages in part to federal deregulation of certain state interest rate ceilings in 1980.

The relatively high profit margins in the subprime mortgage industry have fueled demand in the secondary market from investors seeking higher-yielding securitized assets, especially in an environment of generally low interest rates. In 1996, the subprime mortgage sector issued over $38 billion in securities, the largest increase in securitizations for any lending industry sector in that year. The secondary market's expansion has, in turn, helped to sustain growth in the industry by enabling lenders to raise funds on the open market to expand their subprime lending activities. Freddie Mac, one of the primary government-sponsored enterprises involved in the purchase of mortgages, recently announced plans to enter the secondary market in subprime loans by purchasing significant numbers of "A minus" subprime mortgages by 1998 and the higher-risk "B and C" loans by 1999.

The market for subprime loans is expected to continue growing. Credit card delinquencies are rising and personal bankruptcies are at record levels, which negatively affect borrowers' credit histories, pushing more consumers into higher risk categories. Meanwhile, consumer spending continues to be strong. Together, these factors increase the market for subprime loans. In addition, more borrowers generally may be seeking home equity loans due to the change in the tax code limiting allowable interest deductions to those on a first mortgage.

III. THE PROBLEM OF ABUSIVE 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. Questions increasingly are being raised, however, about certain lending practices, often referred to as predatory lending, that reportedly are occurring in the subprime mortgage market and about their effect on the most vulnerable consumers. These abusive lending practices often involve lower-income and minority borrowers. Elderly homeowners, in particular, are frequent targets of some subprime home equity lenders, because they often have substantial equity in their homes, yet have reduced incomes. 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 their credit history. While subprime lenders point out that they are expanding access to credit to individuals who otherwise would be shut out of the market and consumers whose credit histories make them too risky for conventional loans, such lenders are in a position to take advantage of the consumers in the weakest bargaining position.

It is critically important for all consumers, especially those who live in lower-income communities, to have access to capital. Access that is based on deceptive mortgage lending, however, is false access. Deceptive 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. Deceptive 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.

Reported abusive lending practices in the subprime mortgage market cover a wide range. We will mention here a few highlighted in recent reports. While the reported 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.

Among the most harmful of these reported practices is "equity-stripping." 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.

Another practice of serious concern is "packing," the practice of adding credit insurance or other "extras" to increase the lender's profit on a loan. 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. At the same time, observers have questioned the value to consumers who obtain the insurance in conjunction with their loans, given the high premium cost and comparatively low claims rate.

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 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 are not in a position to negotiate loan terms. They often need to close the loan quickly, due to high debt and limited financial resources. 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 permitted to require 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. In some instances, however, 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. When the lender excludes the required insurance premium from the borrower's disclosures, the cost of credit may appear significantly lower than the true cost of the credit. As a result, the consumer cannot make an informed decision about the cost of the loan.

Another practice that has recently received attention is some subprime mortgage lenders engaging in "flipping," the practice of inducing a consumer to refinance a loan, repeatedly, often within a short time frame, charging high points and fees each time. This causes the borrower's debt to steadily increase. Although a consumer's debt may be on the rise anyway if she borrows money in connection with the refinancing, in some cases, the amount of cash received may be smaller than the additional costs and fees charged for the refinancing. While a consumer's option to refinance is an integral part of a functioning mortgage market, subprime lenders engaged in "flipping" may misrepresent to the borrower the terms and ultimate benefits of the transaction, or induce the borrower to take on more debt than she can handle. By taking advantage of its unequal relationship with a particularly vulnerable consumer, an unscrupulous lender can compromise a borrower's ability to make an informed choice about financing options.

Another reported abuse in the subprime mortgage industry is the targeting of consumers by home improvement contractors who are effectively working as agents of lenders. One alleged abuse involves contractors who may obtain the borrower's consent for a loan with high rates and fees through the use of deception or coercion. For example, the contractor and homeowner may agree on a price for certain work. The contractor, after beginning work on the home, may then present the homeowner with loan documents from the lender indicating higher rates and fees than those that were agreed upon. The 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.

Abusive practices by home improvement contractors and their affiliated lenders 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 mortgage or no mortgage, and who is seeking aluminum siding or new windows, may suddenly find herself with a high-cost home equity loan.

After a loan is closed, consumers may be subject to loan servicing practices that extract monies not owed under the loan terms or that inhibit refinancing options with another lender. A lender may provide inaccurate monthly-payment demands, adding fees and charges that are not owed. Because of the complexities of loan terms, it is difficult for the borrower to know whether the lender's payment demands are accurate. A lender also may fail to provide full or accurate pay-off information. Consequently, the borrower becomes tied to a lender without a means of escape.

Some of these reported abusive lending practices may be illegal under various federal or state laws, including a number of laws enforced by the Commission. Depending on the particular facts, some of the practices may constitute deceptive or unfair practices in violation of Section 5 of the FTC Act or a comparable state statute. In addition, these practices may constitute violations of the TILA, as well as violations of the protections for high-rate and high-fee loans under the Home Ownership and Equity Protection Act ("HOEPA"), an amendment to the TILA that became effective in October 1995. If a lender charges similarly-qualified borrowers higher prices based on age, race, and/or sex, such a practice would constitute pricing discrimination in violation of the ECOA. Additionally, if a lender targets borrowers for abusive practices based on age, race and/or sex, such targeting, depending on the facts, also could violate the ECOA.

IV. THE COMMISSION'S RESPONSE

Given this background, the Commission is taking a variety of steps to address reported abuses in the subprime home equity market. First, the Commission is increasing its enforcement activities to halt subprime lenders who are engaged in abusive lending practices. At the same time, the Commission has been working with states to increase and coordinate enforcement efforts. The Commission also is educating consumers in order to help them avoid potential home equity lending abuses.

In January 1998, the Commission filed a complaint in the United States District Court for the District of Columbia against Capital City Mortgage Corporation, a Washington, DC-area mortgage lender, and its owner, alleging numerous violations of a number of federal laws resulting in serious injury to borrowers, including the loss of their homes. The company allegedly made home equity loans to minority, elderly, and low-income borrowers at interest rates as high as 20-24 percent. Borrowers often faced foreclosure on their properties, after which the company would buy the properties at auction for prices much lower than the appraised value of the properties.

The Commission's complaint alleges that the defendants engaged in deceptive and unfair practices against borrowers at the beginning, during, and at the end of the lending relationship, in violation of Section 5 of the FTC Act. The complaint alleges that the defendants deceived borrowers about various loan terms; for example, by making representations that a loan was an amortizing loan that would be paid off by making payments each month. In fact, the loan was an interest-only balloon loan with the entire loan principal amount due after all of the monthly payments were made. The complaint also alleges that the defendants deceived borrowers during the loan period with phony charges of inflated monthly payment amounts, overdue balances, arrears, service fees, and advances. In addition, the complaint alleges that the defendants deceived borrowers regarding amounts owed to pay off the loans. Further, the complaint alleges that the defendants violated the FTC Act by: withholding some loan proceeds while requiring a borrower to make monthly payments for the entire loan amount; foreclosing on borrowers who were in compliance with their loan terms; and failing to release the company's liens on title to borrowers' homes even after the loans were paid off. In addition to the Commission's allegations of violations of the FTC Act, the Commission also charged the defendants with violations of the TILA, the Fair Debt Collection Practices Act, and the ECOA.

In the area of loans sold with credit insurance, the Commission has a long enforcement history. Most recently, the Commission settled a case last year 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, 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. In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans. The Commission is using the knowledge it has developed through the Money Tree and Tower Loan cases, as well as earlier enforcement actions, to investigate potential insurance problems in home equity lending.

In addition to its casework and ongoing investigations, the Commission is sharing its knowledge and experience with other enforcement agencies and with consumers. Last year, the Bureau of Consumer Protection's Division of Credit Practices held joint law enforcement sessions on home equity lending abuses with state regulators and law enforcers in six cities around the country. These training sessions were conducted to assist states in exercising their relatively new enforcement authority under HOEPA and to share information about recent trends.

In the area of consumer education, the Commission has developed a brochure focusing on consumer rights under HOEPA, for high-rate, high-fee loans covered by that law. In conjunction with the filing of the Capital City complaint, the Commission began distributing a Consumer Alert, advising consumers on how to avoid home equity scams. The Commission today is releasing a new consumer education brochure with additional advice for consumers on home equity abuses.

V. CONCLUSION

The Commission recognizes that abuses in the home equity lending market are a serious national problem. Due to sharp growth in the subprime mortgage industry, it appears that the abuses by subprime lenders are on the rise. As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers -- including the elderly -- 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.