Comments of the National Consumer Law Center

Office of the Assistant Secretary for Housing: HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal National Mortgage Corporation (Freddie Mac) Proposed Rule

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The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eleven practice treatises and annual supplements on consumer credit laws, including Truth In Lending, (4th ed. 1999) and Cost of Credit (1995 & Supp.), and Repossessions and Foreclosures (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers.

NCLC became aware of predatory mortgage lending in the latter part of the 1980's, when the problem began to surface in earnest. Since that time, NCLC has written extensively on the topic, advised legal services and private attorneys about litigation strategies to defend against such loans, and provided oral and written testimony before Congress that led to the enactment of the Home Ownership and Equity Protection Act. In addition, representatives of NCLC have actively participated with HUD in discussions about predatory lending. NCLC is a member of the Task Force on this issue recently created by HUD.

NCLC launched a Sustainable Homeownership Initiative several years ago. As a part of that initiative, NCLC works closely with Freddie Mac, Fannie Mae, the Neighborhood Reinvestment Corporation, banks, and housing counselors to sustain homeownership over the long haul through a variety of activities, including training, coalition building, and directing specific intervention projects in Boston and Chicago.

I. Introduction

We greatly appreciate the attention that HUD has given to predatory mortgage lending, and especially for seeking input on ways in which Fannie Mae and Freddie Mac can affect or reduce this type of lending when they purchase mortgages on the secondary market.

Some history about the rise and growth of predatory mortgage lending is critical. It underscores the importance of HUD's willingness to address this problem on several fronts. The one at issue in the proposed regulations involves the funding of predatory lenders, which if reduced, will help to pull out the root and dry up this abuse.

II. Rise and Growth of Predatory Mortgage Lending

A. The Causes

Though home equity lending abuses are not new, the 1980s and 1990s witnessed a major upswing. In the past fifteen years, "equity-skimming," or "equity-theft" has become a major threat to many homeowners -- particularly to the elderly. A number of marketplace and policy factors converged to contribute to this problem:

Deregulation: In tandem with the appreciation of real estate values, the deregulation of consumer lending in the 1980s left the door wide open for unscrupulous operators. Federal laws passed in 1980 and 1983 preempted both state usury ceilings on mortgage lending secured by first liens (whether purchase money or not),[1] as well as state limitations on risky "creative financing" options, such as negatively amortizing loans.[2]

Federal deregulation also set the stage for many states to remove rate caps and other limitations on other home lending -- including second mortgage lending. Whatever the overall merits of economic deregulation, it undeniably unleashed the greedy instincts of unscrupulous operators all over the country. In keeping with the conventional wisdom of free market theory, "the market" was supposed to take care of any problems. Unfortunately, there are market failures, and predatory home equity lending provides a good example of one. Even though interest rates have declined, these lenders have not lowered their rates, and for a number of reasons, competition and market forces do not operate according to theory on these loans.

The rise in real estate values: The inflation in real estate values in the 1980s created much new wealth -- the equity pool. While real estate values have remained stable in the 1990's (or declined in a few areas of the country), the equity acquired from the brisk rise in values in the 1980s continues to make aging homeowners a prime target of predatory lenders.

The appreciated value of the property led to "asset-based lending" -- that is, loans made based on the value of the security, rather than on the borrower's ability to repay. This has been common in commercial lending, but is generally unsuitable for consumer loans. Most borrowers are simply wage-earners who look to their regular income to repay their debts. The amount of equity in the collateral is only relevant to the ability to repay a loan if the borrower intends to liquidate the collateral. In short, "asset-based lending" is a legitimate-sounding justification to ignore sound underwriting principles, and make unaffordable loans.

The result of this type of lending is now driving the public debate: the number of foreclosures in the United States has more than *tripled* since 1980;[3] families are evicted; neighborhoods suffer; and tax bases decline.

The rise in the secondary mortgage market: Some high-rate mortgage lenders, particularly home improvement contractors, have historically operated by assigning installment contracts they write to other lenders, such as finance companies or banks. But the 1980s added a new wrinkle -- bundling mortgage loans into large portfolios and selling them on the secondary mortgage market. This enabled mortgage companies specializing in home equity lending -- unregulated in many states -- to operate much more profitably. Since there was a "back-end" income stream, they could operate with little capitalization base. They could obtain a line of credit from a major bank; originate predatory loans, taking out very high up-front fees; then dump the loans onto the secondary market.

The securitization of home equity loans: The 1990s saw the phenomenal growth in the use of asset-based securities to fund an ever-increasing supply of mortgage credit.[4] Creating capital flow in this way for *subprime* mortgage lenders took off following 1994. In that year, approximately $10 billion worth of subprime home equity loans were securitized.[5] By the end of 1997, the volume had leaped to about $90 billion.[6]

Prime and "sub-prime" mortgage market: The credit industry refers to "A" and "A-" borrowers (those with good credit histories) as "prime," and "B' and "C" borrowers (those with no credit history or poor credit history) as "subprime." "Subprime" homeowners are the hot new market of the 1990s.[7] The earnings of small-volume subprime mortgage lenders are matching or surpassing the earnings of conventional mortgage lenders with significantly greater loan volume.[8] The securitization of home equity loans is a driving force behind the subprime market popularity.[9] A part of the subprime market includes the predatory lenders which are the subject HUD's concern.

"Tax Reform:" The amendment of the tax laws which retained the deductibility of interest only for home-secured loans added to the massive increase in home-equity debt. Many consumers and taxpayers are not well-equipped to calculate how the tax savings would weigh against the extra interest to be paid. Yet that is a sales pitch given by many creditors, and many homeowners listen to that siren-call.

B. The Abuses

The various predatory practices and abusive loan terms which have affected hundreds of thousands of American households have been widely documented.[10] These abuses include:

- **Steering to high rate lenders** even when the borrower could obtain a conventional loan.
- **Home improvement scams** stemming from unsolicited sellers of home improvements in which the work is generally overpriced, and rarely performed adequately.
- **Mortgage broker kickbacks** which result in higher priced loans than he borrowers qualify for with their lenders.
- **Lending to people who cannot afford to repay.**
- **High interest rates** which cannot be justified by the alleged additional risks and costs of providing credit to homeowners with lower credit scores.
- **Financing high points and fees** which sucks out the equity and jacks up the monthly payment.
- **Falsified loan applications** such that the loan originator pads the borrower's income to make the loan qualify, yet which leads to unaffordable payments for the borrower.
- **Balloon payments terms** for which the borrower has no way to meet without refinancing the loan at excessive costs or losing the home.
- **Negative or non-amortizing loans,** such that even after making loan payments for years the borrowers end up owing *more than* was originally borrowed.
- **Padded closing costs** which can often be fees for settlement services two or three times as high as are charged middle-income homeowners.
- **Financing of credit insurance premiums** which add thousand of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis.
- **High and unfair prepayment penalties.**
- **Mandatory arbitration clauses,** which frequently require only the borrower to submit to it and not the lender and which can force a homeowner to pay large sums for their concerns to be addressed by arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court.
- **Repeated refinancings** which have the effect of bleeding the homeowners' equity from the home by *increasing* the amount borrowed exponentially in each refinancing without providing any benefit to the borrower.
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan.
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans.
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure.
- **125% loan to value loans** which effectively prohibit borrowers from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

Many purchase-money manufactured housing loans are abusive for these and similar reasons, and must also be included in the analysis.

III. Role of GSEs in the Secondary Market

Fannie Mae and Freddie Mac, combined, purchase almost one half of all conventional single-family mortgage loans originated each year.[11] The volume of capital created by these purchases is enormous. The underwriting guidelines of these GSEs help to set the standard for the industry as a whole. The entrance of Fannie Mae and Freddie Mac into the subprime market will encourage the making of subprime loans through the resulting flow of capital back to the originators. Many of these loans are predatory in nature. Unless these entities create strict guidelines which eliminate the risk of inadvertently purchasing predatory mortgage loans, this type of lending will continue to flourish. Thus, the GSEs have an incredible opportunity to reduce harmful lending practices by utilizing positive standards when purchasing mortgages on the secondary market.

HUD's role at this juncture is critical. HUD should ensure that increased affordable housing goals for the GSEs results in Fannie Mae and Freddie Mac purchasing only subprime mortgage loans that are beneficial to the borrowers.

IV. HUD Should Impose Penalty Points for Abusive Mortgage Loans Purchased by the GSEs

A. HUD's Authority

Congress gave HUD broad authority to establish housing goals for each enterprise.[12] The Secretary shall create an annual goal for the purchase by the GSEs of mortgages on homes of low- and moderate-income families; of families in low-income areas and for very low-income families; of families who reside in central cities, rural areas, and other underserved areas.[13] If, however, the Secretary creates subgoals within each of these three general goals, the failure of the GSEs to abide by the subgoals is not enforceable.[14] NCLC recommends, therefore, that no subgoals including the loans defined below be created.

By regulation, HUD is proposing to raise the goals which the GSEs must meet. Congress requires HUD to assess six factors in establishing annual goals for the GSEs.[15] These include:

1) national housing needs;

2) economic, housing, and demographic conditions;

3) the performance and effort of the enterprises toward achieving the low- and moderate-income housing goal in previous years;

4) the size of the conventional mortgage market serving low- and moderate-income families relative to the size of the overall conventional mortgage market;

5) the ability of the enterprises to lead the industry in making mortgage credit available for low- and moderate-income families; and

6) the need to maintain the sound financial condition of the enterprises.

Penalizing the GSEs for the purchase of predatory mortgage loans under all three housing goals is strongly supported by these factors, for the following reasons:

1) The housing needs of low- and moderate-income families in this nation are undermined by the prevalence of predatory mortgage loans in these communities. In its request for these comments, HUD pointed to the "ample evidence that high cost mortgage lending and abusive lending practices increase defaults, have destabilizing effects on neighborhoods, and adversely affect homeownership….[Such loans] quickly erode home equity for unwary borrowers."[16]

2) When low- and moderate-income families lose their equity wealth and their homes to such lenders or other investors, the entire face of a neighborhood can change. Investors who purchase these properties at the auction block are often landlords who then rent the property and fail to properly care for it. Houses become boarded up, families move to "better" neighborhoods. The demographics completely change.

3) While the GSEs have worked hard to meet their goals in previous years, HUD itself indicates that they have the ability and capacity to do more.[17] Indeed, the GSEs receive substantial governmental benefits to do just that.[18] Furthermore, HUD recognizes that the GSEs' charter acts "create an obligation for the GSEs to work to ensure that everyone throughout the country has a reasonable opportunity to enjoy access to the mortgage financing benefits resulting from the activities of these Federally-sponsored entities."[19]

4) The earnings of small volume subprime lenders are matching or surpassing the earnings of conventional mortgage lenders with significantly greater volume.[20] Subprime lending has taken off in the refinancing side of mortgage lending, more so than on the purchase-money side. Since refinancings of all existing mortgage accounted for 50% of all mortgage originations in 1998,[21] it is likely that a significant proportion of these were refinanced by subprime lenders. It is further clear that subprime lenders operate more often in low- and moderate-income communities. Indeed, it appears that some subprime lender *target* these neighborhoods.[22]

5) Many responsible lenders rely on the capital created by the GSEs in order to originate loans. The GSEs purchased almost 50% of all conventional mortgage loans made in 1997. Together, Ginnie Mae, Freddie Mac, and Fannie Mae held $1.9 trillion in mortgage debt in pools or trusts in 1998, while private mortgage conduits held $411 billion and commercial bank held $811 billion.[23] Given this volume, the GSEs undoubtedly can influence the market. By their behavior, the GSEs have the potential to fuel abusive subprime lending or assist in shutting it down.

6) The financial well being of the GSEs will be enhanced if they *refrain* from buying bad loans. The foreclosure rate on conventional loans was a mere .7% in 1998 while the delinquency rate was 2.9%.[24] Although the foreclosure rates of subprime lenders are not readily available, a review of the SEC filings of two publicly-traded subprime lenders revealed delinquencies of 2.81% and defaults (bankruptcies and foreclosures) of 7.51% for one lender. The second lender reported defaults and delinquencies of 16.3% in 1998.[25]

We recommend that HUD affirmatively penalize the GSEs for the purchase of bad loans. As HUD is proposing to give bonus full points and half points for certain circumstances,[26] it presumably has the authority to subtract points as well. Specifically, we propose that points be subtracted from the numerator of the equation but counted in the denominator if the abusive loans are bought. This will penalize the GSE for the purchase of loans with unacceptable terms.

B. Criteria for Penalty Points

We propose that for each loan that a GSE purchases which fits *any one* of the following criteria, there should be two consequences: First there should be no positive consequences for making the loan – the loan should not count toward any of the three housing goals. Secondly, there should be explicit negative consequences -- for each loan that is purchased that meets any of the following criteria, the loan should be subtracted from the total loans that otherwise counted from toward the housing goals.

1) Loans with excessive costs. Loans in which more than 3% of the total loan amount (or 4% if the loan is FHA-insured) consists of upfront points and fees.[27]

2) Loans with higher annual percentage rates: Loans in which the annual percentage rate equals or exceeds four percentage points (4%) over the yield on United States Treasury securities having comparable maturities at the time the loan is made.[28]

3) Loans with prepayments penalties and other abusive terms. Loans which (a) have a prepayment penalty provision; (b) have a clause allowing for the interest rate to increase upon default; or (c) negatively amortize at any point during the term.

4) Loans in which credit insurance is financed. Loans in which the lender financed, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis shall not be considered financed by the lender.

5) Loans which contain mandatory arbitration clauses. Loans which contain a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and defenses the borrower may have against the lender, broker, or other party involved in the loan transaction.

If a GSE inadvertently purchases a loan with any of these characteristics, the GSE should be allowed to modify the loan terms to eliminate the offending terms. If so, then such a loan should be counted toward the applicable housing goal. This ability to "fix" the problem provides legitimate and needed relief to homeowners who have been affected by predatory, subprime lending. On the other hand, it may not be appropriate to allow a GSE to purchase an entire suspect portfolio in order to reform the loans since the infusion of capital that inures to the abusive lender will only fuel its work.

V. INCREASED DATA COLLECTION IS CRITICAL

Effective enforcement of these rules requires sunshine – the GSEs should be required to fully disclose information about its subprime lending, *whether or not the loans are counted toward any of the three housing goals and whether or not they contain any of the criteria listed in the previous section.*. Specifically, NCLC suggests that the GSEs provide specific information about each loan which fit into the criteria listed above. The information should include:

1. the annual percentage rate and interest rate of the loan;

2. the principal amount of the loan and the amount financed (as defined by TILA);

3. the total closing costs, points and fees, and financed credit insurance premiums (and related products);

4. the delinquency and foreclosure rates on an annual basis (for all subprime loans, as compared to other types of loans in the total portfolio);.

5. the length of time between purchase and refinance, if any, on an aggregate basis.

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[1] Depository Institutions Deregulation and Monetary Control Act of 1980, § 501 (DIDA),codified at 12 U.S.C. § 1735f-7a.

[2] The Alternative Mortgage Transaction Parity Act of 1982 (AMTPA). 12 U.S.C. § 3800, *ET seq.*

[3] U.S. Census Bureau, Statistical Abstract of the United States: 1999, Table No.820.

[4] "The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality," FDIC Regional Outlook, Second Quarter 1997.

[5] Daniel Immergluck and Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, at 12, Woodstock Institute (Nov. 1999).

[6] Glenn B. Canner, Thomas A. Durkin, and Charles A. Luckett, Recent Developments in Home Equity Lending, 84 Fed. Res. Bull. 241, 250 (April 1998); U.S. Census Bureau, Statistical Abstract of the United States: 1999, Table No.820 (this table reveals that by 1998, $411 billion worth of mortgage loans were held by private mortgage conduits, including securitized loans; table does not distinguish between prime and subprime lenders, however).

[7] "Subprime Lender is the Place to Be," National Mortgage News, Sept. 22, 1997. Some lenders are exploring even the "D" market. *See* "Countrywide Credit to Offer Mortgages to High-Risk Groups," The Wall Street Journal, Jan. 7, 1998.

[8] *Id.*

[9] For an excellent article on the rise of the subprime mortgage market and the resulting abuses, see Cathy Lesser Mansfield, The Road to Subprime "Hel" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C.L. Rev. ____(2000).

[10] Hearing on Equity Predators: Stripping, Flipping and Packing Their Way to Profits before the Senate Special Committee on Aging, 105th Cong. 2d Sess. (March 16, 1998); Hearings on Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Lending, and Home Equity Lending before the Senate Committee on Banking, Housing and Urban Affairs, 103d Cong. 1st Sess. (Feb. 3, 17, 24, 1993).

[11] Refinancing of mortgages accounted for 50% of all originations in 1998. 65 Fed. Reg. 12631, 12637 (March 9, 2000). Neither Fannie Mae nor Freddie Mac is limited to buying purchase money mortgages on the secondary market.

See 12 U.S.C. §§ 1717 (Fannie), 1454 (Freddie). HUD has not limited the GSE housing goals to purchase money mortgages.

[12] 12 U.S.C. § 4561.

[13] 12 U.S.C. §§ 4562-4564.

[14] *Id.* The Secretary may enforce the general goals by sending a notice of failure to comply; require the GSE to submit a housing plan that promises achievement of the goals in the next calendar year; disapprove of a housing plan if inadequate; issue a notice of cease and desist charges upon the GSE; conduct a hearing on the charges; and, assess civil money penalties. 12 U.S.C. §§ 4566-4588.

[15] 12 U.S.C. § 4562(b).

[16] 65 Fed. Reg. 12631, 12668 (March 9, 2000).

[17] *Id.* at 12636.

[18] *Id*. at 12633.

[19] *Id*. at 12636.

[20] "Subprime Lender is the Place to Be," National Mortgage News, Sept. 22, 1997.

[21] 65 Fed. Reg. at 12637.

[22] Daniel Immergluck and Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, at 12, Woodstock Institute (Nov., 1999).

[23] U.S. Census Bureau, Statistical Abstract of the United States: 1999, Table No.820.

[24] *Id.* at Table No.821.

[25] Cathy Lesser Mansfield, The Road to Subprime "Hel" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C.L. Rev. ____(2000), at VI.C.3.

[26] *See* Fed. Reg. at 12658, 12666.

[27] Points and fees must be defined as: (a) all items listed in 15 U.S.C. § 1605(a)(1) through (4), except interest or the time-price differential; (b) all charges listed in 15 U.S.C. § 1605(e); (c) all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction; (d) the cost of all premiums financed by the lender, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender. Total loan amount means the principal of the loan minus the points and fees.

[28]The equivalent yield for the Treasury Bills should be determined by the following rules: (a) adjusted to a constant maturity of a comparable term (as made available by the Federal Reserve Board) as of the week immediately preceding the week in which the interest rate for the loan is established. Further, b) if the terms of the home loan offers any initial or introductory period, and the annual percentage rate of interest is less than that which will apply after the end of such initial or introductory period then the annual percentage rate of interest that shall be taken into account for purposes this subsection shall be the rate which applies after the initial or introductory period; (c) in the case of an annual percentage rate which varies in accordance with an index, the rate shall be the maximum rate permitted at any time by the loan documents.