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SUBPRIME LENDING: DEFINING THE MARKET AND ITS CUSTOMERS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

AND THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

MARCH 30, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–76

U.S. GOVERNMENT PRINTING OFFICE

94–689 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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SUBPRIME LENDING: DEFINING THE MARKET AND ITS CUSTOMERS

Tuesday, March 30, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEES ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT,
AND HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to call, at 10:08 a.m., in Room 2128, Rayburn House Office Building, Hon. Robert Ney [chairman of the Housing and Community Opportunity subcommittee] presiding.

Present: Representatives Baker, Bachus, Royce, Lucas of Oklahoma, Ney, Ose, Miller of California, Tiberi, Kennedy, Feeney, Hensarling, Garrett, Kanjorski, Waters, Sanders, Maloney, Velaquez, Watt, Carson, Sherman, Lee, Moore, Hinojosa, Lucas of Kentucky, Crowley, Clay, McCarthy, Baca, Miller of North Carolina, Scott, and Davis.

Chairman NEY. [Presiding.] The Housing Subcommittee and Financial Institutions Subcommittee hearing on subprime lending will come to order.

I want to also thank everyone for being here today to discuss what I think is an extremely important issue in the United States: subprime lending. It is obviously not without controversy, but it is an issue I believe that absolutely has to be addressed.

And I want to also especially thank, my good friend, Chairman Bachus, for taking the time from his busy schedule to also chair this hearing with me.

Spence has been a real leader on consumer credit issues, working diligently to pass FCRA, which I think some people had some bets would never happen.

I bet on you and made some money on you, so I am just happy with that.

And he passed FCRA last year and he is now working on predatory lending. And also want to welcome all the members from both sides of the aisle.

The purpose of this hearing is to look at the subprime lending market in the United States. Over the past decade, we have seen the number of people receiving subprime loans increase dramatically.

What we do not know is what this trend means for consumers. This committee has not looked at whether the increase in use of subprime loans means that consumers are paying more for credit

or if consumers, who had previously not been eligible for credit, are now getting access to the mortgage market.

And I think we need to determine that.

Furthermore, we have only begun to look at the implications for consumers if subprime lending is restricted by onerous State and local predatory lending laws or a hodge-podge of laws across the United States.

I believe that in order to truly gauge the effect of predatory lending laws at the State and local levels and in order to truly be able to assess the need for a national standard for mortgage lending, Congress first has to understand the subprime marketplace in order to make decisions.

Our two panels of witnesses today represent a good cross-section of the lending community, academics and consumer groups.

I think with all of them we will be able to do a good job of sharing a picture of who gets subprime loans, what those loans cost and most importantly, how important are subprime loans in helping consumers either obtain credit for the first time or reenter the credit market after previous problems that they have encountered.

And I know that everybody here has heard stories about State and local predatory lending laws cutting off credit for those who need it most. I look forward to hearing those stories brought out in our hearing today and talked about.

Again, I want to thank Chairman Bachus and all of the members from both sides of the aisle of this committee. And I want to thank the witnesses for being here.

Gentleman from Pennsylvania?

Mr. KANJORSKI. Thank you, Mr. Chairman. I think that this is a hearing that we have all looked forward to over the months.

I have had the occasion to direct my attention to subprime lending over the last year and I think that from this testimony today I am trying to extract what I think appears to me to find a market that has been underserved, but particularly is in a destabilized condition because of the State variances in the legislation.

And I hope that in the examination today we are going to receive evidence that will further encourage the committee to go forward with examining a national standard, recognizing that we want to stop the violations that occur and the abuses that occur.

But on the other hand, provide funding available with those that are best served and need the subprime market.

I particularly am aware of the fact that we have today in private bankruptcies more than 1.7 million individuals and under normal procedures it would seem to me many of those, or most of those individuals would not be able to get normal, conventional financing at normal rates.

So, in order to reconstruct their financial positions and to gain the benefits of homeownership again; many of those individuals have to go through the subprime market.

On the other hand, we have all heard the ugly stories across the country that are classified as predatory lending.

And it seems to me that the responsibility of this committee and the Congress to examine whether in fact these stories have any merit, if they do, how we can correct them. And on the hand, provide for this new market that is occurring.

I understand that the market in 1994 was only about $9 billion; today it exceeds $200 billion, obviously, a sufficient amount to warrant the examination of this Congress.

So, once again, I would like to thank you, Mr. Chairman and Mr. Bachus, for putting together this hearing and hopefully it will help us to go forward in a bi-partisan effort to provide some needed solutions to the problems that exist.

Thank you.

Chairman NEY. Thank you.

Chairman Bachus?

Mr. BACHUS. Chairman Ney, I want to commend you on your leadership on this issue and as well, Mr. Lucas and Mr. Kanjorski.

There are several other members of our committee that have done a lot of work and proposed legislation in this field.

I want to commend Congressman David Scott for his work on H.R. 1864, the Prevention of Predatory Lending through Education Act and Congressman Mel Watt and Congressman Brad Miller, who recently introduced H.R. 3974 the Prohibit Predatory Lending Act of 2004.

I look forward to working with Congressman Ney, Congressman Kanjorski, who has proposed legislation and those others working on legislation: Congressman Lucas, Scott, Watt, Miller and all my other colleagues as we continue to look at this, what is sometimes a complex issue.

I will just basically hit four points here this morning.

First of all, there is a confusion between the word predatory lending and subprime lending. Subprime lending is a very legitimate form of financing for housing, home improvements, things of that nature.

Many Americans now own their homes because they have been able to get a subprime mortgage. This is a good thing if it is not accompanied by abusive lending practices.

In fact, many homeowners would be shut out of the market because of either past bad credit history or lack of credit history; perhaps a bankruptcy and they have no choice other than subprime lending.

And these commercialized mortgage loans work very well for them.

We probably have a responsibility, and I think Mr. Kanjorski mentioned that we have basically the one figure: in 1994 there were $34 billion in subprime mortgages, in 2002 the last year we have total results, $213 billion, so you have had an astronomic increase in subprime lending.

And the vast majority of those loans are not in default.

However, as I said earlier, with any responsible lending industry, there are those who are bad actors and their abusive lending practices. And I think most all of us have had to go through the litany of some of these practices.

I will simply say that the timing of this hearing, I don't think, could be better because we have had many States and localities that had responded to these abusive lending practices with legislation.

This legislation, however, only covers the OTS and the OCC. Their rules and regulations, first of all, only cover those institutions which they regulate.

It does not cover really, the majority of institutions which makes up prime lending loans.

And so, we have an unbalanced system of regulation here.

The other thing you have, as obviously, anyone on this committee knows the controversy of surrounding the OCC and the OTS preempting a part, and not the entire subprime lending field, but just a part of it: singling out a part of it because they only regulate a part of it.

There is concern that the OCC and the OTS might not adequately regulate and address these abusive practices.

And I can note, by looking at our first panel, we are going to have a wide diversity of views on this. I think it is the first time that we have had ACORN seated at the table as opposed to outside in the hall.

But it is certainly a much quieter hearing with Mr. Butts, with you at the table. And we look forward to hearing from you and from all our other panelists.

But Mr. Ney, in conclusion, as I have told people in private meetings and otherwise, I think on our side, you are going to the lead committee person on this issue and I think you have a challenging job ahead of you.

I yield back the balance of my time.

[The prepared statement of Hon. Spencer Bachus can be found on page 98 in the appendix.]

Chairman NEY. I want to thank you.

Ranking member?

Ms. WATERS. Thank you very much, Mr. Chairman, for scheduling this hearing to consider the many important issues raised by subprime lending.

While there are many topics that need to be covered in today's hearing, I hope that our witnesses will direct their testimony particularly to the tremendous harms to minorities, to the elderly and to low and moderate income borrowers that stem from the abusive practices known as predatory lending and to the types of remedies that are required to prevent such lending.

The amount you pay for a loan should not vary depending on where you live or what you look like.

I also hope that our witnesses will address the extent of the correlation between subprime loan rates and foreclosures.

While not all subprime loans are predatory, predatory lending is concentrated in the subprime loan market. Predatory lending preys upon poor and minority neighborhoods, where the best loans are rarely available: neighborhoods where the number of subprime loan outlets usually vastly exceed the number of banks available.

Meaningful access to low-cost products depends on branch access and presence.

Household Beneficial Corporation has six branches serving upper income clients in California, while at the same time it has 177 subprime Household Finance and Beneficial branches that offer higher cost products to California's diverse population.

No bank should have fewer branches than its subprime affiliate.

Predatory lending often results in home foreclosures and in borrowers losing their equity. While housing counseling and better education are valuable and important consumer protections there is no way that counseling and education alone can prevent predatory lending.

Unfortunately, there are still unscrupulous lenders in the market who will take advantage of consumers' lack of understanding, of complicated mortgage transactions and use aggressive sales pressure techniques to market loan products that are harmful to the consumer.

Marketing a subprime loan tends to focus on specific neighborhoods, often through door-to-door sales or repeated telephone solicitations.

Surveys of low-income, subprime borrowers indicate that a large percentage of borrowers had not sought out the subprime lender and many were not even seeking a mortgage loan, but were contacted by lenders, brokers or contractors and persuaded to take out a home repair or home equity loan.

While there clearly is a place for responsible subprime loans where a higher interest rate is used to address the enhanced risk posed by borrowers with past credit problems, there are far too many subprime loans that contain abusive terms or conditions.

There are far too many loans with rates and fees that are much higher than can be reasonably justified by the borrower's credit records.

Many borrowers who may qualify for prime mortgage credit are paying higher costs for subprime loans. Freddie Mac has estimated that between 10 percent and 35 percent of AA-minus subprime borrowers actually qualified for prime rates, but received and were paying for more expensive loans.

AARP has found that 11 percent of older borrowers with credit scores that qualify for prime credit owe more expensive subprime mortgages. Franklin Raines, the chairman of Fannie Mae, has estimated that perhaps as many as half of those receiving subprime loans could have qualified for a loan on better terms.

There are simply far too many borrowers who could have qualified for prime loans who are receiving subprime loans because they were steered to subprime products. And because they lack the knowledge and sophistication and the bargaining power to insist on and obtain better terms.

Mr. Chairman, when it comes to predatory lending it is simply not acceptable to say that the borrower should have read and understood all of the terms in the complicated loan documents that were given to him.

In my view, this is an area where the doctrine of quote, let the buyer beware, quote-unquote, can never be good enough. Financing of excessive fees, charging higher interest rates than a borrower's credit warrants, larger pre-payment penalties, refinancing without financial benefits, hidden variable interest rates, loans with extremely loans-to-value ratios that result in negative amortization from day one.

These are just some of the outrageous burdens on consumers as a result of predatory lending.

Then there is the disgraceful practice of sending live checks to consumers to entice them to address their immediate financial needs without regard to the costs imposed or the mortgage terms, including balloon payments, negative amortization and pre-payment penalties that appear as options to reduce the interest rate on prime loans are routinely inserted and higher rate subprime mortgages, sometimes without the knowledge of the borrower.

Even when subprime loans do not involve deceptive or abusive practices they tend to expose borrowers to higher risk than conventional prime loans because of the higher financial burden they impose.

In October 2003, ACORN released a report entitled "The Great Divide: Home Purchase Mortgage Lending" nationally and in 115 metropolitan areas.

The ACORN report confirms that minority applicants for conventional loans are rejected significantly more often than whites, and the disparity has grown over time, with rejection ratios in 2002 higher than 2001 and higher than they were 5 years ago.

Minorities of all incomes are rejected more often than whites of the same income for conventional purpose loans and the disparity increases as the income level increases. Minorities with higher incomes are denied more often than whites with lower income.

Mr. Chairman, I guess some of us have been singing this song for a long time and frankly, I almost did not come today because it seems that I have doing this over and over for so long now and I don't know where it is going to take us.

But I think in the final analysis, if we don't get some relief from these kinds of practices we are going to have to employ other more direct responses to those lenders who are involved in subprime predatory lending.

Again, I recognize that all subprime lending isn't predatory, but too much of it is and we are just going to have to rally and protest and bring people to some of these institutions in ways that banks and some of our mortgage companies would not like to see. I don't know what else to do.

We talk about it all the time, but nothing changes.

Chairman NEY. I appreciate you being here and your input and hopefully we will get something, I don't want to say fair and balanced, that pertains to Fox News, but hopefully we will get something that is decent for consumers and still allows the market to flow.

Thank you.

Chairman Baker?

Mr. BAKER. Thank you, Mr. Chairman. I will be brief. I appreciate your courtesy in calling this hearing on this important matter.

Certainly doing whatever we can to facilitate extension of credit to all interested parties is an admirable goal and should be pursued with every ability we can muster. At the same time, unreasonable constraints on common sense business practice do not make sense not only for the business person, but for the consumer as well.

Denying someone the opportunity for homeownership simply because the rate or the terms of repayment are different from an AAA-credit rated individual doesn't make sense.

I would like to commend those in the industry who have spent considerable time and effort on trying to identify first what constitutes predatory action, not already prohibited by either State or federal laws.

Secondly, on one's finding, whatever that might be, eliminating that loan from their portfolio and taking action not to allow those activities in the course of ordinary business practice be incorporated into the portfolio of these organizations.

I do believe there is a need to continue to improve. I do believe that there is evidence that there are individuals who take advantage of the uninformed consumer.

I do believe that the current body of law is sufficient to catch the bulk of the adverse practitioners, but we should take additional steps to ferret out the very last and most offensive of these practices and open up the access to the lines of credit for homeownership for everyone.

And to that end, Mr. Chairman, I will strongly support your efforts in this regard.

I yield back.

Chairman NEY. I want to thank Chairman Baker.

Further opening statements?

Gentlelady?

Mrs. MALONEY. First, I would like to thank both of the chairs for calling this and we continue to make a practice on this committee of praising the virtues of homeownership as a wealth creator for our constituents and the success represented by near-70 percent homeownership in this country.

These are incredible successes that demonstrate the competitiveness of our housing industry, which is constantly evolving and coming up with new products that put more people in their homes.

Subprime lending as an innovation deserves some of the credit for the vibrancy of these housing markets.

It is a great thing that people with damaged or limited credit histories have a much better chance of buying a home today because of credit innovations and the competitiveness of the subprime market.

At the same time, the explosion of subprime has coincided with increased opportunities to fleece borrowers and a rise in foreclosure rates and predatory lending.

While it is perfectly acceptable for lenders to charge higher prices to riskier borrowers, the fact that a disproportionate high number of subprime loans go to minorities, the poor and the elderly, demand that this market receive very strict oversight.

With this in mind, one of my biggest concerns is that subprime loans only go to those borrowers who need them and that more credit-worthy borrowers be given the opportunity to receive prime loans when appropriate.

I would like to hear from the panel today what can be done, in their view, to attack this problem.

Is it simply a matter of education or are specific policies needed on the books at lenders that have both subprime and prime units,

mandating that borrowers be referred to the prime units if they qualify?

Besides ensuring that subprime loans go to those that qualify for them, I have a major concern with the question of assigning liability.

I strongly believe that borrowers who are victims of predatory lending deserve to be made whole; it is not their fault that the predatory lender who sold them their loan no longer has it on his books and doesn't have any money.

At the same time, legal certainties for the secondary market is extremely important.

The secondary market is really the goose that laid the golden egg in regard to the U.S. mortgage markets. The last thing we want is to scare away investors and home mortgages which provide the liquidity that keeps the whole system funded.

Yesterday a report came out from the bond association on this question and one of the main points of their white paper was that they prefer a national standard which they say would be more efficient than the current 40 different standards they face.

I am not personally sold that a national standard is necessary, but I am sympathetic to the argument that the secondary market should only be assigned liability for lending violations that can be detected in a review of the regular loan documents.

I must add, since this is also a housing hearing, the really inappropriate funding levels of federal support for public housing in America.

I yield back the balance of my time and I look forward to the comments of the panel.

Chairman NEY. The time of the gentlelady has expired.

Further opening statements?

No further opening statements? Mr. Sherman?

Mr. SHERMAN. Thank you. I would like to thank the chairs and the ranking members of the two subcommittees for holding these important hearings.

As other speakers have indicated, this is a hugely important part of our economy and it is important that we get a balanced view because in our work as individual members of Congress, we naturally hear about the bad side of subprime lending.

We hear about the predatory practices and we hear about the situations where it was just bad luck, where somebody got a loan that perhaps they should have gotten, but then something happened and now they are in desperate straits.

We need to hear also the other side, the success stories of people who were rejected for conventional lending and then got a subprime loan to the benefit of their family or to finance a business.

As we seek to protect consumers, we have to understand that the best consumer protection is competition. That is what drives prices down, that is what gives people better terms.

And that competition is imperiled by the idea of every municipality in my state adopting their own laws about lending.

What that does is it will create a lender who specializes in one municipality, to the exclusion of all others. And you will log into ditech.com, having endured 500 annoying commercials, only to find,

"Hey, you can't get the loan, you have to go to that very banker that they vilify in their commercials, who has a captive market in that municipality.

Now, it is true that computers allow subprime lenders to deal with the complexity of, but there is a limit to how much complexity you can deal with if every municipality adopts its own, or even every state, has its own different set of laws with draconian penalties when you violate the slightest one of numerous requirements.

I should point out also, that as an old tax collector, I am not sympathetic to those in your industry who make it easy for somebody to come in and say, "You know, I have a lot of income, I just don't put it on my tax return."

I would appreciate that one of the standards for giving someone a loan is that it is based on the income that they actually report to the agency represented by those of us here, namely the federal government.

I want to think our Ranking Member Maxine Waters has identified some of the bad practices that we need to look at.

But I want to disagree with her on just one small point: I don't think it is bad for a lender to concentrate on subprime lending or to specialize.

If it is good to be in that market and some company decides to be exclusively in that market and all of their outlets in our state are subprime lending facilities, that makes sense, just as some other financial institution might specialize in the other end of the market.

I know that a number of states have adopted confusing laws, creating inefficiencies, allowed their municipalities to come up with draconian penalties and confusing statutes and I want to thank those states and municipalities, because what they have done is they have inspired industry——

Chairman NEY. Time has expired.

Mr. SHERMAN. If I could just continue——

Chairman NEY. Finish your statement surely. I just wanted to——

Mr. SHERMAN.—because it is those actions, inefficient actions, which have inspired industry to come to us and say you want national standards and I assure you those national standards should not be set at and will not be set at the lowest common denominator. We will get effective consumer protections for all the citizens of the country.

Thank you. I yield back.

Chairman NEY. Thank the gentleman.

Gentlelady?

Ms. LEE. Thank you, Mr. Chairman. I want to thank you and Mr. Bachus and our Ranking Member Waters and Sanders for convening this very important hearing on subprime lending. I would also just like to welcome all of our witnesses today who will discuss the costs and benefits of the subprime market.

The subprime market exists because it provides credit access to borrowers who otherwise would not and could not obtain loans. However, far too often, people in the subprime market, particularly minorities and the elderly, are truly victims of predatory lending.

These individuals are actively and purposely preyed upon by lenders who know there is no true punishment or strong federal mandate that will stop them from unjustly profiting off of our most vulnerable communities.

So Mr. Chairman, we must begin out of this hearing, to stop this growing trend and establish a base federal standard that punishes bad actors and champions local and State ordinances against predatory lenders.

And I am very proud to say that my hometown of Oakland, California has passed a local ordinance against predatory lending which will, hopefully, stop the growing trend that we see in Northern California, of not only first-time predatory home loans, but also more often the predatory refinanced loans.

So, I hope that we can work with everyone in the industry: our consumer groups, members of the community, to truly educate and protect people before, during and after the homeowner process.

Of course, education starts with financial literacy, housing and foreclosures counseling, and really good faith from the lending community. So, I believe that we can work together and create the protections and guidelines that will benefit everyone.

So, today's hearing is a very good start. I hope the dialogue will grow, but I also hope that we come to some realistic approach to deal with the very bad actors that are out there, some of which are subprime, some of which are not.

Thank you, Mr. Chairman and I yield the balance of my time.

Chairman NEY. Thank you.

Gentleman?

Mr. HINOJOSA. Thank you Chairman Ney and Bachus. And I want to also acknowledge Ranking Members Waters and Sanders.

I thank you for calling this very rare joint hearing of two important subcommittees on the topic of particular concern to me and to my constituents: subprime lending and predatory lending.

I hope that this will be the first in a series of hearings that you will hold on this subject in both subcommittees and then the Full Committee. As many of you are aware, subprime lending has increased abusive lending practices, particularly aimed at vulnerable populations, such as the Hispanic populations in my district.

These constituents do not qualify for prime loans and must trust subprime lenders not to impose unnecessary fees or to trap them into schemes where they end up losing their homes, thereby, transforming a subprime lender into a predatory lender.

I was concerned to read in Mr. Smith's testimony that a study by ABT and Associates in Atlanta found that foreclosures attributed to subprime lenders accounted for 36 of percent in all foreclosures in predominantly minority neighborhoods in 1999. While their share of loan originations was between 26 and 31 percent in the preceding 3 years.

However, I understand that lenders need to maintain appropriate capital levels and to weigh the risks of the loans they make to lenders. The need exists for a subprime lending market for individuals that pose more of a risk to the lending institution.

However, subprime lending has yet to be defined and some claim that it is impossible to define. If that is the case, then I wonder

if we are chasing our tails here today. Perhaps we should wait until it is defined.

Regardless, legislation has been introduced on subprime lending and predatory lending by my esteemed colleagues, Congressman Ney and Lucas and Congressmen Miller and Watt. I intend to review those proposals, carefully, prior to taking any positions on the legislation. It is also my understanding that our Ranking Member, Paul Kanjorski, is working on draft legislation that will be available in 30 to 60 days on this same subject.

My staff has already expressed to his staff my desire to work with him on his legislation to ensure that it addresses the needs of the Hispanic population, and other minority populations in the United States, to ensure that our views are protected under its clauses and provisions to every degree possible.

My ultimate goal is to protect my constituents from predatory lenders, while ensuring that they receive fair, subprime loans if they do not qualify for the prime loans. I have yet to review the preemption issue at any great length.

Mr. Chairman, I yield back the balance of my time.

Chairman NEY. Thank you.

Mr. Royce, gentleman from California?

Mr. ROYCE. Thank you, Mr. Chairman.

The title of today's hearing is Subprime Lending: Defining the Market and its Customers. Personally, I have always been surprised with a debate on non-prime lending.

What non-prime lending does is it prices risk, which is the borrower's ability to repay. This is not a phenomenon reserved solely for non-prime mortgages.

If we took a look at other examples in the U.S. bond market, investors demand that State and municipal governments pay a higher rate of interest than the U.S. government pays on treasuries.

That does not mean that the investors are engaged in predatory lending in that case, I would assume. What you are actually doing is you were looking at the question of risk.

Banks and investors tend to charge start-up companies a higher rate of interest on loans than they charge a Fortune 500 firm. Question is: "Is this predatory?"

Insurance firms usually charge higher premiums on drivers convicted of DWIs than on drivers who have perfect records. Is this a predatory practice?

On balance, I think that non-prime lending has greatly benefited millions of Americans and on balance, I think it has helped our economy and I think we should keep that in mind as we move forward with this debate.

And I thank you, Mr. Chairman.

Chairman NEY. I thank the gentleman.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman and Ranking Members Waters and Sanders for having this hearing.

First of all, let me thank the panelists for appearing here today. I look forward to hearing your testimony. I look forward to hearing, about the important issues that pertain to the Hispanic and low-income communities: the issues of subprime lending and predatory lending.

Today, there are over four million Hispanic homeowners throughout the nation and more and more are becoming homeowners, especially in my district.

The subprime market plays an important role in increasing access to homeownership for Hispanics; especially those with poor credit histories, subprime loans represent 20 percent of home purchase loans to Hispanic versus 7.5 percent to white borrowers.

Similarly, subprime loans represent 18 percent of the mortgage refinancing loans to Hispanic versus 6.7 percent to white borrowers. That is why predatory lending practices that sometimes occur in the subprime lending industry are so troubling.

Our committee and Congress must look at protecting all consumers from such abusive lending practice.

That means helping consumers learn how to protect themselves through effective financial literacy programs and making substantive changes in HOEPA.

We must be careful to do so without adversely affecting the ability of minorities and others to receive affordable credit.

Again, I look forward to hearing you testimony and learning more about these important issues.

Thank you very much, Mr. Chairman and ranking members.

Chairman NEY. Thank you. Thank you.

Gentlelady from Indiana: Ms. Carson?

Ms. CARSON OF INDIANA. Thank you very much, Mr. Chairman and certainly all the conveners. This issue of predatory lending has been around for a long time, we just haven't given it any public hearings.

I am sure those of you who are in the mortgage business, who have been around a long time remember the reprehensible district in my district, Indianapolis, about 15 years ago where a young man who was being foreclosed, who did not look like me, did not live like me, who took on the mortgage lender and walked the president down the street behind a gun for like three hours, since they were taking his property.

And interestingly, the man who was doing the gun holding aroused a lot of interest and support in the community for his actions.

I don't believe that we can hold one entity responsible for the problems that emanate from this whole issue. In my district alone, Indianapolis, Indiana, ZIP Code 46201, has the highest incidence of foreclosures in the nation in Indianapolis, Indiana.

Indiana and Indianapolis, unfortunately, exhibit high rates of foreclosures among homeowners. And I have convened several meetings and was inspired to create a 1-800 number, which is overwhelmed now: 1-800-888-7228.

And what I want that number to do before people sign their names for any reason on anything, they call that number and they get the help of a consumer counselor, and they also get the help of legal services, if they are in the midst of being foreclosed, or if they are being threatened with foreclosure, because we have to protect the consumer.

And I also recommend that the lending institutions have got to assume more responsibility before they approve these loans.

I know that you don't do it alone, necessarily, but it is like the mathematical axiom: that the sum equals the whole of its parts, and while you might have a lender that has a wealth of integrity, that lender may be dependent on some appraiser, who is just a fly by-night appraiser, who is going to escalate the value of a home charged a bunch of money and before the consumer realizes it, a big moving truck is being put out on the street in front of their house that they did not send for.

You have title companies that has jumped into the business now that are major culprits that perpetuate this problem abound.

And I think as we look at this, we can't just look at Countrywide or Irwin Mortgage or other companies that is in the business of lending money, but we have got to look at the whole equation, in terms of how do people end up in this kind of predicament.

Do lenders rely solely on some appraiser that comes in and tells them that a house is valued at so much money or not?

Do the lenders, and should the lenders, take some responsibility before they write the check over in behalf of the consumer and end up in a very precarious situation?

Mr. Chairman and the conveners, thank you very much for your time and I will yield back.

Chairman NEY. Thank you.

Anyone else on this side?

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

For most Americans, the purchase of a home is the most important investment they will ever make. For Americans living in poverty or near-poverty, the purchase of a home is a huge step into the middle class. The equity they build in their home becomes the bulk of their life savings.

American homeowners borrow against the equity in their home, their life savings, for a variety of reasons: for their children's education, for unexpected medical expenses, for retirement, for home repairs, for all the various rainy days that all of us experience in life.

I am committed to protecting access to credit for American consumers to buy homes and to borrow against the equity in their home when they need to.

Yes, many lower income borrowers present a higher credit risk to lenders. Yes, that risk could be reflected in interest rates and lenders should make a fair profit from the credit they extend to higher risk consumers.

But there has been a dramatic increase in unconscionable practices that take advantage of the most vulnerable consumers and take from them the equity in their home: their life savings.

Consumers sign long documents, page after page of indecipherable legalese, knowing only how much money they will get at the closing and how much they will have to pay each month.

What they don't know is that they paid exorbitant fees at closing that came straight out of their life savings, straight out of their equity in their home. And once they sign those documents, it is gone forever.

Consumers learn that there is a balloon payment or that the lender can call the loan requiring that it all be paid immediately and they can't possibly make the payments.

They borrow again, losing still more equity, more of their home's equity, or they lose their home to foreclosure.

And just as purchasing a home is a huge step into the middle class, losing a home to foreclosure is a huge step back into poverty.

The profit that lenders derive from those practices go well beyond what is fair. But those unconscionable practices that strip the home equity of vulnerable consumers are all perfectly legal under federal law.

Mr. Watt and I have introduced legislation to provide protections to all America's consumers that North Carolina consumers now have under state law passed in 1999.

I am delighted to accept Mr. Bachus' invitation to work with him; to work with Mr. Ney; to work with Mr. Kanjorski; to work with Mr. Watt; to work with industry, with banks, mortgage bankers and brokers, with consumer groups; with all of God's children to try to achieve workable legislation to protect vulnerable consumers from abusive lending practices and still make credit available on fair terms.

I look forward to the testimony today.

Mr. BACHUS. [Presiding.] I appreciate that Mr. Miller. And I think it is our goal, all our goals should be here today, to preserve this affordable lending, but to crack down on the abusive practices.

Mr. Scott, did you have an opening statement?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I want to thank Chairman Ney, Chairman Bachus and Ranking Member Waters for holding this joint hearing with the financial institutions subcommittee today regarding subprime lending. I also want to thank the distinguished panel of witnesses today for their testimony on this subject as well, for it is indeed, a most important subject.

About half a typical family's wealth is in home equity, yet many communities are clearly missing out on one of the basic assets of wealth building.

I have heard from some representatives from the mortgage industry that subprime lending provides homeowner opportunities for many individuals who normally would not qualify for prime loans.

I have also heard from consumer advocates that subprime mortgage lending provides ample opportunity for amazing and tragic predatory lending practices and gives incentives to liberally approve loans to individuals who cannot afford a loan.

I look forward to today's hearing to help identify the true benefits of opening credit markets to more consumers, while examining the unsavory lending practices and high default rates that accompany the expansion of credit to at-risk communities.

Advocates from consumer advocates and subprime lenders both, would like to see the creation of a national predatory lending law. But what I want to know is, if such a law is indeed necessary, and if so, how should we preempt state laws.

We must fight predatory lending without harming legitimate businesses that offer mortgage services to consumers with less than perfect credit histories.

As a former member of the Georgia State Senate, I can speak of the impact that overly strong regulatory measures can have a housing market. I was one of the first individuals at the State level to put forth a predatory lending act in response to the difficult problems we had with fleet finance coming into Georgia and using our usury laws unfairly.

But 2 years ago, the Georgia Fair Lending Act had several provisions, including assigning liability to secondary markets, which caused financial companies to pull out of my State and withdraw some lending products.

The Georgia General Assembly had to revisit that law last year to prevent additional companies from leaving the State. In an effort to stop unscrupulous lending practices that fair lending act caused hardship to legitimate lenders.

While it is not a panacea, we must bring homebuyer education directly to communities to help stop predatory lending practice.

That is why I am pleased to have worked with Chairman Ney, other members of this committee, Congresswoman Velazquez, to introduce H.R. 3938, the Expanding Housing Opportunities through Education and Counseling Act.

Several sections of H.R. 3938 are similar to the legislation that I introduced last year.

H.R. 3938 will establish a housing counseling commission in HUD and will create a real 1-800 toll-free number for consumers to call to learn about loan policies and home owners' issues.

That bill will also provide grants to local home counseling agencies and study predatory lending practices. No, it is not a panacea, but education is the key.

If we can arm our most vulnerable populations with the education information they need and put a 1-800 number out there, so that they can have a lifeline to call and speak to a human being on the other end of the line, we will go a long way in helping to provide them with the ammunition to protect themselves so that they can have a way to call a number before they sign on the dotted line.

I look forward to hearing today's testimony to help address the devastating impact caused by predatory lending practices.

And again, Mr. Chairman, I commend you and thank you for recognizing me.

Mr. BACHUS. Thank you.

And just for the record, Mr. Scott, you have 1865? Is that not the correct number of the bill that you have now: the Prevention of Predatory Lending through Education Act or is 3938?

Mr. SCOTT. It is 3938. What happened was we incorporated some of the features, most of the features from my previous legislation into that.

Mr. BACHUS. Okay.

Mr. SCOTT. Chairman Ney was kind enough to oblige me and I appreciate it.

Mr. BACHUS. Have you, is 1865 still? Is that still pending, too?

Mr. SCOTT. Yes.

Mr. BACHUS. Okay. All right. Thank you.

Ms. VELAZQUEZ. Mr. Chairman?

Mr. BACHUS. Are there——

Ms. VELAZQUEZ. Mr. Chairman?

Mr. BACHUS. All right.

Without objection.

Thank you.

Are there other members who wish to make opening statements? If not, we will proceed to our first panel.

First panel is made up of six individuals. First, from my left is Sandy Samuels—and I understand that Mr. Sherman would like to introduce Mr. Samuels.

Before he does, I would direct everyone's attention to Mr. Samuels' testimony. I think it debunks several of the fictions about who takes out a subprime loan and the demographics of those borrowers. I think it is a very useful opening statement in that regard. He goes into a lot of facts and figures about who their customers are.

Mr. Sherman, I will introduce you at this time.

Mr. SHERMAN. Thank you, Mr. Chairman, for the opportunity to introduce Sandy Samuels to the members of both subcommittees.

Sandy joined Countrywide in 1990 and is Senior Managing Director and Chief Legal Officer for Countrywide Financial Corporation. In this capacity, he oversees the transactional, regulatory and litigation affairs of Countrywide.

He holds an undergraduate degree from Princeton and far more importantly, a law degree from UCLA.

He has roughly 20 years of experience dealing with the very issues that these hearings address. I have known Sandy for many years. He represents the largest financial institution based in the Los Angeles area, which plays such an important role, not only in the Los Angeles area in general, but the valley Las Virgines area, in particular.

Sandy?

Let me just add. Sandy, I have read your testimony. I have to rush off to a non-proliferation hearing.

Mr. BACHUS. Now, if you introduce a witness, you have to stay for their testimony.

Mr. SHERMAN. I will inform Chairman Hyde to delay the start of the hearing on nuclear proliferation.

Mr. BACHUS. Thank you.

Before you go, Mr. Samuels, let me introduce the rest of the panel and then we will start with your testimony.

Our next panelist is Ms. Teresa Bryce; she is the vice president and general counsel of Nexstar Financial Corporation in St. Louis, Missouri. She heads the legal department for Nexstar.

Prior to NexStar, she held a number of senior positions in the legal divisions of various mortgage companies, including Bank of America Mortgage, Bank of America Corporation; PNC Mortgage Corporation of America and Prudential Home Mortgage Company.

And you are testifying, Ms. Bryce, on behalf of the Mortgage Bankers Association. So, we welcome you.

Our next panelist is William M. Dana, president and CEO of Central Bank of Kansas City, testifying on behalf of the American Banking Association. He serves on the ABA's community banking counsel and on its communications staff counsel.

And I guess that is why you are here, communicating with us today?

Mr. Dana has had varying degrees of experience in all levels of community banking management for over 30 years. You began your career as a teller and worked in every phase of banking to his current position as CEO, which you have held for the last 11 years, as I understand it.

Mr. Dana has been a featured speaker at various national conventions on banking and community development. We look forward to your testimony.

Mr. George Butts. Mr. Butts is program director of ACORN Housing Corporation of Pennsylvania and is testifying on behalf of the Association for Community Organization for Reform Now. From 1991 to 2003 Mr. Butts served as president of the ACORN Housing Corporation.

We welcome you, Mr. Butts.

Mr. Eric Stein, senior vice president for the Center for Responsible Lending of North Carolina and that is an affiliate of Self-Help. Mr. Stein holds a law degree from Yale Law School and a B.A. from Williams College.

In addition, his work experience includes Fannie Mae's office of Low and Moderate Income Housing and he works with Congressman David Price for U.S. Fourth Circuit Court of Appeals Judge Sam J. Irwin III.

Is that Senator Irwin's son? Okay. Good.

Self Help is a North Carolina-based non-profit community development lender that includes a credit union and a loan fund. Mr. Stein manages its home loan secondary market, commercial lending and real estate development programs.

So we appreciate your testimony, as well as Mr. Butts.

And last Terry Theologides. He is executive vice president, general counsel and secretary of New Century Financial Corporation and is testifying on behalf of the Coalition for Fair and Affordable Lending.

He is a frequent speaker on predatory lending prevention and avoidance from the perspective of loan originators and secondary market participants.

Received his law degree from Columbia University School of Law; earned his Bachelor's degree from Princeton University.

Mr. Theologides runs the Compliance Legal and Fair Lending functions at New Century which is the country's second largest non-prime lender.

So, we welcome our panelists, obviously very knowledgeable panelists. We look forward to you informing our committee about the day-to-day practices of the subprime lending market.

Mr. Samuels, I am sorry, this is the first I have called your first name, but if you will, Sandor, if you will open the testimony.

STATEMENT OF SANDOR E. SAMUELS, SENIOR MANAGING DIRECTOR AND CHIEF LEGAL OFFICER, COUNTRYWIDE, ON BEHALF OF THE HOUSING POLICY COUNCIL OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. SAMUELS. Good morning Chairman Bachus, Chairman Ney, Ranking Members Waters and Sanders and members of the subcommittees.

I am Sandy Samuels, Senior Managing Director and Chief Legal Officer of Countrywide Financial Corporation.

If I seem a little nervous it is not just because this is my first time testifying before a House committee, my 16-year-old daughter is taking her driving test this morning. So I am a little nervous about that.

We appreciate the opportunity to testify today on behalf of the Financial Services Roundtable's Housing Policy Council. In today's testimony we want to give the subcommittees a better picture of the non-prime borrowing market served by Countrywide and the member companies of the Housing Policy Council.

While the market knows us primarily as a prime lender, Countrywide entered the non-prime lending market in 1996 as a natural extension of our commitment to reach those outside of mainstream mortgage markets.

Despite the industry's ongoing successes in expanding access to prime loans, the fact remains that a large segment of the borrowing public does not meet the eligibility criteria for prime loans.

Two recent examples of actual Countrywide borrowers will illustrate this. Earlier this year, Countrywide made a non-prime loan to Mr. and Mrs. S. from Nicholasville, Kentucky, who were struggling to make ends meet.

They had a high rate second mortgage at more than 14 percent. This and other consumer debts pushed their monthly debt service to over 50 percent of their $3,000 monthly income.

Although the S's had an excellent credit score in excess of 700, the loan-to-value ratio necessary for them to consolidate their first and second mortgages exceeded the guidelines for a prime refinance loan.

Our non-prime affiliate, Full Spectrum Lending, was able to make them a $94,000 loan at a loan-to-value ratio of 99 percent. The new loan had a 30-year fixed rate of 7 percent with points and lender fees totaling $2,500, and lowered the couple's monthly payments by more than $200.

Their monthly debt-to-income ratio is now a much more manageable 43 percent. However, had Mr. and Mrs. S. lived in North Carolina or New Jersey their loan would have been considered a high cost loan and Countrywide, which does not make high-cost loans, would not have offered it at those terms.

Our second example, Mr. C. from Clovis, California, had a 510 credit score and monthly mortgage and other debt payments that exceeded 60 percent of the income from the tanning salon he owned.

We helped Mr. C. consolidate his 7.75 fixed-rate mortgage, his adjustable-rate second mortgage and his other debts into a 30-year fixed rate first mortgage at 6.875 percent with total discount points and lender fees equal to 4 percent of the $264,000 loan amount.

This loan lowered Mr. C's monthly payments by more than $1550 and reduced his monthly debt ratio to a much more manageable 43 percent of his income.

Mr. C's low credit score precluded any rate reduction refinance or debt consolidation with a prime loan. Again both New Jersey and North Carolina law would consider this a high cost loan, and therefore, we would not have been able to make it at these terms.

Let me share with you some of the broad demographics of Countrywide's prime and non-prime first mortgage borrowers based on our most recent three months of production through February of 2004.

The average age of our non-prime borrower was 43, identical to the average age for our prime customers; 6 percent of our customers were over 60; 10 percent of our prime customers were over 60. Not surprisingly, the average FICO score of our non-prime borrowers was 608 compared to 715 for our prime borrowers.

The average amount borrowed was virtually identical between prime and non-prime customers: $179,000 for non-prime, $182,000 for prime.

Even the incomes between our prime and non-prime customers are remarkably similar: $69,000 for non-prime compared to $74,000 for our prime borrowers.

The average note rate on a non-prime loan was 7.12 percent over the three-month period; the APR on our non-prime products for the period was 7.83 percent compared to 5.44 percent on our prime products.

As illustrated in the additional borrower profiles in my written testimony, several elements, in addition to credit scores, can move a borrower from prime to non-prime status including the borrower's ability or willingness to document income, stability of borrower's income, lack of financial reserves, loan-to-value ratio on the mortgage property and the characteristics of the property that affect its collateral value.

Non-prime products give borrowers more choices and make credit more readily available because we, and other lenders, can price loans according to the level of risk.

Before the advent of risk-based pricing, the mortgage banker's only other choice was to reject those borrowers who did not fit the prime lending standards.

Of course, in taking more risk we find that credit problems leading to delinquency do occur more frequently in the non-prime market. However, our experience indicates that they occur for predominately the same reasons that they occur in the prime market: life disruptions that interfere with the borrower's ability to repay.

Fortunately, responsible non-prime lending can be a second chance for individuals to get their economic houses in order and reestablish good credit.

Just as these life disruptions represent temporary, not permanent setbacks of families, Countrywide's internal data show that non-prime status is a temporary condition for many of our borrowers.

Of our non-prime customers who refinance with Countrywide approximately 45 percent graduate into prime products. This is com-

pelling evidence that non-prime loans do indeed, provide a second chance for families who have experienced adverse life events.

The industry recognizes that bad actors have taken advantage of vulnerable segments of our communities and they must be stopped.

This is why the HPC supports congressional efforts to accomplish four main objectives: enactment of strong, uniform national standards to directly address these predatory practices; effective enforcement of those standards by both federal and state regulators; stronger financial literacy programs that begin in our school and reach to those who never got the chance to gain literacy skills in their formative years; and expanded access to high-quality home ownership and credit counseling for those who seek it and for those who need it.

The industry supports a strong new federal standard, but this standard must not unduly increase costs, eliminate choices or reduce the availability of credit to the types of borrowers that I mentioned earlier my testimony.

Non-prime loans play a crucial role in promoting home ownership and providing financial options to customers outside of the main stream: a mission I know the members of these two subcommittees share.

We look forward to working with the Congress to advance these mutual goals. Thank you very much for your attention and I would be pleased to answer any questions the committee may have.

[The prepared statement of Sandor E. Samuels can be found on page 157 in the appendix.]

Mr. BACHUS. I want to thank the witness for your testimony.

Next we go on to Ms. Bryce.

STATEMENT OF TERESA BRYCE, VICE PRESIDENT AND GENERAL COUNSEL, NEXSTAR FINANCIAL CORPORATION, ON BEHALF OF MORTGAGE BANKERS ASSOCIATION

Ms. BRYCE. Good morning, Mr. Chairman and members of the committee.

My name is Teresa Bryce and I am the general counsel of Nexstar Financial Corporation, a national mortgage lender and a mortgage loan processor for other financial institutions, both large and small.

Today, I appear on behalf of the Mortgage Bankers Association as a member of its board of directors. Thank you for giving us the opportunity to share our views.

Mr. Chairman, the mortgage banking industry is vital to the nation's economy. Today, more than two out of every three American families own their own home.

This is a truly amazing historic achievement and MBA members continue to push for even greater availability of credit, especially in those communities that have traditionally lacked access to financial opportunities.

The so-called subprime market that we are exploring today serves a traditionally underserved group of borrowers that would otherwise have little or no access to credit because of blemished or other credit problems.

We can make loans to these consumers through risk-based pricing and other innovative financing options that were not available 20 years ago.

The future growth of the subprime market is however, confronting very serious hurdles. In the zeal to protect our more vulnerable consumers, State and local governments are passing far-reaching laws that are creating a confusing and fragmented mortgage market.

As we have testified in the past, over the past 3 years close to 30 states have enacted different anti-predatory lending laws with more pending.

We are beginning to see that this bewildering patchwork of State and local laws is forcing reputable lenders out of the market and deeply stifling the flow of capital to many deserving communities.

Mr. Chairman, in my capacity as legal counsel, I have spent considerable time tracking and focusing on the issue of predatory lending.

Even though over the years I have been very involved in promoting the expansion of credit to underserved communities I have advised my company to avoid operations in the subprime market.

I am very disappointed to reach this conclusion, but it is a decision premised on the enormous legal risks that have evolved in this market segment.

Risks that, in my opinion, very much outweigh any possible benefits that could be derived from subprime operations.

Mortgage lending is subject to pervasive federal consumer protection and disclosure laws. On top of these strong federal regulations, the layer upon layer of state laws is making it increasingly impossible to ensure compliance and legal certainties.

Even lenders who concentrate on prime market loans have to spend much time and money in trying to navigate this maze of State and local anti-predatory laws.

At Nexstar, we have purchased an expensive and sophisticated software package to evaluate each individual transaction subject to those laws to ensure that our loans do not trigger coverage.

Notwithstanding these efforts, there is still no assurance of compliance because some of the tests imposed by these disparate laws are so complicated or subjective that they cannot be programmed into a software system.

For instance, the Georgia reasonable tangible net benefits test worksheet is three pages long and still requires very subjective decision making that is always reviewable by a judge.

Even using the best tools available in the market, there is no way for a mortgage company to proceed with certainty in knowing that it has successfully complied. This increasing legal disarray is a real albatross for small businesses.

The penalties under these laws for even unintentional violations are often draconian and pose too much financial risk. These penalties are dreadful for large institutions, but they are potentially fatal for small businesses.

Since these high cost laws impose assignee liability most investors simply refuse to fund them. Moreover, our investors are now requiring us to give strict representations and warranties that we are not selling them loans covered by these State and local laws.

Again, this adds great cost and much risk and is a burden that falls especially hard on small lending institutions.

In summary, the legal risk associated with subprime operations are so great and the liability so enormous that I cannot in good conscience recommend that my company enter this market.

Nexstar Financial originated over 17,000 loans last year. None of these loans were in the subprime market.

It is truly regrettable that our company and other reputable lenders are opting to entirely forego this neediest segment of our mortgage market.

We must act to remedy this situation because in the long run only true market competition among a large number of lenders will work to expand choice and lower costs for those communities that are most in need.

Mr. Chairman, industry participants are in agreement: we need a single national standard so that we may bring order to the bewildering fragmentation of our mortgage market and thereby preserve competition in this segment.

Thank you for the opportunity to appear before the committee. I look forward to answering your questions.

[The prepared statement of Teresa Bryce can be found on page 109 in the appendix.]

Mr. BACHUS. Thank you.

Mr. Dana?

STATEMENT OF WILLIAM DANA, PRESIDENT AND CEO, CENTRAL BANK OF KANSAS CITY ON BEHALF OF AMERICAN BANKERS ASSOCIATION

Mr. DANA. Thank you.

Chairman Bachus, my name is William M. Dana, president and CEO of Central Bank of Kansas City, Missouri.

We are designated as a community development financial institution. I am pleased to testify on behalf of the American Bankers Association. I commend you for holding these hearings.

Subprime lending, or more precisely, lending to those with less-than-perfect credit ratings is an important category of lending that has helped better lives of many Americans.

As with all lending, it must be done in a straightforward manner with all appropriate disclosures so borrowers understand the obligations they are undertaking.

Subprime should not be confused with predatory lending which is characterized by practices that deceive or defraud consumers.

Predatory lending has no place in our financial systems and there should be aggressive enforcement of laws and regulations designed to prevent such practices.

Subprime lending is an extremely important part of my small bank's business.

The community my bank serves has many individuals and families who are not wealthy and often lack a perfect credit score, who need credit and look to our bank to provide it. In many cases the loans for which they qualify are subprime.

We provide full disclosure of all the terms of these loans and work hard to make sure our borrowers understand the obligations they are assuming.

It does our bank no good and certainly our borrowers no good if they do not fully understand this important financial obligation.

I would like to share some examples of the kinds of lending, subprime lending, my bank does and the impact on our community if we do not extend these loans.

We have helped people who have been victims of predatory loans like a retired couple with a $19,000 annual income.

They had taken a second mortgage against their home with a siding contractor paying 19 percent annual interest. My bank refinanced their mortgages on much better terms and eased their worry about losing their home.

My bank also helped new businesses get started like a loan to buy an accounting and tax service business targeted to Spanish-speaking immigrants.

The applicant had a low credit score and her business partner had an even lower score. Nevertheless, Central Bank financed the acquisition at 8.5 percent using the business and a personal residence as collateral.

Without our loan, these women would not be in business serving our large Hispanic population. They were both inviting targets for predatory lending by unscrupulous lenders, but instead they have a good loan at a fair price benefiting them and the customers they serve.

We have also helped those in trouble in our community. A local church came to us when they had a church van repossessed and another lender had begun foreclosure proceedings against the church.

The Pastor came to us and even though he had a troubled credit history, he agreed to guarantee a loan made by Central Bank. Working together we were able to help him save both the church and the van.

Without Central Bank's participation in the subprime market, these borrowers, and many more like them, would not have these opportunities to help themselves and their communities. Instead they would likely have been targets for predators.

A desire to do more to prevent predatory lending is understandable. It is important to note however, that the practices typically associated with predatory lending are already illegal. What is often lacking is proper enforcement.

Laws that add additional requirements only raise the cost of these types of loans. Complying with many different State and local requirements adds a regulatory burden, impedes efficiency, raises costs and reduces the amount of credit available.

In ABA's opinion, a national standard to prevent predatory lending may be desirable to ensure that all lenders, whether they are depository or non-depository, operate under the same requirements.

The ABA looks forward to working with the members of the Financial Services Committee to explore legislative options for a national standard to combat predatory lending.

Thank you.

[The prepared statement of William M. Dana can be found on page 141 in the appendix.]

Mr. BACHUS. Want to thank the gentleman for his testimony.

And Mr. Butts?

STATEMENT OF GEORGE BUTTS, PROGRAM DIRECTOR, ACORN HOUSING CORPORATION OF PENNSYLVANIA, ON BEHALF OF ASSOCIATION FOR COMMUNITY ORGANIZATIONS FOR REFORM NOW

Mr. BUTTS. Thank you.

My name is George Butts and I am the program director of the ACORN Housing Corporation of Pennsylvania.

Equal Housing has offices in 34 cities throughout the United States. We are one of the largest providers of housing counseling services in the country. We have put 52,791 people into homes.

ACORN Housing works closely with our sister organization: ACORN, a leader in the fight-to-win economic justice for all.

When we first started this fight it was about access. There wasn't any money coming into low-income neighborhoods. That is what creates a vacuum that subprime and predatory lenders rushed in to fill.

Now the question is not access, but what kind of access. The fight is becoming making sure that the subprime market is cleansed of discrimination and predatory lending.

Let us be clear: we are not against subprime lenders. They have a role to play in our marketplace; everybody is not going to qualify for an A loan.

But we also know that there is a lot of work to get to a well-functioning market in this industry. Recent steps taken because of public pressure are helping get us there.

For example, in recent years Ameriquest, Household Financial, Citigroup, Fannie Mae and Freddie Mac have all made changes to help stop predatory lending.

However, for every reformed household, there is an unrepenting Wells Fargo Financial and a dozen small subprime brokers who routinely engage in predatory practices.

The subprime market is still an unregulated mess. These problems run deep, are systemic and occur to people from all backgrounds, but they are particularly targeted to elderly, low-income and minority homeowners.

Let me start with a story of a family from Louisiana.

James was a veteran of 25 years in the Marine Corps. He and his wife, Doris, bought a home through the G.I. Bill in 1994. Their mortgage had an interest rate of 8.5 percent.

Wells Fargo Financial first contacted——

Mr. BACHUS. Excuse me, Mr. Butts, if you could just speak up. Thank you. We want to make sure we get it. Thank you.

Mr. BUTTS. Okay.

Wells Fargo Financial first contacted them by sending live checks in the mail and they cashed one which resulted in a very high interest rate loan.

Then Wells began pushing them to consolidate debts into their mortgage, promising lower monthly payments. In December 2001, Wells gave them a nine-year mortgage.

The loan officer never told them that it included almost $11,000 in finance fees. This was over 11 percent of the amount financed compared to the typical 1 percent charged by banks.

James and Doris already had insurance but were forced to finance in single-premium credit life and disability insurance, which stripped away another $6,400.

Instead of their current interest rate of 8.5 percent, Wells put James and Dorothy into a higher interest rate of 11.4 percent. The massive fees put the loan well over the house's appraised value.

When the couple fell behind on payments, Wells convinced them to refinance, promising lower rates which added in thousands in new fees, an unnecessary insurance policy and a higher interest rate of 13 percent.

James and Doris wanted to refinance to a lower rate, that is when they discovered that they had a five-year prepayment penalty which would add $10,000 to the cost of the loan.

This is just one story among tens of thousands. Unfortunately, too many loan features that are totally legal are profoundly uncompetitive and non-transparent.

Higher finance fees, prepayment penalties and yield-spread premiums are all easy to hide. Strip equity from borrowers and reward lenders and brokers for the number of transactions they complete rather than how many performing loans they set up.

The annual study we released earlier this month, Separate and Unequal Predatory Lending in America, shows that African America and Latino homeowners are at least two times more likely to receive a subprime loan.

What makes this especially troubling is a recent report in Inside B&C Lending indicating that nearly 83 percent of subprime loans went to customers with A-minus or better credit ratings. This happens particularly to people of color. This, itself, is a form of predatory lending.

There is no reason to accept claims that fair regulation of subprime loans will lead to lenders leaving the market. In North Carolina, for example, the State was able to reduce predatory loans without hurting the subprime market.

Other states have passed strong laws against predatory lending. Federal laws should not preempt this progress.

In my home state of Pennsylvania, Philadelphia's predatory lending law was preempted by the State's much weaker and ineffective law. On a federal level, the Community Reinvestment Act needs to be strengthened; banks should be given more credit for prime loans than subprime loans.

By strengthening the CRA, we can help create a stronger market of good loans in underserved communities. This will help drive out the predators.

This is going to be hard, but that is okay. As Frederick Douglass wrote, "If there is no struggle, there is no progress. Power concedes nothing without demand. We have seen the system move before and it can move again."

Thank you for the opportunity to address you today and I will be happy to answer any questions that you may have.

[The prepared statement of George Butts can be found on page 124 in the appendix.]

Mr. BACHUS. Want to thank the gentleman for his testimony.

Mr. Stein?

STATEMENT OF ERIC STEIN, SENIOR VICE PRESIDENT, CENTER FOR RESPONSIBLE LENDING OF NORTH CAROLINA

Mr. STEIN. Thank you very much. I am Eric Stein with the Center for Responsible Lending, which is a research and policy nonprofit.

Thank you Chairman Ney and Chairman Bachus for the opportunity to testify; and Ranking Member Waters.

The Center for Responsible Lending is affiliated with Self-Help, which is also a community development financial institution. And we have done $3 billion worth of financing across the country to 37,000 families for one purpose: and that is to make people build wealth through homeownership.

As a lender, starting in the late 1990s, we started seeing families come to us who had loans that were directly attacking our mission because they received loans but these were loans that put their homeownership at risk.

I will just give one quick example.

A woman who works for the Durham Public School System came to us with a loan from Green Tree Financial. A $99,000 loan, $16,000 of which were upfront fees, including single-premium credit insurance.

She is an elderly African American woman. She had a very high interest rate, higher than her credit warranted and she had a prepayment penalty, which meant she couldn't get out of that loan.

There was nothing we could do to help her. And everything that was wrong her loan was legal under state law and federal law at that time.

We got together with industry groups in North Carolina, a really remarkable coalition: large banks, small banks, credit unions, mortgage bankers, mortgage brokers. We all negotiated on a bill, along with community groups and civil rights groups that really had one primary strategy: and that was to squeeze down on fees and allow interest rates to adjust.

The reason that we thought to do this was that most of the subprime lending are refinance transactions. The reason that Mrs. V., it is the borrower that I mentioned, paid such high fees is that she didn't realize what she was doing.

If you have a refinance loan and an unscrupulous lender wants to charge high fees, they tack it on to the loan balance. And all that does is decrease the equity available on the house.

It is not like you are paying out cash at closing, like in a purchase transaction, but it is really an easy thing to do and the same thing happens on the back end as happened to her, in terms of a prepayment penalty: she would have had to pay that later and she didn't feel the pain when she signed the loan document.

So, in North Carolina, we wanted to squeeze fees, let interest rates adjust. We believe in risk-based pricing; we do risk-based pricing or we wouldn't still be in business.

If the lender overcharges on interest rates, the best protector of that are responsible lenders who will come back later and refinance that borrower out and give them an appropriate interest rate.

But, if a lender charges fees that are too large, there is nothing you can do once you sign those loan documents. That family wealth is gone forever; it is not there to pass on to future generations.

That was the strategy that we all agreed to in North Carolina and the results 4.5 years later are in and the results are positive. Other states have taken the same strategy.

First, what we found is that equity stripping is down; that stripping of wealth that we tried to address is down. University of North Carolina did a study that is the most comprehensive by far, and found that the number of refinanced loans with predatory aspects to it is down in North Carolina significantly after the law.

Loans like Mrs. V.'s were flipping, which did not benefit the borrower. Those types of loans are now illegal, so those types of loans have decreased as well.

Second, steering is the second predatory characteristic that has decreased in North Carolina.

The UNC researchers found that loans-to-borrowers with credit scores above 660, those who are much more likely to be able to get lower cost conventional loans are down 28 percent in North Carolina, whereas conventional lending was up 40 percent in North Carolina.

Which I think leads to an important point: in the next panel, you might hear that if the number of subprime loans decreases, that inherently means that the State law is a disaster. But what you need to do is to look what type of loans aren't being made, because it is not that credit is reduced, it is the number of subprime loans are down and that might be a good thing.

In North Carolina, the UNC research has found that it was a good thing that there were equity-stripping loans that were not being made and there were subprime loans that could go to conventional that weren't being made.

The third problem in subprime that we addressed in North Carolina is foreclosures. There is going to be more discussion next panel. It is too early; we don't know what the research says about that in North Carolina.

What we do know is there was a study in Louisville that a third of all the foreclosures there were due to subprime loans with predatory features, exactly those features that North Carolina made illegal and UNC found were reduced as a result. So we can be hopeful there.

The other point I would like to make about North Carolina is that while the number of abusive subprime loans are down, credit is still widely available.

UNC found that subprime purchase loans, the ones that actually buy a home and increase homeownership are up, faster than the national average.

Subprime refinanced loans to borrowers who have no other options, who have credit scores below 580; they are up as well by 19 percent.

The other point is that Inside B&C Lending found this, and UNC found it as well, if credit really were scarce in North Carolina, one would expect interest rates to increase because credit would have been rationed and the way to address that is by raising the price of it, which is interest rates.

In fact, that hasn't happened. Interest rates have not risen in North Carolina, compared to the rest of the country.

The Banking Commissioner received tons of complaints about mortgage lending; not a single one by a borrower who couldn't get access to credit.

The last point I would make is that the subprime industry increased this year compared to last year: 2003 over 2002 by 50 percent, to $332 billion. And it is not an industry that is in peril, is the point I would like to make.

[The prepared statement of Eric Stein can be found on page 190 in the appendix.]

Mr. BACHUS. Thank you.

And we will move on.

Just to explain, the bells have rang, so we have two votes: one 15-minute, one five-minute vote.

But we will go on with Mr. Theologides, his testimony. And then we will do the votes and members will come back for questions.

STATEMENT OF STERGIOS THEOLOGIDES, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, NEW CENTURY FINANCIAL CORPORATION, ON BEHALF OF COALITION FOR FAIR AND AFFORDABLE LENDING

Mr. THEOLOGIDES. Thank you, good morning.

The Coalition for Fair and Affordable Lending and New Century Financial Corporation, the second largest non-prime lender, appreciate the opportunity to testify.

I am Terry Theologides, executive vice president of Corporate Affairs for New Century, one of CFAL's founding members.

We believe that in today's nationwide housing finance market, uniform, federal statutory standards for non-prime lending should be enacted to apply equally to all types of mortgage lenders and to provide strong protections to all Americans, while preserving access to affordable, non-prime mortgage credit.

New Century and other CFAL members look forward to continuing to work with you to help craft legislation that can be passed with very broad bipartisan support.

It is my honor to appear before you.

Chairman Ney, Chairman Bachus, Congresswoman Waters, we commend you for holding today's hearing to further members' understanding of the non-prime market and the Americans who rely on it.

Non-prime mortgage lending originations were roughly $325 billion in 2003, representing 10.5 percent of all mortgage originations.

The non-prime mortgage market's expansion since the early 1990s has significantly increased access to affordable credit for millions of Americans who historically have been unable to qualify for credit under so-called prime mortgage underwriting standards.

We acknowledge that unfortunately, there have been unscrupulous lenders, who have engaged in abuses that are fraudulent, deceptive and illegal.

Clearly, enhanced enforcement, together with more financial education and counseling opportunities are needed to help prevent these abuses from occurring.

More importantly, however, we believe that it is imperative for Congress promptly to pass new federal standards to strengthen

consumer protections while preserving access to affordable credit. We want to work with you to craft such a law.

In my testimony this morning, I want to summarize four key points, which I addressed in much more detail in my written testimony.

These are: what is the profile of a typical non-prime borrower; how do we ensure that non-prime borrowers we lend to have the ability to repay those loans; how do we determine the appropriate risk-based price for loans we make to our borrowers; and why don't these borrowers qualify for prime loans.

The profile of the typical non-prime borrower is that they are middle-class, in their 40s and 50s and their racial and ethnic mix is representative of the U.S. population as a whole. They had an average income, in 2002, of $71,500.

Before you and in my written testimony, we have several charts that summarize these demographic characteristics.

When responsible non-prime lenders underwrite a mortgage loan, we look to assure ourselves that the borrower will have the ability to repay that loan.

In doing so, we recognize that borrowers who have more challenged credit profiles, or exhibit other higher risk loan characteristics represent a greater risk; therefore we analyze each loan carefully before we approve it.

As a result, our industry has a 52 percent loan denial rate for non-prime loans, compared to a much lower denial rate of 13 percent for prime lenders.

The pricing of loans in the non-prime mortgage market is very much a function of both competition and risk. As a result, the spread in the interest rates between prime and non-prime mortgages continues to compress and it now averages between 1.75 to 2 percent above today's typical prime mortgage rates.

The handout accompanying my oral testimony and my written testimony demonstrate how our interest rates and points and fees track by risk grade. Our risk-based pricing starts with the categorization of applicants into one of six separate risk grades, based on a variety of factors.

An automated computer program assigns our applicants' risk grades. Once an applicant is categorized into a risk grade, her interest rate depends on a variety of additional factors, including loan program, loan size, credit score band, loan-to-value ratio, income documentation, property type and a variety of other factors.

Many Americans have difficulty qualifying under the more stringent prime mortgage underwriting guidelines.

To help illustrate why our borrowers end up with a non-prime loan instead of a prime loan, we took our key underwriting guidelines and juxtaposed them to Fannie Mae guidelines. We then ran through our entire population of 2003 loans through these screening criteria.

We found that 81 percent of our customers had a credit score below 660, which alone would have disqualified them from the prime market.

Moreover, when we dug further and looked into credit income documentation and other loan characteristics, we found that 96.5 percent of our borrowers had characteristics that would have pre-

cluded them from qualifying for a conforming mortgage, based on the published Fannie Mae guidelines.

Of the 3.5 percent that could potentially have qualified for a conforming mortgage, they end up in our top credit grade and today, those rates are 5.5 to 6.5 percent.

Mr. BACHUS. Not to interrupt the witness, but the time has expired.

We are going to go to the vote, and so the committee will be recessed approximately 15 to 20 minutes.

We will be back.

Mr. THEOLOGIDES. Thank you, Mr. Chairman.

Mr. BACHUS. Thank you.

And then we can conclude.

[Recess.]

Mr. BACHUS. Members will be arriving in and out. We have a member, I am sorry. Four members. Five.

Not that I am not paying attention to you, Mr. Clay, I just got back here and was a little unnerved over a close vote. How about that?

Well, what we will do is we will go ahead and did you have any final comments, because the bells were ringing, Mr. Theologides?

Mr. THEOLOGIDES. I did. Just a couple more comments.

Should I start, Mr. Chairman?

Mr. BACHUS. Real brief.

Mr. THEOLOGIDES. Sure.

Before you all left for your vote, I was indicating that on credit, about 81 percent of our customers had credit scores below the level that is used by regulators and many financial institutions to demark where is a prime and where is a non-prime loan.

And that looking at other characteristics, you actually get down to about 3.5 percent of our borrowers that maybe would have qualified for a prime loan. And they receive very attractive rates from us in the 5.5 to 6.5 percent range.

We recognize there are some bad lenders and brokers who take unfair advantage of borrowers.

We accordingly support strengthening current federal law, as well as enhancing enforcement in consumer financial education opportunities.

We also understand that many State and local legislators who have stepped in to try to fill the gaps in the federal HOEPA law had been well-intended; however, the irrational patchwork of State and local anti-predatory lending laws that is developing is not workable.

New Century and CFAL strongly support prompt congressional action to provide clear, effective, and workable uniform national fair lending standards for non-prime mortgage loans.

Thank you.

[The prepared statement of Stergios Theologides can be found on page 222 in the appendix.]

Mr. BACHUS. Thank you.

One of the ideas that has been proposed or bandied about was to prohibit charging separate points and fees on a subprime loan, and I guess you would call it front-loaded or put into the interest rate.

Do you have any comment on that? Or anybody on the panel? I am sorry.

Mr. THEOLOGIDES. I would be happy to comment on that, Mr. Chairman.

Certainly, if people are being charged points and fees that are not disclosed to them that is not proper. And certainly that is characterized appropriately as an abusive practice.

But forcing everything into the rate does have its downside.

Many borrowers cannot afford the monthly payment if the compensation is packed into the rate. So, offering them an option of electing either to take some points and fees upfront to buy down the rate and lower that payment gives them a choice.

And certainly, that is our position. Our rate sheet, which is included with our testimony, shows that trade-off. If you want to pay a little bit more in points or a little bit less in points, the rate can adjust accordingly.

So——

Mr. BACHUS. You would also, wouldn't you have to look at the longevity of the loan and the cost if you put it into the interest rate versus outright payment?

Mr. THEOLOGIDES. That is right.

Mr. BACHUS. Or if anybody has calculations or examples of that, I would be interested in that too.

What it would cost versus——

Mr. THEOLOGIDES. Right. The paying additional points can lower the interest rate 50 basis points or more for each point. Which again, on an average loan, can mean $100, $200 in difference in payment.

And so, just as in the prime world, people are making that trade-off, we are concerned that if everything is driven into the rate, that works well for someone who can has the extra cash and can put it into the rate, but it removes some choice from a borrower who may want to make that well-informed choice to buy down their rate, sir.

Mr. BACHUS. Anyone else like to comment on that? No?

Mr. STEIN. I would like to make one point, if I could.

As I mentioned in my testimony, the North Carolina law's goal is not to get rid of points and fees, but to squeeze them a little bit, because that is where most of the abuse occurs.

And you are still allowing five points, which is five times the points and fees paid on a conventional mortgage. It is not like they go away, but it is just favored.

High-cost loans can still be made, but again, there are more protections in place because that is how equity is stripped.

Mr. BACHUS. Thank you.

Mr. SAMUELS. Mr. Chairman?

Mr. BACHUS. Yes?

Mr. SAMUELS. One of the issues that we are confronting is trying to make as many loans available to people who have the ability to qualify and to afford the loans.

And one of the things that we are discussing is where should the appropriate lines be on these triggers, as to what constitutes a high-cost loan, where should they be drawn? The lower they are

drawn, the more people are going to be cut out of the credit market.

Certainly, there are abuses that have been talked about, bad practices that are legal that need to be addressed, such as: people who are made loans without the ability to repay them; people who are made loans who derive no benefit from them; people who are steered to subprime if they could qualify for prime.

Those things, I think, if they are addressed in the legislation, I think that drawing an appropriate line for high-cost triggers that allows people choice, that gives people the opportunity either to finance their points and fees up to a certain level, or to pay them upfront, I think is something that we want to be able to do because it will expand the opportunity for people to get credit.

Mr. BACHUS. Well, thank you.

Go ahead.

Ms. BRYCE. I would just add that is what we have seen in the marketplace is that in the purchase market, in particular, there has been difficulty with consumers being able to come up with the amount of money they need for closing costs and down payment, even on prime loans.

So as a result, I think you need to leave the option of doing either one because they may need to finance in some of their points and fees in order to be able to get the loan.

Mr. BACHUS. Thank you.

One question I have, Ms. Bryce, is you talked about the patchwork of state laws, and some of the complications that arise over that.

I wonder if you could just give us an example.

And I am going to finish my questioning in the back and forth here, and we will have some additional time.

But very quickly, if you can give me one example of a complication of state laws; different patchwork, but also, I also I would even take it a step further, I guess, as we go on here, of municipalities.

I mean dealing with the State is one thing, but I can tell you in municipalities, and I know in Ohio, I think it is been unfair to people.

If you are in Cleveland it is going to be a different story for you than maybe if you are in Dayton or somewhere else and defined of the State law by the locals, so you have a hodgepodge of laws all over our state.

But right now, if you could just tell me about a complication involving state laws.

Ms. BRYCE. Sure.

I would echo what your comment is about Cleveland, because with——

Mr. BACHUS. Not to become Cleveland, but——

Ms. BRYCE.—but for instance, a good example is in the State of Illinois, with the City of Chicago.

Where you already have the federal HOEPA laws, but the Department of Financial Institutions of Illinois also has issued a set of regulations on mortgage loans.

Cook County has also passed an ordinance related to these practices, as has the City of Chicago, in addition to the already expansive mortgage lending laws that cover our lending practices.

So in fact, in the City of Chicago, you are subject to at least four sets of laws, not including the federal law.

Mr. BACHUS. Thank you.

And my final question, and then I will move on to other members, would be for Mr. Butts.

In the separate and unequal study, I think it is asserted that a large number of the current subprime borrowers actually qualify for prime loans, I think is what it said.

Now, I think if you have a credit score below 660 you can't receive prime credit. So, how can that study say that 35 to 50 percent of the subprime borrowers qualify for prime rates when about 80 percent of those individuals have credit scores below 660, which would be a cutoff rate?

Mr. BUTTS. Because in a lot of cases a lot of mainstream banks have products that are not just based on credit scores, but they are based on the credit report and what the credit report says.

And people who come to counseling agencies like us, because we have things to help mitigate the risk. So, our rate right now for a fleet loan with a credit score of 580 is 5 percent.

And a lot of people——

Mr. BACHUS. Sorry, 580 is 5 percent?

Mr. BUTTS. Five percent.

So, people can qualify. And I mean that is one of the reasons that we put that statement at the beginning, where we say what really needs to happen is that the mainstream financial institutions need to work harder at providing alternative products to what the predators are doing.

I mean this is some of the things that are happening in Philadelphia right now, with our Mini-PHIL and PHIL-Plus programs.

That was a consortium of banks and counseling agencies, and the city, where we all put together and got a product that directly addresses what the predators were doing, which was going after people with home improvement loans and giving them high interest rates.

Now they can come to a regular mainstream bank with a credit score, for some institutions, as low as 550, and get a regular home improvement loan and not have to go to the predatory loans.

Mr. BACHUS. Can I ask the lender? I just haven't heard of below 550 at 5 percent.

Mr. DANA. Mr. Chairman, maybe I can address a little bit from our experience, as a community development bank.

We typically make loans regularly on credit scores that would not qualify as what you would consider a prime rate. Most of our clientele that we deal with have had some type of credit experience or difficulty with credit in the past.

So, basically it becomes an issue of working with those borrowers on a one-on-one basis regardless of what their credit score is to get them a product that will accomplish what they are looking for, which is in most cases, wealth-building of some type.

Mr. BACHUS. So it can happen with 580 and you can get 5 percent? Statistically, you know what percentage of individuals can do that?

Mr. DANA. I can't quote statistics, I can just speak to what happens in our individual institution, but if there are statistics like that, we could see if we could find some and get back to you.

Mr. BACHUS. Mr. Theologides?

Mr. THEOLOGIDES. We are the second-largest non-prime lender, so we are working with programs that can be offered, sort of, nationwide.

And for a 580 borrower a 5.5 percent interest rate is probably not impossible, but it is pretty tough. It has to fit into a lot of other parameters. But that borrower would today get in the sixes or in the sevens.

And again, we have grown to be the second-largest in this industry not charging more than everybody else. We have been among the most competitive.

So, I think while there might be some specialized programs——

Mr. BACHUS. Because not a down payment might be a factor also, I suppose?

Mr. THEOLOGIDES. Amount of down payment, loan-to-value rates——

Mr. BACHUS. If they have a lower credit score, but they have a certain amount of holdings or assets?

Mr. THEOLOGIDES. Absolutely.

What I would illustrate is, and what we have put in our testimony is there are lots of variables; it is not a black box. You look at the different variables of what the credit is, what the loan-to-value is, what the assets are, and it is available on our Website.

It is not mystery pricing, it is looking at all of these variables and how they affect the risk to the lender and everyone. We are competing vigorously against Mr. Samuel's company and when his rates go down in the morning, I hear it from my people in the afternoon.

We are always struggling to try to compress how we can balance the risk, the increased risk, but at the same time maintain competition in this segment of the market.

Mr. BUTTS. I also think the key to mitigating that risk ha been loan counseling.

We do a lot of what we call character lending, where we are actually looking at the circumstances and we are suggesting. And a lot of times we have access to the underwriters who are actually drafting, approving these loans.

And we are making the case that based on this set of factors we think you should make this loan. And more often than not, because of the parameters that we have set up with them, we are able to do that.

Mr. BACHUS. Now in some cases, when you are talking about the 580 or below, is the CDFI subsidizing, well, giving the full-faith backing?

Community Development Finance——

Mr. DANA. I can speak to that.

We are a CDFI, and on an individual loan-by-loan basis, the CDFI does not grant grants based upon individual loans. They do it on the overall picture based upon your increase in lending into distressed communities.

Mr. BACHUS. Not a grant, but I mean a subsidation.

Ms. BRYCE. I think you do have to look at certain bank programs because some of them are created for CRA purposes and they are a negotiated program.

And sometimes they are essentially unprofitable programs for the banks, but they decide to do those programs at any rate.

So, I think you have to know what you are looking at and how it compares to what else is available in marketplace.

Mr. BACHUS. Well, in a generic basis, a broad-brush basis, are these loans exceptions to the rule or it happens a certain amount of time, or it happens a lot, to put it kind of in layman's terms because we don't know statistics.

Are these exceptions to the rule, the below 580 credit score at 5 percent or do they have them with certain frequency or?

Mr. DANA. Yes, Mr. Chairman, I would agree with Terry, that it is an unusual situation. You would have to look at the circumstance.

Certainly, you can buy down the rate to very, very low, but with 580——

Mr. BACHUS. Not to interrupt you, but let me put this caveat in there.

Let us just talk about market-based loans; no CDFI, no type of special, first-time homebuyer rates, market-based loans. Are a lot of people getting these loans below 580?

Mr. SAMUELS. I mean one of the things I mentioned in my testimony is that our average rate for the last three months ended in February, was just a little over 7 percent for our non-prime borrowers. That is the interest rate.

The APR would be in the high sevens. So, a 5.5 percent rate for someone who is clearly in the subprime category, which somebody of 580 or below credit score would be, that would be unusual. But again, we would have to take a look at the circumstances.

Mr. BACHUS. I apologize; I have run way over my time.

Ms. Velasquez? Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

Let me just say first of all, since this is the first hearing or opportunity since H.R. 3974, the bill that Mr. Miller and I dropped, let me make a couple of comments.

I know this is about subprime lending, but most everybody has talked about predatory lending and is sometimes difficult to know where the line is between subprime and predatory lending.

So, what I wanted to ask each of the panelists, and maybe other people in the audience, to do is now that the bill has been dropped, essentially reflecting what the North Carolina standard is, in as many respects as the North Carolina standard fit at the federal level.

There were some respects where we had to make some adjustments just because it was not a perfect fit at the federal level.

I want to invite comments and feedback from those participants in the industry who understand this dynamic and want to emphasize that as North Carolina's purpose was not to drive lenders out of the market, neither was Representative Miller, and my purpose to drive any lender out of the market.

And we are trying to find what the appropriate balance is. We think our balance is better on balance than the Ney-Lucas bill, I would have to say.

But——

Mr. BACHUS. You always have time to reflect and maybe change your mind.

Mr. WATT. But we also understand that reasonable minds can differ on a number of the issues, and so this is the stage at which feedback is welcome.

We couldn't get feedback from everybody before we dropped the bill, but that is the purpose of dropping a bill, that is the purpose of having hearings and hopefully through a series of hearings we will get to a bill that is an appropriate standard.

Having said that, we know that there are and have been specific benefits that have resulted from the North Carolina law, and since Mr. Stein is here from North Carolina, perhaps I would give him the opportunity to put some of those benefits into the record as we start to build this record.

Mr. Stein?

Mr. STEIN. Thank you Mr. Watt.

You probably won't be surprised to hear that I think your bill is an excellent one.

I think based as it is on the North Carolina law, which was negotiated by industry and consumer groups, I did mention a lot of the benefits, and going back to the previous question about are people getting the appropriate loan, and I think for people in North Carolina that is increasingly the case.

Since borrowers with credit scores above 660, again, there are fewer of those in North Carolina getting subprime loans, they are getting conventional loans.

There is less equity stripping because fees are squeezed into a five-point bucket, which isn't squeezing so far again, that is five times the amount of fees in conventional, but UNC found that abusive equity stripping loans are gone from the market, and yet credit is still widely available.

I think it has been a pretty unqualified success in North Carolina as a result of the law.

Mr. WATT. Perhaps we could get a copy of the study that was actually done.

And Mr. Chairman, I might ask unanimous consent to make that University of North Carolina study a part of the record of this hearing so that everybody would have the benefit of it.

[The following information can be found on page 273 in the appendix.]

Mr. BACHUS. Without objection.

Mr. WATT. I think my time is about up.

I wanted to go a little bit further into this issue that the chairman raised about the interplay between points on the one hand and interest rates on the other hand. But I think we will have opportunity to do that over time.

So trying to keep within the spirit and the letter of the five-minute rule, Mr. Chairman, I will yield back.

Mr. BACHUS. I want to thank the gentlemen.

Mr. Hensarling?

Mr.HENSARLING. Thank you, Mr. Chairman.

I certainly appreciate the serious nature of this hearing and the serious legislation that has been drafted to attempt to address it.

But there is a great challenge for the committee because, as I listen to the testimony very closely and listen to the opening statements, as we are dealing with the issue of subprime lending, and I guess it is evil cousin predatory lending, there doesn't seem to be an acceptable definition of what constitutes predatory lending.

If so, it is going to be very difficult for us to legislate against something that we are having a little trouble defining in the first place.

I, for one, believe that absent any compelling evidence of force or fraud, I am loathe to outlaw a commercial transaction between consenting adults.

When we are dealing with the issue of fraud, obviously these subprime loans are subject to a number of disclosure regulations already, so the first question I will place to a couple of members of the panel.

What disclosures are presently missing from HOEPA that you would like to see in legislation? What is not being disclosed to the consumer in the offering of this credit?

Why don't we start with you, Mr. Samuels?

Mr. SAMUELS. Thank you, Mr. Hensarling.

First of all, I want to thank you for your leadership in Plano, Texas, where we have a large facility and we appreciate all your help in moving a lot of employees over to Plano.

Let me address what predatory lending is, and then we will get to the disclosures.

I think that predatory lending can be defined in a number of ways, and we are talking about bad practices, including fraud, including making loans to someone who cannot repay, including making a loan to someone where there is no benefit to that individual.

And I think that those are the areas that we really need to focus on in crafting good, solid, uniform federal legislation, preemptive federal legislation that can really address directly the issues that we are talking about.

In addition, however, in direct response to your question, we have a number of disclosures that Countrywide uses to help people understand what the nature of the loan is.

For example, there is been a lot of talk about prepayment penalties.

One of the things that we do is we provide our borrowers with a choice between a loan with a prepayment penalty and a loan without a prepayment penalty.

And we have a disclosure form that very clearly sets forth what the loan looks like with a prepayment penalty and what the same loan would look like without a prepayment penalty, and what benefit would be gained from taking a prepayment penalty, and what the amount of the prepayment penalty would be, to give people a good idea of whether it would make sense for their particular circumstance to take a loan with a prepayment penalty.

If they take the loan with the prepayment penalty, they will get a benefit on the price of the loan. You see? So we have that disclosure.

We are also creating a disclosure that I have talked to several of your colleagues about. That is, a summary of loan terms, because as you know, we have a very thick stack of documents at closing.

What we want to do is to take the summary of loan terms and we call it, "Understanding Your Loan," that basically says, "Here is what your loan is. Here is the interest rate, here is the monthly payment."

"Is it a 30-fixed? Is it an ARM?" All of the basic and important terms of the loan, so that somebody could see that before they sign on the bottom line.

Also, they would be able to use that document if they decided they wanted some counseling and they wanted somebody to look at that loan, the counselor would not have to pour through hundreds and hundreds of pages, they would have a document that says, "This is what the loan looks like, is it a good idea or not".

Those kinds of disclosures. We have broker disclosures, having our borrowers understand what the role of a broker is, and how a broker is compensated.

So we have a number of things that we do to try to help the borrower understand the loan process.

Mr. HENSARLING. Thank you.

Mr. Samuels, the time passes quickly, I see my time is about to run out.

No pun intended, but I was hoping on giving Mr. Butts a chance to rebut.

I notice in your testimony you mention that a predatory, if I am reading this correctly, that you cite prepayment penalties as a predatory feature, yet Mr. Samuels says there can be a rate differential, based on prepayment penalty.

So, it seems to me that if we are taking away consumer options, how is this helpful to the consumer? And why is a prepayment penalty, per se, a predatory lending practice, Mr. Butts?

Mr. BUTTS. Well, like financed fees it is so easy to hide prepayment penalties.

I think the problem that we have with them, generally speaking, is that one: they are too long, two: that they are not really fairly disclosed to people.

That you understand that you can't, if you take this loan with this prepayment penalty, you are, sort of, stuck in this loan for a certain period of time, and you need to know that upfront before you sign the paperwork.

And the fact that there is no real disclosure about it a lot of times; I know because I have had loans like that before.

God has a wonderful sense of humor; most of the stuff that we have been through, my wife and I, is stuff that we talk about all the time.

So, I saw the paperwork that said prepayment penalty when we sign for a loan that we got, and we said, "Well, why do we have to?"

Well, at the time there at settlement, we had to sign the paperwork, whatever the terms were that they were giving us, we still had to sign it because our circumstances with such that we were told, "Well, you have to. The loan is going to be this much interest

rate and we have got the table with a different interest rate that said, well, you can finance down later on. Just take the loan now."

Those are the kinds of things we hear all the time. And the prepayment penalty was just another part of the process, and another thing they told us not to worry about when we had to sign the papers, because you had to sign it because otherwise you wouldn't get the loan to get out of the mess that you were in.

Mr. HENSARLING. I see my time is up Mr. Chairman.

Mr. BACHUS. Thank you.

Gentlelady from California?

Ms. WATERS. Thank you very much. There are a couple of questions I would like to raise.

First, I am just curious how many lenders represented here today support preemption. Do you support preemption Mr. Samuels, do you support?

Mr. SAMUELS. Yes ma'am.

A federal preemptive bill.

Ms. WATERS. And what about you, Miss——

Ms. BRYCE. Yes, we do.

Mr. DANA. Speaking on behalf of our bank, we are a state nonmember bank, so we are not regulated by the OCC. So, it would be difficult for us to speak to that issue, but the ABA can get back to you on that.

Ms. WATERS. All right.

Let me ask about mandatory arbitration. Can a borrower be refused the ability to get the mortgage, rather, if they disagree with mandatory arbitration? Can you be turned down and turned away?

Ms. BRYCE. Well, there are a lot of mortgage products, or a lot of mortgages in the marketplace today that don't require that don't require mandatory arbitration.

So, I think there is certainly availability of those products without mandatory arbitration.

Ms. WATERS. Now, let me back up.

I personally have been looking at properties and went to escrow in one and talk with realtors about others, and talk with bankers, talk with everybody, and it seems that this is almost a standard practice now to have these mandatory arbitration clauses.

Ms. BRYCE. I can only speak to our company. We do not have a mandatory arbitration clause.

Ms. WATERS. Oh, good.

Ms. BRYCE. And we have discussed that issue, because frankly, having been in the mortgage industry for quite some time now, I have seen a lot of class actions.

And unfortunately, a lot of them have not been because there has been any real damage to the borrower, if any, but rather, because the class-action lawyer was looking for fees.

And so, the whole issue of mandatory arbitration came up in the industry as a way to really have a way to address disputes with a particular borrower.

They really had an issue and have a forum, an alternative way to deal with that, in lieu of finding the industry involved in a lot of class actions.

Ms. WATERS. Yes, I know the reason for it.

What is represented, but I guess the question becomes: Can a customer, can a consumer be denied simply because they disagree with the mandatory arbitration?

Mr. DANA. We do have mandatory arbitration, Congresswoman Waters. And it is one of the required documents that we ask a borrower to sign.

We have worked very hard to make sure that our arbitration agreement is extremely fair.

Ms. WATERS. But could you turn somebody down because they disagree?

Mr. DANA. You mean if they refuse to——

Ms. WATERS. Yes, if they refuse to sign that? Just that one; that is the only thing they have an issue with in there?

Mr. DANA. But it could happen. It could happen, yes madam.

Mr. THEOLOGIDES. If I could comment on that as well, Congressman Waters?

Ms. WATERS. Yes?

Mr. THEOLOGIDES. We have not made a loan ever with mandatory arbitration; it is not in our standard package. But we, CFAL, group Coalition Repair and Affordable Lending, believe this is an area, again, for appropriate federal regulation.

Now, the Countrywide arbitration clause, from what I have heard, is a pretty fair one and they bear all the fees, but there are abusive arbitration——

Ms. WATERS. General standards.

Mr. THEOLOGIDES. Yes.

Ms. WATERS. What I am told is you don't know who will be selected to be the arbiters; you don't know whether or not you have to travel long distances to get involved.

And there are no standards, so what one company could call fair, well, everybody could call theirs fair, but it is all different. There are no standards, is that right?

Mr. THEOLOGIDES. Well, New York adopted some pretty good standards about what goes into a fair, as opposed to an abusive, arbitration clause.

So that is something that this committee should discuss, as it is evaluating how to regulate non-prime lending, to the extent lenders have some standards about what is a fair.

What are the rules; how is the arbitrator selected; who pays; it doesn't seem fair for the borrower to have to write a check just to pursue their rights about a potential dispute.

Ms. WATERS. Why isn't it voluntary?

Mr. SAMUELS. I am sorry?

Ms. WATERS. Why isn't it voluntary? Why can't the consumer have a choice?

Mr. SAMUELS. Frankly, because at the time of the dispute, when the lawyer gets involved, they will always want to get to the jury lottery, and they will not choose the arbitration.

And by the way, I agree with you in terms of standards, and we think that one of the things that a good piece of legislation ought to have are standards so that the venue is in the place where the property is located or where the borrower lives.

Ms. WATERS. Would you accept preemption if a mandatory arbitration was eliminated altogether?

Mr. SAMUELS. Would I accept preemption? That is a difficult question.

What I would do——

Ms. WATERS. You support it now?

Mr. SAMUELS. I would——

Ms. WATERS. And if it had everything in it you wanted except mandatory arbitration would you support it?

Mr. SAMUELS. It is a negotiation process, I would say, and I would say that that would be part of the negotiation.

And if we got everything that industry wanted, I think that that might be something that we would be able to certainly discuss.

Ms. WATERS. Yes, sir.

Mr. THEOLOGIDES. If I could comment on that?

Ms. WATERS. Okay, yes.

Mr. THEOLOGIDES. One of the reasons that many companies elect to have arbitration clauses is this concern about lawsuits. One way to address that might be to provide a meaningful right to cure.

I know that responsible companies, you make a mistake. We had 160,000 loans last year; you are going to make a mistake. If you are a responsible company, you want to hop on that, address it, fix it.

Right now, in the federal HOEPA, there is not, we feel, an adequate right to cure. So if you have made a mistake, God help you.

And so that, as a result, lenders respond to that saying, "Well, I lost my ability to fix it, now I need to defend," and be concerned about that.

So I think many, not speaking for Countrywide, but I think many lenders philosophically, if they had a right to fix their errors, may be more receptive to constraints on mandatory arbitration because then you don't have to worry about it.

Look, I will clean up. If one of my people made a mistake, it is my job to fix it, give me that chance for 30 or 60 days, upon proper notice, and then shame on me if I haven't fixed my mess.

Ms. WATERS. Would you agree with that, Mr. Samuels?

Mr. SAMUELS. Yes ma'am.

Ms. WATERS. Thank you.

I yield back.

Mr. BACHUS. Thank you.

The gentleman from Vermont: Mr. Sanders.

Mr. SANDERS. Thank you very much, Mr. Chairman.

Before I ask a few questions, I do want to point out that I always am amazed that conservatives, who often tell us how bad the big mammoth federal government is, now want to preempt those little old states where democracy flourishes.

So, I always find that interesting.

I maybe think that what we need is a very strong federal floor, in terms of predatory lending, but we have to allow states to address their own needs, and if they want to go further than the federal government, I think that they should be very clearly allowed to do that.

Let me ask Mr. Stein a few questions, if I might.

Mr. Stein, how has North Carolina's subprime mortgage market changed since the enactment of the 1999 anti-predatory lending law?

Mr. STEIN. The market has changed by limiting upfront fees that borrowers pay, which has eliminated a lot of the equity stripping abuses that have happened.

It has also changed in the sense that borrowers, who qualify for conventional loans, are actually getting conventional loans more than they are getting subprime loans.

So, both of those factors mean that there are fewer subprime refinanced loans that are happening in the State, but that is not the same thing as saying credit is not widely available, it is just the fact that the borrowers can go to the conventional market and get a loan.

And I think that the market has improved significantly.

Mr. SANDERS. So, you have touched on this.

My second question and that is, Has North Carolina's anti-predatory lending law hurt Self-Help's ability to make subprime home loans?

Mr. STEIN. No.

This is a national statistic, but we made $3 billion worth of loans nationally. In North Carolina it is probably $1.25 billion worth of loans.

And the interesting thing about the North Carolina law is that it was the representatives of the large banks, of the community banks, of credit unions, and when those are agreeing to actually voluntarily be regulated, then that is something to take notice of.

North Carolina is not a hotbed of government regulations, and they were supporting a bill that imposed regulations on them. They haven't asked to be preempted from it.

And so all of us have been able to make responsible loans in North Carolina following the implementation of the law.

Mr. SANDERS. Has anyone ever brought to your attention a prospective borrower who could not get a mortgage loan because of North Carolina's laws, provisions?

Mr. STEIN. No. We have never seen such a borrower.

We have seen a ton of them who receive loans that they shouldn't have received because there is no benefit to the borrower.

The Banking Commissioner is the one who probably would have heard the complaints more than us.

Seventy-5 percent of all the Banking Commissioner of North Carolina's complaints are due to mortgage lending.

Not a single one has ever been from a borrower who couldn't get access to credit, and we haven't seen that borrower either.

Mr. SANDERS. There are contradicting studies of the effects of the North Carolina law.

Could you briefly tell us why you think the University of North Carolina study gives a better picture of North Carolina's subprime market than the study conducted by the Credit Research Center?

Mr. STEIN. Sure.

UNC has the most recent and far-reaching study. They used a loan database called Loan Performance, which is the only one that actually looks at the terms of the loans that were happening in North Carolina.

They looked at seven quarters before the law was implemented, and seven quarters after the law was fully implemented, and compared those two, compared it with the country.

The Credit Research Center, their research ended the day before the law became fully implemented. You can't really learn much there.

And all they could do is say that credit had decreased a little bit.

But what UNC did is they took it a step further.

What subprime loans were not made because to say that subprime loans were not made could be a good thing; could be a bad thing.

And what they found was that the loans that weren't being made were the ones that the law intended to prohibit, which are equity-stripping or abusive loans.

So, they used a much more comprehensive database, they looked at the terms, and they used a longer time period.

Also, it is a publicly accessible database, as opposed to Credit Research Centers which is proprietary with anonymous lenders.

Mr. SANDERS. Okay.

My last question is how does the North Carolina law prevent the flipping of subprime home loans?

Has the provision helped curb abuses?

Has the tangible net benefit under all the circumstances created problems for responsible lenders?

Mr. STEIN. That was a very controversial provision when it was placed in there and we have had a lot of discussions about what should the standard be.

And it is kind of like obscenity, in the sense that it is hard to put an exact definition to it.

And what we said was if anybody could think of a better standard we are happy to implement it. And nobody could, and so nobody loved it, but everybody lived with it.

And I think it is had as much impact as the rest of the law. The important thing about it: I agree on class actions, in this case.

This is not something where you can really do a class action because it is the individual circumstances of the borrower looking at their new loan, looking at their old loan, looking at all their circumstances.

So, there is been very little litigation in North Carolina about it. I think that provision is largely responsible for the fact that North Carolina borrowers who are eligible for conventional loans are getting those instead of subprime loans.

Mr. SANDERS. Okay.

Thank you very much, Mr. Chairman.

Thank you.

Mr. BACHUS. Thank you.

Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

We all know, or we all heard that they are hanging on their subdefault on foreclosures in the subprime market.

And the numbers are, unfortunately, skyrocketing in some low-income communities, like my district in New York.

It has been brought to my attention that some lenders and loan servicers have developed relationships with large housing counseling agencies, in which they contact the housing counselor when one of their borrowers becomes delinquent. Then the counselor contacts the family to offer assistance.

Can any of the lenders and consumer groups comment on this type of relationship and whether you think it would be helpful in preventing recipients of subprime loans from going into foreclosure?

Yes?

Mr. STEIN. May I respond?

We think that is a wonderful idea, and frankly we are working with the 3-1-1 program in Chicago, where that is one of the features of the loss mitigation tools.

Our biggest challenge in helping people avoid foreclosures is getting people to call us.

That is the biggest challenge that we have, because when we can talk to someone, we more often than not, and way more often than not, can do a workout with them. You see?

Our company loses on average $30,000 for each foreclosure. It is not in our interest, it is not in our investor's interest, and it sure isn't in the borrower's interest to go through a foreclosure.

And we spend a lot of time and effort and resources to mitigate these losses.

We have a very large Loss Mitigation Unit, and we would be delighted to work with housing agencies or counseling agencies.

Ms. VELAZQUEZ. Okay.

Mr. STEIN. There are privacy considerations, but they can be overcome, and we can develop those kinds of arrangements.

Ms. VELAZQUEZ. Yes?

Mr. BUTTS. When we initially bring people in for counseling, one of the forms that they sign is a disclosure form, stating that it is okay for the lender to get back in touch with the counseling agency if the loan goes to 30 days late, or even 15 days late in some cases, so that we can intercede on the lender's behalf to try to see if there is something we can work out.

A lot of times, what we have been finding especially lately, with the high foreclosure rate in Philadelphia, is that a lot of people haven't been driven to us to get that help in the first place.

The sheriff's department had a record 1,000, over 1,000 foreclosures last month and it worried everybody to such an extent that everybody in the area got together: the lenders, the city, the counseling agencies, everybody.

And we held this big symposium on the 18th, where we had people who were about to lose their homes, the sheriff's sale, come in and try to get work outs and everything done.

They had to sign disclosures saying that it was okay. But it was the unification of will, I think, that sort of helped get that done.

And what we are finding, looking at a lot of these cases now, that people are starting to come in from the sheriff's sale, is that a lot of them, when you look below the surface, had bad loans to begin with.

They had servicing problems with the servicers that caused defaults. They had problems with the lawyers. Then the banks wanted to work out an agreement, but they couldn't because the lawyers wanted their money upfront.

And there wasn't enough money there to solve the default and pay the lawyers. All kinds of wild and unusual problems that are showing up here that are causing these defaults and foreclosures.

Ms. VELAZQUEZ. Thank you.

Many borrowers who may qualify for prime mortgage credit are paying higher costs for subprime loans.

What role do you think consumer education can play in ensuring that families that qualify for the prime mortgage do not end up with higher costs of a subprime loan?

Yes Ms. Bryce?

Ms. BRYCE. Well, I think with consumer education there is an opportunity there to let people know that they have so many options.

And that is why it is so important to promote competition in the marketplace.

It is important for people to know that they should shop for a loan. We have encouraged that, the whole disclosure scheme that we have is designed around trying to shop, but in fact, a lot of——

Ms. VELAZQUEZ. But that is part of education.

Ms. BRYCE. Right. A lot of people don't do that, and so we need to promote that.

Ms. VELAZQUEZ. Okay.

On the other side, we have many borrowers who are not financially prepared to purchase a home that are targeted for subprime loans and are a greater risk of default and foreclosure.

Do you think requiring subprime lenders to advise families to seek housing counseling before purchasing a subprime loan will help mitigate the effects of predatory lending?

Mr. BUTTS. I think that is absolutely true, that that would be one of the things that we would actually need.

I mean in some ways, education is the easiest part of this to fix, because everybody is out there doing education.

It is the systemic problems that are in a lot of the industry that we really need to fix, because we can't get at that if people going door-to-door talking people into getting loans that they can't afford.

Ms. VELAZQUEZ. Can we hear from the lenders side?

Ms. BRYCE. It is also an opportunity to deal with fraud and misrepresentation.

I think that has come out in a couple of situations and discussions here, and those are the kinds of practices that you can only get to through some type of counseling to understand that that is going on.

Those are already practices that are illegal, but identifying them up front would help then move a borrower into another situation.

Mr. SAMUELS. Right, we very much encourage people, if they wish it and seek it, to get counseling, and we provide the 800-number for the HUD counseling services.

We believe if there is an educated borrower, we win.

Ms. VELAZQUEZ. But you don't have any problem if that is a requirement?

Mr. SAMUELS. A requirement, you mean mandatory counseling?

The problem is the expansiveness of the requirement. There are people who need it, certainly, but there are people who really feel that they don't need it.

And a lot of these people feel very insulted and actually discriminated against. That is what our experience has been.

We had a HUD required counseling program. Many people were very upset about it. We think that counseling programs need to be

available; people need to know about them; they need to have an 800-number that they can easily access; and we should encourage people who feel that they need that to access it.

A mandatory counseling program, however, you are talking about, you know, millions of counseling sessions.

Mr. BACHUS. Time has expired.

Ms. VELAZQUEZ. Yes.

Mr. BACHUS. Go ahead, if you want to finalize it.

Mr. THEOLOGIDES. Well, I would concur with Mr. Samuels.

That every borrower within three days of application gets the 800-number from us of a counselor. Some elect, many do not.

We think borrowers should have the choice, should they feel they need it, but making it mandatory for two or three million loans is a lot of counselors that today don't exist.

And so we would be concerned about making it mandatory, because it would slow down the ability of people to re-fi or buy a home.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. BACHUS. Excuse me.

Thank you.

Mr. Miller?

Mr. GARY G. MILLER OF CALIFORNIA.Thank you, Mr. Chairman.

I have been in the development industry for over 30 years, and I agree with what you are saying.

Most people come in, they want to know what their down payment is going to be, their closing costs, and what interest rate, and that is it.

You want to try to steer them to the proper people, but mandatory could make it very, very difficult.

And like we were discussing RESPA reform, and putting a reform measure out there that really made it very difficult for mortgage brokers to stay in the business really bothered me, because a lot of people will go to a lender who don't have time to go out and worry about a person's credit report, and they will get turned down, because they don't qualify for prime.

And they will go to a mortgage broker, and they will work with them and find a way to help them with their credit report, look for a lender who makes the subprime loan and get them into a home where they might not otherwise be able to do that.

I am not putting lenders down, don't get me wrong, it is not intended to do that, but it is a difficult, complicated marketplace. It is like a puzzle, anytime you impact part of it, you impact the whole.

And oftentimes we start debating subprime and predatory, and we blur the distinction between the two.

And we need not do that. I mean I have been very concerned with looking at what we have done in about 30 states and municipalities, especially Oakland in California and Los Angeles.

Things they have done on the Georgia line really, really bother me because there is a lot of people out there who have credit ratings that are not quite what they would like them to be, and what some lenders in the prime marketplace have to look and categorize as less than prime.

And if you start allowing the direction I think they went in Georgia and Oakland in California, you start eliminating the option for many people who otherwise would be able to buy a house, you put them in a position where they have to be renters.

And above all, we want to avoid that because we look at the major opportunity for people to acquire private wealth, it is owning your home.

I voiced today the issue of, you know, section 8 vouchers. They are fine temporarily, but we have to do something to have a move up market, where people can get out of the section 8 into a home of their own.

And I guess I would like you to, Ms. Bryce, maybe you could answer this one: could you please expand on how the additionally newly passed and soon-to-be effective laws that are very similar provisions to the Georgia law, how those really impact people who want to borrow money to get in a home?

Yes, madam? And anybody on the panel who would like to address that.

Ms. BRYCE. Well, I think what happens is as each one of these laws comes down, and there is almost not a day that goes by that I don't get an e-mail about something new that is pending, we are having to step back and look at what the ramifications are in that particular marketplace and decide whether that is something where we have to pull back in that marketplace.

And that is something that we are just not accustomed to having to deal with.

And so, I think that what it does is it reduces the amount of competition because that means there is less availability of credit in that marketplace, and competition is really what is going to drive better terms in the subprime market.

And I think what we want to do is balance what we do to protect consumers who have been preyed on and still preserve that competition and in fact, increase that competition in the marketplace.

Mr. SAMUELS. Some of these laws and regulations at the local level and the State level have created difficulty for the secondary market.

I think it is reasonable to say that if within the loan documents and the loan papers that a secondary lender looks at them, if they can understand that this is a predatory loan they should back off, but if the secondary marketplace reviews the loan documents and goes through the normal recourse, and there is no information in the report that shows, in any way, that that is a predatory loan.

Some of these local ordinances and laws have put a secondary marketplace where they are liable regardless. What detriment do you think that is going to have if we don't clarify this in the law?

Ms. BRYCE. Well, I think we have already seen some of the rating agencies come back and say that they are not going to rate pools of loans for mortgage-backed securities that include loans in some of these jurisdictions.

And that essentially creates a situation where the lender doesn't even have a choice because if you are someone like us, we don't have a portfolio, so we have to sell our loans into the secondary market.

And so, if the rating agencies say, "We won't rate them," then essentially everybody pulls back.

And I think it is important, whatever standards there are, they need to be clear so that each of us knows as we go about doing our business what the rules are so that we can comply with those rules and not have a situation where later someone is going to second-guess whether it was right or wrong.

Mr. SAMUELS. I mean I have watched and listened to the debate at the local level, city council in passing ordinance on this, and they are well-intended. I don't argue that they have the wrong goal in mind, but the consequence is disastrous to people who want to own a home.

And you often look and say, "Well, states should have rights to make certain laws and requirements and ordinances that people should comply with," but don't you think it is time for a national standard on this?

Because why should people in one part of the country or one specific city be a jeopardy of the concept of owning a home just because an unintended consequence occurred by a local ordinance or a state rule?

Don't you think at this time we have enough information that we can clearly define predatory and subprime and come up with a national standard to comply with?

Ms. BRYCE. Well, I think certainly the federal government has the resources to come up with a good national standard.

Mr. SAMUELS. I believe we do too, but don't you think it is time that that happened?

Ms. BRYCE. I think it is definitely time that we need to do that.

And frankly, I don't see why for a consumer who is sitting in Washington D.C. that there are different rules if you decide to buy in Washington D.C., Maryland or Virginia.

And there are a lot of places that are the same for those people who live in St. Louis who might decide to live in Illinois or people in the New York metro area.

I think if you have one standard then it is also much easier to educate consumers so that they know what their rights are, and they know how to identify the practices that are illegal.

Mr. SAMUELS. Would anybody else like to respond?

Mr. STEIN. And one other benefit is our ability to lower the costs of homeownership, because if we have one standard as opposed to having this patchwork quilts, where our compliance costs are just going through the roof, if we are able to do it at all.

From a macro level we have to decide whether we are going to stay in a jurisdiction or pull out of a jurisdiction, or restrict our lending in a jurisdiction.

And from a micro level, looking at the borrowers that I described in my testimony earlier, these people would not be able to get their loans.

And so, you can look at it from the business standpoint, we also need to look at it from the consumer standpoint and what the benefits of these types of laws——

Mr. BACHUS. Time has expired.

Mr. SAMUELS. In closing, Mr. Chairman, we need to have a standard that is transparent, that it is not vague and ambiguous,

leaving the secondary market at risk for an unintentional act on their part trying to do well.

Thank you, Mr. Chairman.

Mr. BACHUS. Mr. Lucas?

Mr. LUCAS OF OKLAHOMA. Mr. Chairman, on behalf of the Ney-Lucas bill, I think that certainly, the North Carolina standard has done a lot of good.

And as Mr. Watts and Mr. Miller have some legislation out there, but I think the testimony and comments have been very enlightening here today, and it is very beneficial to me.

But I think all we are really trying to accomplish here is to come up with some good public policy where it is a win-win situation: where the law of unintended consequences isn't over burdensome.

Certainly, Mr. Butts, the case you talked about, with the Marine veteran for 25 years and what happened to him was very egregious, and those things should never happen.

But I think we have got to be careful when we come up with new standards that they aren't overly burdensome. We are never going to come up with anything perfect.

I guess what I would like to hear from anyone on the dais that would comment is is there anyone who would speak against a uniform national standard; a state standard, Mr. Stein?

Mr. STEIN. I think if, for example, the Miller-Watt bill were passed, and that is inherently preemptive in the sense that it overrules anything that directly conflicts with it.

Plus, it is a strong standard, so there would be no incentive for states to pass another law because it will be an ineffective one.

I think Mr. Miller's point really goes to the question of federalism.

Should states be allowed to make rules on what happens within their state? There is an interesting article by the American Enterprise Institute that talks about if you have something that is a local activity, where the commercial actors there can exit, they can leave if they don't like what the politicians do, then that is something that should be left to the State.

If Georgia goes too far in seeking assignee liability, which they did, then the rating agency is totally within its rights to say, "I am not going to rate any loans there." And lenders then can't make loans there.

But what happened was the General Assembly realized that, and they quickly corrected that problem. That was federalism at work.

If HOEPA preempted back in 1994, North Carolina never would have been able to say that single premium credit insurance is an abusive product.

The question is does Congress have, while, there is a lot of wisdom in Congress, are they necessarily going to get it right?

A state has much greater ability to change on the fly when there are abuses or when there are loopholes. Debt cancellation agreements are a supplement to single premium. States can fix that, and it is much more difficult for Congress to do so.

So I think you can have a national standard, but it should be a floor, and I think that floor will govern most of the country, but if North Carolina realizes that there is a single premium credit insurance problem, it should be able to correct that problem.

And the last point I would like to make is that it is not like the subprime industry has been driven into the ground by state laws. I mean it increased by 50 percent last year.

How many industries increased by 50 percent in one year? I think that the subprime industry is very strong and vigorous, as it should be, but if states see an abuse, they should be able to fix it and protect their citizens.

Mr. BACHUS. Okay. Others?

Mr. Butts, comments?

Mr. THEOLOGIDES. If I could figure out my microphone. There we go.

The comment on that last point, I mean we do feel that there needs to be a national standard, that a lot of states don't have protections comparable to some of the leading states at this point.

But in so doing, we have to take greater about how that standard is designed. And although I say we learned a lot from the North Carolina experience, and we, New Century, are lending there, and I think we learned a lot of good lessons from North Carolina about how to structure it.

There are also a negative consequences, and you know, in the two of our top 20 states, the two states where we have the highest interest rates, are North Carolina and New Jersey.

Why is that? Not because our rate sheet is automatically higher for those states, but because we are not able to use all of the different tools that we have in the toolkit that can offer a borrower a chance to lower their payment.

And so more gets driven into the rate, and in those states the rates are slightly higher. Now, many of the borrowers can make that adjustment, but there are some borrowers who can qualify at that $1200 a month payment, but they can't at the $1400.

And if we take away the tool, whether it is a prepayment charge or the ability to finance some points and fees, to bring them down to that $1200, those borrowers are not getting credit.

And that is our belief that at the margin, in the lower credit grades and in the smaller loan amounts, that are the most sensitive to those variations that borrowers today in New Jersey, in Georgia and North Carolina, are not getting access to credit that their neighbors in neighboring states can get today.

Mr. BACHUS. Good point.

Any other comments?

Ms. BRYCE. I would just add that I think the numbers are telling, in that MBA, our estimate, is that about 6,000 lenders are out there nationwide and about 150 of them are in the subprime market.

And I think this is a driver of why that number is so low.

Mr. BACHUS. Time has expired.

Go ahead if you would like to.

Mr. BUTTS. The aim here should be to have a good floor.

I think the experience in Philadelphia is instructive here, because what we did in Philly was pass one of the strongest predatory lending bills in the country, and it got preempted by the State legislature and replaced with a much weaker, ineffective bill.

And we wouldn't have had a problem with the Philadelphia law being preempted if that law was going to be strong and address the issues that we need to protect our constituents.

But that didn't happen in Pennsylvania's case. And so we want the same thing here, if there will be a federal preemption law, that it would be a strong protection in it for our constituents.

Mr. BACHUS. Well, gentlemen, I also want to thank the gentleman from Kentucky for his hard work on this bill and support throughout the whole process.

Mr. Miller, from North Carolina?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Samuels?

Mr. SAMUELS. Yes, sir?

Mr. MILLER OF NORTH CAROLINA. I had a question or two about the examples that you gave on page seven of your testimony.

Mr. and Mrs. S, $94,000 loan, lend-to-buy ratio 99 percent, 30-year fixed rate of 7 percent, points in lender fees totaling $2,500; and you say that that could not have been done under North Carolina law.

What is the provision in North Carolina law that would prohibit that loan?

Mr. SAMUELS. It was the points and fees trigger, sir.

Mr. MILLER OF NORTH CAROLINA. Well, that is $2,500 on a $94,000 loan that is 3.65 percent.

Mr. SAMUELS. There is also a prepayment penalty involved in this, and that would have been also included in the points and fees trigger.

Mr. MILLER OF NORTH CAROLINA. That is not listed in the hypothetical. There is no mention of that in the hypothetical.

Mr. SAMUELS. No, no.

Mr. MILLER OF NORTH CAROLINA. Okay.

And in the second hypothetical——

Mr. SAMUELS. The reason I took it out, frankly, was to try to get it under 5 minutes. But anyway, that is——

Mr. MILLER OF NORTH CAROLINA. Okay.

But the only thing that made it illegal was the only thing, was what you took out to shorten your testimony?

Mr. SAMUELS. I am sorry?

Mr. MILLER OF NORTH CAROLINA. The only thing in the description of this loan that would have prohibited it, under North Carolina law, is what you took out to shorten your testimony? I visualized a prepayment penalty.

Mr. SAMUELS. I know it was a prepayment penalty.

Yes, the prepaids plus the points and fees put it over the limit.

Mr. MILLER OF NORTH CAROLINA. Okay. Prepayment is not listed in the facts that you set forth.

Mr. SAMUELS. Correct.

Mr. MILLER OF NORTH CAROLINA. And what you set forth is 3.65 percent of the mortgage.

In the second example, again, there is a fairly long description. It sounds like a good loan: 30-year fixed rate, less than 7 percent. Four percent upfront, discount points, lender fees.

Some language in here about why he needed to borrow the money; it all sounds like good reasons. And again, the only thing in this real case, is the prepayment penalty, is that right?

Mr. SAMUELS. Well, there are four points here.

Mr. MILLER OF NORTH CAROLINA. Okay.

Mr. SAMUELS. Another issue that is of concern, that is also not here, again because of the time, has to do with affiliate fees. These are fees that are paid to our affiliates for closing costs, appraisals, things like that.

Mr. MILLER OF NORTH CAROLINA. Is that in the——

Mr. SAMUELS. It is not in the testimony, no sir.

Mr. MILLER OF NORTH CAROLINA. Okay. All right.

And in the last example that you gave, that would in fact, well, apparently——

Mr. SAMUELS. Yes, in the written testimony, that would have qualified.

Mr. MILLER OF NORTH CAROLINA. Okay. Thank you.

Mr. Dana?

Mr. DANA. Yes, sir?

Mr. MILLER OF NORTH CAROLINA. How are you, sir?

Mr. DANA. Fine.

Mr. MILLER OF NORTH CAROLINA. Ms. Waters asked earlier if everyone here agreed with the preemption. I think that you said that you couldn't really state the ABA's position on that, and then Mr. Stein, I think, leaned forward and whispered in your ear. Was he telling you that, yes, the ABA does support preemption?

Mr. DANA. Yes, a preemptive national standard would be supported by the ABA.

Mr. MILLER OF NORTH CAROLINA. That is what I thought he was telling you.

Mr. Dana, your testimony says, "Concerns about predatory lending should be addressed through a unified national standard and you will recommend that Congress actively consider proposals for such an approach to predatory lending."

Have you heard the phrase, "It takes an act of Congress"?

Mr. DANA. Yes.

Mr. MILLER OF NORTH CAROLINA. Okay. What does that mean to you?

Mr. DANA. Lots of red tape and regulation in order to get it done.

Mr. MILLER OF NORTH CAROLINA. It is really hard.

Mr. DANA. Yes.

Mr. MILLER OF NORTH CAROLINA. That is what it means to me, too.

It used to be just a phrase and in the last year it is taken a real meaning.

And when I am asked to describe what it is like to serve in Congress, nimble is not one of the words that comes to my mind.

HOEPA was passed in 1994. I think almost none of the practices we are talking about were addressed by HOEPA because they weren't really prevalent or even existing at that time.

If we pass a law that lifts certain practices and prohibits them, and then says no State or local government can do anything else, when new practices come along that we haven't thought of, it is going to take an act of Congress, isn't it?

Mr. DANA. Well, I think one of the things we have to remember is that we are interested in making our communities better.

We want asset building, we want wealth accumulation, we want folks to be able to own housing when they are able to qualify for it.

Mr. MILLER OF NORTH CAROLINA. How are we going to get at new abusive practices?

Yes sir, I would like an answer.

Mr. THEOLOGIDES. I believe we have certainly learned a lot over the last 10 years, and in the first cut we should knock out the abusive practices that have been identified today, but accompany that legislation with some authority federally to provide some means to regulate and provide, again, a federal standard that would be uniform nationwide to address those abuses.

I mean we do see responses in the various agencies to abuses, and usually they can get their faster than the legislature can, but right now, there is no mechanism in most of the non-prime lenders, like ourselves.

We have 50 different state licenses and so if there could be a single approach or mechanism to deal with those abuses, again, folks that are in it for the long haul want those abusive practices out of the industry.

And we do want people to be nimble to respond to it, but we would prefer to have one really good response that covered everybody instead of 100 different ones, some of which might be effective and some of which might not be.

Mr. BACHUS. Thank you.

Mr. Sherman, then Mr. Clay, and then Mr. Scott and Mr. Davis.

Mr. SHERMAN. For the first time in the history of this committee we have two Brads in a row.

I would like to address Brad's concern that the federal government is not terribly nimble with a couple of things.

First, whatever law we pass should give substantial authority to whichever regulatory agency we empower because it takes an act of Congress is a big deal, it takes a regulation of an agency is a smaller deal.

And I think that a regulatory agency with expertise might be about as fast as at least my state legislature.

I would point out also that while the States may look nimble, if one or two or three states can act quickly, there are many States that right now don't prohibit any of these practices.

And so, we shouldn't judge the federal government against the most nimble, we should try for most nimble for the most Americans.

And that a federal regulator might be as nimble as the average State and might be even more nimble than my state.

While talking on federalism, I would also point out that perhaps we would want to have in our federal law something that says a state could embrace plan A or plan B.

I don't think you folks can deal with 400 different municipalities, but you may be able to deal with one or two different approaches.

I also want to address Ms. Maloney of New York's concerns for assignee liability.

Assignee liability I think kills the secondary market, and the secondary market is critical.

At the same time, what we want is really solid assignor liability. And the problem Ms. Maloney brings up is your assignor may be a fly-by-night or an undercapitalized operation.

What I will be proposing in the legislation is that we have a bond or an insurance requirement. Now, if the assignor is very solid, the insurance company should sell the insurance very cheaply. If the assignor is, in the belief of the insurance company, a risky operation, then they should charge a lot for it.

But I would think that if an assignee is buying a portfolio, where the assignor is liable and that liability has some insurance behind it, that that ought to be enough to ensure it protection.

I have a question for every member of the panel, and that is, Could you identify one, two or three states that you think has a good law that Congress ought to use as one of the models for drafting federal law?

I guess I will start with Mr. Theologides, as I believe he is the most anxious to respond.

Mr. THEOLOGIDES. Right, well, you know, I figured I might run out of states.

Mr. SHERMAN. Well, no, you are allowed to name the same states.

Mr. THEOLOGIDES. Okay. I would say——

Mr. SHERMAN. In fact, if you all agree that one state is the best model you will make our life a lot easier. Go ahead.

Mr. THEOLOGIDES. Well, I think there are elements, there is no silver bullet, but there are elements, certainly, of California, New York, and North Carolina that I think this process needs to consider very carefully, and elements of those laws have been very effective.

Mr. SHERMAN. Mr. Stein?

Mr. STEIN. Yes, I think North Carolina, New Mexico and New Jersey, and I would say that North Carolina does have assignee liability, as long as damages are is bounded to secondary markets the rating agencies can rate the loans and the lending can continue, and the borrowers have a chance to save their house, as opposed to suing a lender and perhaps collecting money five years later.

Mr. SHERMAN. Yes?

Mr. BUTTS. North Carolina and California——

Mr. SHERMAN. You like California?

Mr. BUTTS. Oh, it is all right.

Mr. SHERMAN. It is a beautiful state.

Mr. BUTTS. I would say North Carolina and New Mexico.

Mr. SHERMAN. So you are naming California, New Mexico, and North Carolina?

Next?

Mr. DANA. Congressman, we feel at the ABA that we will work with the committee to get the right combination of whichever laws are most prevalent.

Mr. SHERMAN. Next?

Ms. BRYCE. Perhaps Indiana, but also I would echo that we would be looking at what the best practices are amongst the laws that are out there in crafting a federal standard.

Mr. SHERMAN. You have to start somewhere. And my fellow Californian?

Mr. SAMUELS. Right, well, since I'm your fellow Californian, I will start with California, with a few modifications. Also New York.

I agree pretty much with what Terry said.

Mr. SHERMAN. Okay.

If time permits, I will ask a question of Mr. Theologides, and that is what does New Century do to ensure that it brokers do not engage in predatory lending?

Mr. THEOLOGIDES. Well, most mortgages today originate through brokers, and in our case, 90 percent of our loans come through brokers.

And the fact that we have grown to be the second-largest lender in the non-prime world without a major incident or class action or anything shows that the broker business can be done well. It is blocking and tackling, it is background checks, it is a licensing process, it is monitoring the loans, both the data and the individual files, it is listening to your borrower complaints. It is putting the bad brokers on a watch list or getting rid of them, and in extreme cases, even referring them to law enforcement.

Where we struggle is, again, there is not a national repository or database of the list of bad brokers. There are a few state databases and there are some states that don't regulate brokers at all.

So one thing we did like about the Ney-Lucas bill is it provides us a place where we can make sure the broker we just cut off didn't just change his name and moved to the neighboring state.

I think that is another area where a national registry would be helpful to us.

Mr. BACHUS. Time has expired.

Mr. SHERMAN. And as part of that registry——

If I can have just 10 more seconds, is we ought to include those who have been in other financial areas under the jurisdiction of the committee, in particular, who have a bad record in stock brokerage shouldn't then just be able to move over to real estate.

And I yield back.

Mr. BACHUS. Thank you.

Next is Mr. Clay.

Mr. CLAY. Oh, thank you, Mr. Chairman.

And let me think the panel for being here today. Ms. Bryce, welcome to the committee, good to see you.

Let me ask you, when a borrower applies for a loan with your subprime unit but has the credit to qualify for a prime, do you have procedures in place to ensure the borrower receives a prime loan and should not subprime lenders have a policy in place to make sure that each borrower gets the best loans that they qualify for?

Ms. BRYCE. Well, actually Congressman Clay, we don't have a subprime unit, so that wouldn't apply to our company.

However, in a previous company that I worked with we did have procedures for making sure that if a prime borrower was identified that there was a process for trying to move them into the prime area of the company.

Mr. CLAY. Mr. Dana, would you like to address it?

Mr. DANA. Well, all of our borrowers get the same treatment, whether they are subprime or prime borrowers.

The qualifications of the borrower indicate which rate they will be charged at. The higher risk credits may indeed require a higher rate.

Mr. CLAY. Now, you know I am going to follow up with that one.

You know, why is it that African Americans are steered at five times the rate of white Americans to subprime loans when they qualify for prime loans?

Mr. DANA. In our institution, which is the experience that I can talk to, our rates are the same regardless of gender and race.

Mr. CLAY. Excuse me. These costs hundreds of thousands of dollars over time to people, who are steered, who actually qualify, have the same background and qualifications as the next person.

Have you been reading these recent studies lately?

Mr. DANA. Well, we don't discriminate because of race or ethnic background. Our responsibility is to make our community as good as it can be. So, we will take in an application and price it accordingly, regardless of race.

Mr. CLAY. Does this not qualify as economic injustice?

Mr. DANA. Well, the fact that we are making these loans to regardless of what their race is, is not an economic injustice.

Mr. CLAY. Mr. Samuels, perhaps you could tackle it.

Mr. SAMUELS. Yes, sir.

We do have a process. Everybody who comes in through our non-prime unit is run through artificial intelligence underwriting.

If somebody looks like he or she can qualify for a prime loan, that person is flagged and goes to a separate underwriting unit, and we try to make that person a prime loan.

We do a very good job of making sure that we do not steer people who could qualify for prime loans to non-prime. It is probably the thing that we are most proud of because we know what a big issue it is.

Mr. CLAY. Thank you. It sounds like it should be standard practice for the industry.

Mr. Theologides, would you like to add something?

Mr. THEOLOGIDES. Yes. Earlier in my testimony I did note that it has not been our experience that we are seeing borrowers in significant numbers who would qualify for prime and who are being steered to non-prime.

But having said that, I agree that if someone qualifies for prime, they ought to be able to get a prime product or the best product they qualify for.

Having said that, I think one reason that you see a higher concentration of lower income people in non-prime, and Americans of color, is that with lower incomes or lower wealth, it may be more difficult.

We do see in a prime world there are higher denial rates unfortunately for certain segments of our community. So that may be why there is the appearance that there is a higher concentration in non-prime, although if you look at it loan by loan, we are not making non-prime loans to borrowers of any color that would qualify for prime.

Mr. CLAY. Okay.

I am going to come back to you.

Go ahead, Mr. Stein.

Mr. STEIN. I was just going to support your point.

Harvard Joint Center for Housing Studies just released a report where they looked at the question, "If people living in African American neighborhoods get subprime loans at five times the rate of white neighborhoods, 49 percent versus 9 percent, is that based on risk or is it based on some other factor?"

And they said it was not based on risk. I think that the companies that you are talking to here do a good job of making sure that they are not doing that, but in the wider subprime arena, it is clearly happening.

Mr. BUTTS. I think it is also speaks to my earlier point, that there aren't branches in our neighborhoods for people to go to, so the choices they get are with the subprimes or the creditors.

And they get targeted that way, that is true, and there is racism involved here too, and that is true. But the fact still remains that there aren't a lot of branches in mainstream financial institutions in our neighborhood. And I think that is one of the reasons for this.

Mr. CLAY. One more question, Mr. Chairman, for Mr. Theologides.

What credit grade do most of your borrowers, especially those who are minorities, fall into? And are you charging mostly of your borrowers your highest rates?

Mr. THEOLOGIDES. Our borrowers, of whatever color, are run through our same automated engine and they fall into our full credit spectrum.

Most of our loans are in the higher subprime grades, so those people are people that maybe have a few dings on the credit but haven't had a recent bankruptcy or a serious impairment.

And our average interest rate right now is under 7 percent, and for the folks in our top credit grades, they are getting interest rates closer to the low sixes, so we do price according to the risk.

And I think you have hit on, obviously, a very important point that needs to be the subject of this committee's deliberation, is how best to deal with the fact that there are always going to be some borrowers that walk into a branch that maybe doesn't have the right product for them.

And maybe one idea is that to the extent it is a New Century, well, we are a niche player, we are not Wal-Mart, we focus on one thing.

We certainly wouldn't object if a borrower met certain basic criteria that it looks like they might qualify for prime. Let us give them a notice or something saying, "You might want to talk to another institution, they might offer a lower rate than what we would offer."

Mr. CLAY. You all also offer financial education and financial literacy, I understand.

How does that work?

Mr. THEOLOGIDES. We have partnered with both national and local organizations. To offer financial education nationally, we have partnered with NCRC and Southern Christian Leadership Con-

ference, the Congressional Black Caucus Institute, WOW, and the Hispanic Caucus Housing Initiative.

Again, we concur with all the panelists that an educated borrower is in the best position to make an informed choice and avoid being victimized. That goes without saying.

Mr. CLAY. I thank you for your responses. I thank the panel.

Thank you, Mr. Chairman.

Chairman NEY. [Presiding.] Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much.

Mr. Chairman, the essential question we are here to deal with is how do we combat predatory lending without damaging the subprime market?

I take it that everyone sitting at the panel agrees that we need a national federal anti-predatory lending law. It is clear.

There are 44 State and local anti-predatory lending laws. What lessons have we learned from the experiment of these predatory lending laws at the State level; number one on that question.

And number two: what recommendations would you make to us here in Congress in fashioning a federal anti-predatory lending law that would stress what we should avoid doing?

Anyone?

Yes?

Mr. STEIN. Congressman, let me start with the second question first, as to what should be avoided.

And what I think you have heard pretty much a chorus from the lenders is that while we do want to stop the bad guys, and believe me we do, because it is in all of our interests to do that, we don't want to do it in such a way as to dry up credit or to eliminate choices and opportunities for people, who can qualify, should be able to qualify, to obtain credit.

That is a big concern of ours, and you know one of the things we have talked about is that there is been a proliferation of credit in all the States, and that is true. We have experienced historically low interest rate.

These are 40-year lows, and so everybody has been working seven days a week, 24 hours a day to keep up with the business.

The law of physics is what goes down must come up. And so, ultimately the interest rates are going to rise, and we have to take a look at these laws and what the triggers are that we are going to be imposing.

How are they going to operate when interest rates are not at 5, 6, 7, 8 percent but they are at 7, 8, 9, 10 and above?

And we have to make sure that what we do is to preserve the ability for people to have choices in how they manage their financial affairs, while at the same time targeting the bad abuses.

Chairman NEY. Okay. Thank you.

Yes?

Ms. BRYCE. I would suggest that one of the things we need to avoid are subjective standards, and I think we have seen that in a number of the laws that have passed such that lenders can't really know how to comply with the law, or be sure that they are complying with the law.

So, I think that is something that we definitely need to avoid in putting together a national standard and really look at how do we promote a situation where more lenders are willing to come into the subprime market to enhance competition?

Chairman NEY. Thank you.

Mr. DANA. I would agree with Ms. Bryce that we have to make sure that our standards should be clear and not vague in nature.

The last thing we want to do is restrict the flow of credit to deserving individuals.

Chairman NEY. Mr. Bachus?

Mr. BACHUS. I am very interested in what you have to say Mr. Butts, because you referenced your comments by saying you want a strong law.

Mr. BUTTS. Right. We had negotiations with Ameriquest around subprime lending and we yelled and screamed at them and fussed at them and called them predators and did all kinds of nasty stuff to them and they finally——

Mr. BACHUS. I am sorry, if you can talk into the microphone.

Mr. BUTTS. All right.

—and we finally settled down and we talked to them and what we asked from them was to become the gold standard of what a subprime loan should look like.

And, we believe that our agreement with them sort of accomplished that. So, you can get a subprime loan from Ameriquest right now with a $550 fee and that is it; no points and none of that stuff.

No pre-payment penalties, none of the really nasty stuff that is in these bills. And they feel that they can market their products to everybody, and so we know it can happen.

I think it is just the collective will that everybody wants to really understand what that standard should be. And it should be a standard that suits the marketplace that we are going after.

Mr. BACHUS. Okay.

Mr. STEIN. I tell you, in North Carolina we learned a couple of things that were important.

The first is that while disclosure and counseling are both important, on their own they are not going to be enough.

I don't know if you saw this recent GAO study that addressed that question, but it concluded that disclosure and counseling will not significantly address predatory lending. If you have someone in a refinance transaction, they might have learned something a year ago, 2 years ago, six months ago, but it is not like they are going to remember it every second of the day.

And so that is not going to be enough and you are talking about a lot of the borrowers are less sophisticated. What if they have 75 sheets of paper then each one?

The other thing is that subprime lending is actually more complicated than conventional lending, so to expect disclosures and people understanding all the different loan terms as opposed to structuring the market in a fair way is to expect too much.

I think in North Carolina, as I mentioned before, what we try to do is structure the market so lenders compete primarily on price. They can charge five points a fee; they can charge pre-payment

penalties within that. They can't do single premium credit insurance.

But, limit the amount of fees because that is where borrowers spend their wealth, that they don't realize they are spending, and let interest rates adjust up and down a little bit on a floating basis.

North Carolina didn't cap interest rates any more than federal HOEPA does, but federal HOEPA law's interest rate trigger hasn't caused a problem.

Mr. SCOTT. Yes, okay.

Yes?

Mr. THEOLOGIDES. Two things.

One: we learned from the Georgia experience on assignee liability that we need to tread lightly in that area to recognize that if unlimited assignee liability is combined with vague standards to cap points and fees, leaders will flee the market and Americans will be unable to get credit.

The second thing is: we also need to tread lightly in figuring out what that right balance is in limiting points, fees, and what we count in points and fees: prepayment penalties, payments to brokers.

That in so doing we may unwittingly eliminate the ability of a borrower to lower their payment and today in a low interest rate environment that is not as big of a deal, but believe me, when rates move up a 100 basis points, 200 basis points, people are going to want to have every tool in the tool chest to be able to pick a product that allows them to have a lower payment and still either refinance their home or buy that home.

Mr. SCOTT. Right.

Let me ask you this one quick question, because in Georgia, which is my home state, and we had a good law, I felt very concerned about the assignee liability to the secondary market.

In grappling with that, would you say one solution might be that we assign the liability to the secondary market only for those lending violations that can be detected from a review of the regular loan documents?

Mr. THEOLOGIDES. I think you are on the right track. Clearly, you don't want people turning a blind eye, they have it within their powers staring it in their face. You want them to look at that loan and if it is abusive, push it back.

But we also need to recognize that, well, my company is in the mortgage business, we can do that, but the teachers' pension fund that buys our AAA-rated mortgage backed securities really is not in a position to evaluate those loans and the assignee liability shouldn't extend that far down the chain.

Mr. SCOTT. So, and in a federal law, if we did that, if we just assign it to those that we review those regular loan documents; you feel that would answer the bond market's problem?

Mr. THEOLOGIDES. I can't speak for them, but I believe if there is some clear standard about when you have done enough due diligence, what the degree of diligence is appropriate to make sure that if one loan gets through you don't have an Armageddon scenario.

I think they can work within those parameters, is our experience as a lender because they are doing diligence in our shop every

week. They are looking at loan files. So we see it on the receiving end.

I think it is the being held accountable for something that they can't possibly detect, or that would require them to review every page of every single loan of the hundreds of thousands of loans they buy that becomes just very difficult for them to deal with in it.

And the way they deal with it is essentially, "We are not going to buy your Georgia loans, let us buy them from the other 49 states."

Mr. SCOTT. I think he wanted to comment. One more point, Mr. Chairman.

Chairman NEY. That was your fourth "one more point, Mr. Chairman."

Mr. SCOTT. This one is very important, Mr. Chairman.

Chairman NEY. Well then, we had better hear it.

Mr. SCOTT. All right. I hope it lives up to that billing.

Mr. SAMUELS. In Georgia assignee liability clearly went too far. The images were potentially unlimited, but then the State senate passed a bill, which still provided for assignee liability, it just bounded that. It said it wouldn't be greater if somebody tried not to buy a high-cost loan.

It wouldn't be greater than the amount of the loan outstanding and some fees. And it didn't limit it just to what is written on the loan document.

Problem is, if you do that, what you are saying to an innocent home buyer is, "You have a predatory loan and we are so sorry that in this case the lender sold the loan but we are going to foreclose on you, you are going to lose your house, you are going to lose all your wealth. Three, 4, 5 years later perhaps, because there is not mandatory arbitration, you might be able to sue against the lender, if they are still there, if they still have money. And get some money, but you have a destroyed credit rating."

So you need assignee liability. You can have it, but these rating agencies are going to rate loans if it is bounded and you can't have class actions when it is small. And that is what Georgia passed in their state senate and that worked fine.

But the person in the pension funds who buys the mortgage-backed security, they are never going to face assignee liabilities. The trust is perhaps going to face it.

So you can't limit it to just to what is on the document. It sounds good, but if you have an innocent homebuyer who was victimized, you have an innocent secondary market purchaser, that innocent secondary market purchaser can price for that risk and it is minuscule because it is limited to the amount of the loan and there aren't going to be many cases that get through there.

Mr. SCOTT. All right.

My final 15 seconds, Mr. Chairman, was this point that I just had to respond to.

Earlier, my colleague, Mr. Clay, mentioned about the peculiar emphasis unfortunately of predatory lending on the African American community. I think it is very, very important that we make sure we get the record straight on this that race is unfortunately

a real reason why we have predatory lending. African American communities are targeted.

They are purposely targeted. They are just not targeted at low income, they are targeted up and down the strata and they are targeted precisely because they are African American communities.

A lot of that has to do with the low savings rate, another part of financial literacy. I bring this point up because myself, Chairman Ney and some other members of this committee have been very, very strong on the application of the two-way toll-free number.

And it is very critical in that community because when they are targeted, folks come, they leave a card. And if we have a 1-800 number, we have a way of lassoing in and being preemptive and getting a hold of some of these predators before the damage is done.

And I would think that if I get an assessment for you all just to give us your feelings on the value of that 1-800 number and providing that two-way dialogue and that two-way help.

Would that be a help as we move forward in that predatory lending?

Wonderful. Thank you. I got everybody shaking their head.

Thank you, Mr. Chairman.

Mr. BACHUS. Thank you.

And one problem we do have with the five-minute rule is it does very much limit substantive discussion and particularly when you have a member like Mr. Scott who is knowledgeable on the subject, who had participated in legislation when he was a member of the Georgia legislature, so I am glad to give the extra time to my colleague.

Mr. SCOTT. Thank you very much, Mr. Chairman. I appreciate that and God bless you.

Mr. BACHUS. Thank you.

Now your partner to the right there, Mr. Davis, not right by political parties but in direction, he on the other hand, since he has been elected he and I share the Birmingham newspaper.

And he has totally preempted any publicity that I was able to get in that newspaper. I am going to yield to him 30 seconds.

[Laughter.]

The gentleman from Alabama has five minutes.

Mr. DAVIS. Thank you, Mr. Bachus.

And by the way, we have been keeping time today; 30 seconds would be about five minutes.

For a minute I thought Mr. Scott was running for the Senate from Georgia, too.

Let me, if I can go back to the questions that Mr. Clay was getting at earlier and try to get a little bit more specificity from all of you.

I understand that no one sitting on this panel is going to acknowledge that any of your institutions are engaged in predatory lending, so that is not the question I am posing to you.

Do any of you disagree with the statistics that Mr. Clay cited? And let me hone in on just one part of those specifics.

I understand that you are going to have a higher rate of African American subprime loans, in part because you have a wealth gap. I understand, as I suspect Mr. Clay understands that.

What is more striking though is that as Mr. Scott just alluded you have a significant amount of subprime lending and most likely predatory lending as well that goes on in the upper income black community.

In fact, the statistics that I have seen are that you are twice as likely to find a subprime loan in affluent black neighborhoods than in low-income white neighborhoods.

Now, first of all, that appears to be a complete deviation from any kind of market reality. Obviously, there is no reason one would think at all that you would have subprime loans in a fairly high income market.

It is typically subprime loans, as I understand them, are intended for low-income individuals with credit problems, recognizing some people may make a bad choice to get in the market, there is no question that is who they are intended for.

So, let me ask you this question. Why is this happening? Because as I understand that everyone says my bank is not doing it, my institution is not doing it, but can someone grapple with just this question?

What set of practices are happening in this country that are leading to such a high subprime rate in affluent black neighborhoods?

Yes sir?

Mr. THEOLOGIDES. It is a very difficult question to answer, but let me take a cut at it.

Two things. One: most of our borrowers contrary to popular belief are not low-income.

So, white or any color, our loans are actually not concentrated in the low-income area, although they do share a common element of presenting a higher risk for credit or for other reasons.

Two: even across income strata, our data, our lending data do show that even in the higher income grades our African American applicants are falling into a lower credit grades when run through our automated scoring engine. And believe me; we spend a lot of time trying to figure out why that is.

Based on our initial analysis, it is not necessarily income, it may be wealth, it may be credit, it may be in the case of the Hispanic community, there are high self-employment rates that we see, too.

And no doubt there is some element clearly of the predators have targeted communities of color and the elderly. I mean, that is some element.

Mr. DAVIS. Let me ask you this question. I have touched off; let me ask you this question.

Do any of you have any data on the degree of subprime lending in African American communities that have good credit histories? Has anybody looked at that very narrow question?

Mr. THEOLOGIDES. Yes, we did look at that narrowly. We ran through all of our borrowers through Fannie and Freddie proxy to see how many and of our African-American borrowers, 2 percent of them could potentially have met those guidelines.

So, 98 percent of them are squarely in need of a non-prime product to hopefully migrate up into that market.

But, again I think more analysis needs to be done. I think the studies that look at income oftentimes are looking at income by census tract, so we are not comparing $100,000 high-income white to necessarily $100,000 high-income minority.

Mr. DAVIS. Mr. Butts, do you agree with that? Because you have been the person on the panel who is been most direct about the prevalence of subprime on the black community and presumably part of your argument is that it is not just a low-income, high credit risk areas, but that it pervades into categories of lenders or borrowers, frankly, who don't need subprime at all.

Are you the same way that this gentleman is about this issue?

Mr. BUTTS. No, I think this is probably going to sound politic of me, but I think part of what is going on here is this way.

What is instructive is I had a conversation with somebody one time, a subprime marketer, and what he told me was that they want to be number one the bank of opportunity when somebody needs money and they want to market that way.

And the other part is that they start at yes, where everybody else starts at no then the risk is later according to what things accept at yes.

And a lot of times when people are marketing to our community and are talking to us around those terms that are already set, that they are not going to give us this loan.

And I know I can't qualify for it, because this happened to me or that happened to me or whatever, and then when somebody comes along and says yes, you can have this loan, it is just you are going to have to pay through the nose to get it, but you can have this loan, that makes it easier to be marketed to that way and I think maybe that is partly one of the things that they understand in a really going after that market because of that.

I mean, they make it easy.

Mr. DAVIS. Let me try to quickly——

Chairman NEY. Let me interrupt just a second.

Mr. Dana you have a flight?

Mr. DANA. Yes, I do.

Chairman NEY. So we are going to excuse you at this time.

Mr. DANA. Thank you very much.

Chairman NEY. Thank you.

Mr. DAVIS. Let me just ask one question on a slightly different topic since Mr. Dana is leaving I might direct this to you, Ms. Bryce.

Let me shift to a different area altogether.

All of you have embraced the idea of having a national standard, and I recognize there is some disagreement about what the substance and content of that standard would be.

Is it your position, Ms. Bryce, the national standard would be a floor or a ceiling?

Would it be in effect the minimum that states would have to do or the minimum that rather lenders would have to observe or would you suggest leaving any leeway for the States to add their own set of regulations?

Ms. BRYCE. Well, I think our position is that a national standard should include federal preemption. So that it is clear, many of us are national lenders and it would allow us to have one standard to work from in all jurisdictions.

It would mean that people who live in sort of multi-jurisdictional areas, whether it is in D.C. and you are looking at whether you want to be in Maryland or Virginia or D.C. that there is one standard that would allow for consumer education across the board with one standard.

So we are really looking at it from the point of view of saying one standard will enhance competition will allow for better consumer education but that should be the standard nationwide.

Mr. DAVIS. And let me ask one quick question before I turn my time back.

Mr. Miller was making a point earlier that I want at least one of you to respond to, which is that obviously sometimes Congress has a glacial pace; it takes a while for things to happen around here. State legislatures often have the ability to get things done at a much quicker pace.

Mr. Miller's observation was why should we restrict or prohibit the States from being innovative, from doing some things that frankly might be illustrative to us sitting here in Washington?

Why not give the States some capacity to at least experiment in some of these areas?

That strikes me as a fairly reasonable proposition on his part. I recognize the counter argument that you want uniformity but I think everybody on this panel recognizes that a whole host of legal areas we don't have uniformity.

And that all the many areas in which we don't have uniformity certainly cost somebody somewhere and they produce litigation costs, et cetera, et cetera. But yet we still tolerate that in our legal system.

So can any of you, before I turn my time back, speak to Mr. Miller's observation that the States have some capacity to innovate, and to be laboratories in this area?

Yes, sir.

Mr. SAMUELS. One of the things that we can't lose sight of is that we have the best home finance system in the world. Countrywide has an operation in the U.K. and we see the difference between what we have here and what they have overseas.

It is really the envy of the entire world and one of the reasons that we have that is because of the national system that we have. Somebody can buy a house in Oregon and the financing for that will probably come from Florida or even from Japan.

Mr. DAVIS. Has the North Carolina innovations somehow dramatically undermined the market in that state?

Mr. SAMUELS. Well, in our view I think one of the issues that we have been talking about is there has been a broad increase in lending but there is a group sort of at the top end that should be able to qualify for a loan that should be able to have a choice as to how to reduce their monthly payments, but because of where the triggers are set, they cannot.

And that is the concern that we have. Our view is that we should have those triggers set at a more reasonable place, and at the same

time one thing I want to address is we talked about, you know, some people want stronger laws.

We want strong laws, too, and that is very important but we want the strength of those laws directed at the bad acts, at somebody taking a woman who has a social security payment and giving her a loan with a monthly payment equal to her social security payment.

That is a bad act. But to say that we need a strong law to cut off a group of people who could qualify for the loan under any of our underwriting standards because we set the trigger at too low a level, I think is the wrong approach.

I think we need to target the bad acts with very strong legislation while at the same time preserving that choice and accessibility to credit.

Mr. DAVIS. Thank you, Mr. Chairman.

Chairman NEY. Thank you. Mr. Crowley, do you have a question?

Mr. CROWLEY. Thank you, Chairman.

First let me thank you, Mr. Chairman, for holding this hearing on this issue. As I have stated before in committee, I believe that this is a very, very important issue and deserves the hearings that are scheduled to take place, and it is good to see the panel before us come from all angles on this issue.

I for one believe that the non-prime and subprime market is actually afforded opportunities for wealth where in the past that opportunity had been denied because of a lack of capital access.

My constituencies in New York City, and especially in the southern part of the Bronx, where I have seen people who had nothing because of subprime be able to afford a moderately priced home 15 or 20 years ago now have seen a great deal of wealth created because of their ability to access that capital in the first place.

So I think this really is for many an inner city issue. And therefore I am very, very concerned about how we walk and how we tread on this issue so as not to diminish the opportunity for capital where in the past it had been denied.

But I do want to follow up. My friend from Alabama and I am working on some legislation to address some of the issues that he was raising before and that is because of what I believe is disturbing an issue that was highlighted and I believe by ACORN and the separate and equal predatory lending in America report.

And that is when its happening reportedly between ten and 35 percent, and I have heard numbers much lower than that, of A-minus subprime borrowers actually qualify for prime rate receive subprime loans that are more expensive and especially as it pertains to the African-American community and apparently may be the target oftentimes of that practice.

Let me just ask the lenders if they could talk about the data as they perceive it and how it was put together and how we address it. And then also maybe the consumer groups as to how they compile that information.

Mr. Theologides, maybe you can address that and what they think can be done to address it as well.

Mr. THEOLOGIDES. I would be happy to start. I mean, again, that is a very important issue and believe me we in the industry are

reading those reports very carefully and I think that is absolutely appropriate for this committee to try to address both analyze that and figure out a way to address the issue that sometimes referred to as steering borrowers who would qualify for prime being steered into a higher cost subprime or non-prime product.

Mr. CROWLEY. Do you think that 10 to 35 percent of the A-minus is an accurate figure?

Mr. THEOLOGIDES. I do not think that is an accurate figure; I think that is from 1996 from a Freddie number.

In my written testimony, sir, we analyzed our data and we think we are representative of the industry; we are the second largest; we are 8 percent of the market. And that number was closer to 3 to 3.5 on paper could potentially have qualified for it.

Now for Countrywide, they offer a full range of products. We are a niche player and we specialize at being a low cost provider in non-primes. To address your question, one solution might be that to the extent a lender doesn't offer a full array of products that a borrower appears on paper to have the characteristics that might qualify for prime let them know.

And give them information either whether it is to an 800 number, like Congressman Scott was saying, or through some form of notice because, again, I think that is something that we can grapple with through a national legislative approach to address that issue and clearly part of it is people preying on someone that might not be as familiar with the process and part of it is just luck of the draw.

There aren't as many prime branches today in the inner cities. And so I think absolutely that is something that ought to be dealt with in the context of this national standard.

It is my understanding that this data came from the data. And that is how we came up with it; analyzing the metropolitan area. That is where we got the figures.

Mr. STEIN. That is one of the issues, having complete data because if all you look at is income that does not tell the whole story.

Our situation is different than New Century's because as was mentioned we do have a full pantheon of products.

Everybody who enters our company through a non-prime channel is put through artificial underwriting and processing and if it looks like they can qualify for a prime loan, they are flat and they go to a certain underwriting group that tries to get them a prime loan.

Now, oftentimes what happens is the borrower says no I don't want to provide this documentation or I need a higher loan to value ratio or I want to take more cash out of my home than Freddie guidelines would allow.

So that even though they could qualify for a prime loan, in fact they are a non-prime borrower and the loan that they end up choosing is a non-prime borrower and they understand that because of the characteristic that they have chosen that they may not qualify under the underwriting standards that Fannie and Freddie and the secondary markets you know has implemented.

But we do a pretty good job of making sure that people who can qualify under the prime standards are given the opportunity of a prime loan.

Mr. CROWLEY. Ms. Bryce.

Ms. BRYCE. I do think it is an issue to just focus any study on the HMDA data by itself without looking at credit scores for various groups and also looking at debt to income ratios and other underwriting factors.

Our economists have been looking at some of those studies and we could certainly provide their comments after the hearing. There are some other studies that are in development, as I understand it.

Professor Bostic, who is at the University of Southern California, has been looking at the credit scores of different African American sorts of groups of economic groups and one of the interesting things that seems to be coming out of his study is that the credit scores of African Americans with high school educations appear to be higher than those with college educations.

I don't know what the reasons for that will be or if he will have a reason for that, but those are kind of interesting studies that we are tracking to try to get a better understanding of what might be going on in the marketplace.

But I think you have to look at those underwriting factors in order to really evaluate the issue and figure out what that percentage really is.

Chairman NEY. Time is up, Mr. Crowley.

Ms. BRYCE. I think she is right that you need to look at risks; you can't just look at income.

In fact, there is an affiliate of the Mortgage Bankers Association, the Research Housing Institute I think it was called, that did a study that looked at home purchase subprime loans, and it had access to credits, and it compared African Americans and whites and found that for the exact same risks the chances of an African American borrower getting a subprime loan were a third higher.

And so this steering, as you were mentioning clearly goes on. It is hard to quantify in some companies the ones here do a much better job at not doing that. But it is a clearly significant problem.

The other study that looks at risk as opposed to just income is the UNP study of North Carolina and what they found was after the law was in effect, the percentage of loans to borrowers above 660 credit scores who could potentially get a conventional loan decreased by 28 percent, while conventional lending in the State increased by 40 percent.

So, what you found in North Carolina after the law was set for very good standards, I think was that there was less of this steering that went on.

And I think the New York law has been very effective too. Your banking commissioner said that the rates are down but that credit access is still widely available. I think that also has a lot to commend it.

Chairman NEY. Okay, thank you.

I am going to forego my question, because we have a second panel, but if anybody has looked at any statistical trends of more individuals going into subprime. It didn't matter if the neighborhood was white or black or Asian or you know any——

I don't want to take a lot of time.

Mr. THEOLOGIDES. Well we at CFAL did commission a nationally recognized firm to analyze this issue, because we recognized the potential for this and we will be issuing that shortly.

I have seen sort of the preliminary data, yes. I think that will be informative and advance the discussion for all of us panelists here.

Chairman NEY. Well, I thank the panel for all of your time and a second panel for waiting, so we will move on.

I want to thank the first panel for your time here in the Capitol. Thank you.

Move on to panel two. Thank you we will start with panel two.

Panelists testifying, there is Charles W. Calomiris.

He is a seasoned professor and author who has written and published numerous books in American Economic Review, articles detailing the experience of the U.S. and international financial markets.

He currently serves as the Henry Kaufman professor of financial institutions at the Columbia University Graduate School of Business, also the professor at Columbia's School of International Public Affairs.

Mr. Calomiris is the recipient of several research grants, and serves as the co-director of the project on financial deregulation at the American Enterprise Institute and as the chairman of the board of the Greater Atlantic Financial Corporation of Publicly Traded Banks based here in Washington.

I want to welcome you.

Anthony Yezer is a member of the Department of Economics at George Washington University where he directs the Center for Economic Research.

His research interests include the measurement and determinants of credit risk and lending, the effects of regulations on credit supply, and models of the demand supply of credit to households.

His articles have appeared in the Journal of Finance, the Journal of Real Estate Finance and Economics and Journal of Law and Economics, just to name a few.

He currently serves on the editorial boards of five journals, and is editor of the American Real Estate and Urban Economics, association monograph series.

Norma Garcia is a senior attorney at the West Coast regional office of Consumer's Union, a non-profit publisher of Consumer's Report magazine.

Her specialty at Consumer's Union is as an advocate on behalf of low-income consumers, especially in the areas of credit and finance.

She is a published author of "Dirty Deeds, Abuses and Fraudulent Practices in California's Own Equity Market" and "The Hard Sell: Combating Home Equity Lending Fraud in California" and "Fighting Home Equity Lending Fraud and Abuse in California."

She was Consumer Union's principle lobbyist for the passage of S.B. 2045 and A.B. 489, legislation adopting a statewide anti-predatory lending law.

Mr. Geoff Smith is the project director at the Woodstock Institute. Woodstock is a 30-year-old Chicago-based non-profit organiza-

tion that works locally and nationally to promote reinvestment and economic development to lower income and minority communities.

Mr. Smith received his Master's in geography from the University of Wisconsin, Madison, in July of 2000. Prior to becoming project director, he served as a research project associate at the Woodstock Institute, where he worked on community development issues.

Dr. Michael E. Staten is a distinguished professor and director of the Credit Research Center at the McDonough School of Business at Georgetown University.

Mr. Staten has designed and conducted projects on a wide range of policy issues involving markets for consumer credit and financial services.

He is an expert witness on credit and insurance issues and has published numerous articles in various journals, including the American Economic Review, the Journal of Law and Economics, and the Journal of Health and Economics, just to name a few.

I want to thank all of you. We will begin with you, Mr. Calomiris.

STATEMENT OF CHARLES W. CALOMIRIS, HENRY KAUFMAN PROFESSOR OF FINANCIAL INSTITUTIONS, COLUMBIA UNIVERSITY

Mr. CALOMIRIS. Thank you, Mr. Chairman. It is a pleasure to be here today.

With your permission, I would actually like to depart from my written comments, which I would like to have entered into the record.

Chairman NEY. Without objection.

Mr. CALOMIRIS. But, having sat through the first panel, I thought that it would be useful to follow up on an excellent discussion on regulatory measures, which is really not the focus of my prepared statement, because I didn't think that was the focus of our discussion today.

But I do want to talk about it a little bit.

I just would preface my remarks by saying that I think everyone understands there has been remarkable progress and growth in subprime lending.

Access to credit markets for minorities, for low income people, but also more broadly, more flexibility for everyone, and subprime is not just about credit to the poor, not just about credit to minorities, it is more flexible credit for everyone.

And I think that everyone is in agreement that this is a very valuable resource in our economy, and I think also people understand that the technological improvements that have helped that to happen are really two kinds: they are statistical scoring models that have permitted the quantification of risk, the pricing of risks rather than the yes or no of risks.

And, secondly, it has been the development of securitization markets that have added to the low financing costs in this market, and also the competition in this market. That is why there is so much competition right now. And that is why we have a national market because of those securities markets that are standing behind the developments in this area.

So consumer finance, mortgage finance, has become a boom to the American consumer, particularly in the last decade, because of those two major innovations having to do with the way it is financed ultimately in the capital markets and the way it is scored.

And those two, of course, are closely related. And I think that we all, I hope, share a goal that we want to see a continuation of a national mortgage market. National in its competitive scope, national in its opportunities for everyone.

And so we want to balance that goal with the goal of avoiding predatory practices. So I just want to suggest a few ideas that I think could be very helpful and that I have been suggesting for a few years, which I think might be useful as you are considering any bill.

First of all, as the first panel made clear, what good lenders want is safe harbor. They want to know that if they act appropriately that there isn't some hidden liability hiding out there that is going to come back and bite them.

So I think that clear rules that establish safe harbors so that if they know that if they go through a set of very specific practices that they are going to actually not be treated unfairly themselves.

I think that is important. A second principle has to do with disclosure. Everyone I think recognizes we have a massive amount of disclosure in the mortgage market right now.

We probably need less disclosure in the sense of volume of paper. I think anyone who has been through a mortgage, as I have been sees that it becomes trivialized. You stop paying attention to the paper, because there is just too much of it.

What we need is meaningful disclosure. And I think we need disclosure that particularly addresses Mr. Clay's question.

How do we create disclosure that helps someone who is not a sophisticated borrower at the time of the mortgage signing know that he or she is being overcharged?

I have a very specific concrete suggestion that I have been making for a few years and I haven't been able to get much response on it. Here is my suggestion.

Suppose that we had a common statistical sample of borrowers and so if you know what your credit score is, if you know your credit score, and you know your loan to value ratio, there would be one piece of paper that would tell you, the borrower, that people with that credit score and that loan to value ratio on average get the following interest rate, the following points, the following pre-payment penalty, for a mortgage of that term.

Chairman NEY. I don't want to interrupt you, but it seems as a good roll that you are on, and it is good but my——

Mr. CALOMIRIS. Am I going over time?

Chairman NEY. No, no, I think it is fascinating. But I just wanted to ask would this, also. We had talked earlier about whether you had a subsidy of type or CRA or whatever. Would this be just for everything market-based?

Mr. CALOMIRIS. This is for the population. What I have in mind, whether it be some sort of measure coming from some kind of overall market data base and, of course, the particular borrower may be getting better terms if it is a CRA-related loan where there is some subsidy.

Or the borrower may be getting worse terms because the borrower's credit is really worse than the credit score reflects.

But, nonetheless, you wouldn't have the opportunity for the egregious kinds of violations that Mr. Clay and others have been talking about.

If you simply as a borrower were able to see what on average people of your credit score and your loan to value ratio were getting in the market.

To me, that is one page and it would be an extremely meaningful disclosure and it is not beyond our ability to do it.

And I think that it is much more effective than what I call in my testimony stealth usury laws. Laws that have the undesired consequence that many of the first panelists were talking about, which is to effectively deny credit access to people who need to pay very high interest rates, that denial happens because the costs imposed by the State laws, like North Carolina's.

The costs of compliance basically have a chilling effect on the supply of credit to high cost mortgage lenders and so, for high cost lending, people simply withdraw from that little niche.

So, I think that we want to have more and better kinds of disclosure, maybe less volume of disclosure and I think we want to avoid stealth usury laws, which I think have been very adverse in their consequences for certain small niches of borrowers.

I also want to talk a little bit as an economist and as someone who has done, probably with all due modesty, more statistical research than anybody who has been before you today, about the quality of the statistical research that has been described which is, to put it mildly, highly uneven.

Many of these studies are not controlling properly for all the variables one would want to control for. And they also define predatory lending in different ways.

So, studies that tend to be cited by people who like what I described as stealth usury laws, States' laws that have a very negative effect on supply of credit to certain niches, those people tend to cite studies that really define as predatory loans that are expensive.

They describe them as equity-stripping.

These are highly judgmental categories, and I think that part of the problem here is when we get these different views of the statistical evidence it is really not different statistics, it is different interpretations, different definitions and different standards for adequate control.

So I really caution you not to take those discussions too seriously. I also caution you not to think that it is a good idea to be too prohibitive of pre-payment penalties.

Pre-payment penalties can reduce the cost of borrowing because pre-payment risk in the mortgage market in fact on average is of a greater size and of a greater consequence for lenders than default risk.

And so pre-payment risk is mitigated by pre-payment penalties and reduces borrowing costs. Be very careful about the arguments of people who tell you that they want to get rid of pre-payment penalties or sharply limit them. That can hurt borrowers.

I think another set of rules that I think are worth exploring are not just counseling on a voluntary basis, which I agree with, but also budgeting more money for testers.

If you are going to establish standards, it makes sense to actually also budget for people to go out and see if they are being complied with. If you want to find the bad lenders, a great way to do it is by sending people out as testers and I think we should do more of that.

I don't want to go over my time; I know it is late in the day, so I will pretty much stop on that point except I want to make one final comment about federalism.

Dual banking has served the United States well for 140 years.

I do see the advantage to allowing the finance companies who are not themselves under the OCC to enjoy a uniform national standard and I haven't made up my mind on this issue, but I do want to point out that there is an advantage, as Congressman Sanders mentioned, of some kind of federalism.

The way we have done that for the last 140 years in the United States is that we have federally-chartered institutions that are under a uniform national standard.

And that is what I think the Comptroller in particular has insured with his, I think, quite proper preemptions. But we have also allowed the States to regulate non-federally chartered institutions.

So it seems to me that there may be some regulations or some standards that we want to put into fair lending laws for the whole nation but that some of the regulations of the lenders might want to be different between the federally regulated lenders and the others.

Thank you very much.

[The prepared statement of Charles W. Calomiris can be found on page 134 in the appendix.]

Chairman NEY. Thank you.

Mr. Yezer?

STATEMENT OF ANTHONY YEZER, PROFESSOR, DEPARTMENT OF ECONOMICS, GEORGE WASHINGTON UNIVERSITY

Mr. YEZER. Sorry.

Chairman NEY. Whenever you are ready.

Mr. YEZER. I would like to thank the——

Chairman NEY. If you could move the mike a little closer.

Mr. YEZER. I would like to thank the chairman and the committee for inviting me to make these comments.

My colleague here, my written testimony, I certainly stand behind, but in view of the discussion this morning and my enhanced knowledge of the committee's task, I want to part from those comments.

I was reminded as I heard the discussion of my involvement as an expert on the credit practices rule. Now this is a Federal Trade Commission rule.

It goes back to when we started studying it in about 1978 and the notion of the credit practices rule was that there were abusive practices in credit remedies applied to consumer credit and the notion was that the Federal Trade Commission should seek to regulate these.

Now, as an expert economist testifying for the commission, I was given a wonderful data set which was a stratified random sample of the laws around the country for loans from around the country and their experience and of lenders.

And I could see the variation and regulations across the States and I could find which limits on credit or remedies appeared to have little or no effect on the availability of credit and which ones really affected the supply: the notion being that you could restrict lots of credit or remedies that had very little effect on the cost of credit, but you didn't want to restrict ones that would substantially raise the cost of credit.

I did that with my colleagues, the GW when most of our recommendations were adopted. By the way, the papers are also published in academic journals so the academic folks liked it.

And while there were lots of screenings from both sides about our recommendations, I think overall the trade regulation rule worked out pretty well. So this is a sort of background.

Now we come to——

Chairman NEY. I am sorry. The recommendations were in which article?

You talk about the recommendations——

Mr. YEZER. Okay. Well, the Credit Practices Rule, which was adopted in 1981 by the Federal Trade Commission governing creditor remedies. The two papers that have most of it in; I could give you the citations.

Chairman NEY. Okay. Yes, if we could get that.

Mr. YEZER. And plus, we had a huge volume of testimony.

So, now we turn to subprime lending and subprime lending I sort of defined in my testimony as something that is about 125 basis points or more above prime. And then we look at statements about that market and my first comment is we have no clue.

We don't know how much subprime lending there is. If you look at property records, you will see the name of the mortgagee.

When you look at actual property records and look at names of mortgagees, especially in inner city areas of large cities, you find an awful lot of brand X mortgagees.

These are not covered by anything, they are not reporting to anybody. They are not in any data set. We don't know what is happening there, but I have my suspicions, okay?

Other data sets are really problematic. HMDA clearly gives false impressions of the growth of subprime lending because HMDA keeps adding lenders and not only that existing lenders lend through HMDA who are recently added report larger and larger volumes of loans simply because they are computerizing their databases.

So all the entrances based on HMDA are sort of a statistical artifact of the sampling procedure. Other databases are also partial.

Now, could we expand HMDA? Well the problem with expanding HMDA and getting more reporting publicly like that is there is already a big disclosure problem in HMDA.

I can go to property transfer records and I can match up a loan amount on the census tract with the name of a lender and HMDA and I can identify the mortgages in the individual HMDA records of half the members of Congress.

And probably 60 percent of the public because I have done that. Okay?

So if you expand HMDA the more and more small lenders there is just no privacy in the disclosure at all.

Now, in addition, you are still not going to get to the brand X people so we don't know how much lending there is and we don't know what its characteristics are and the worst of it is probably opaque.

To the extent there has been some testing and I recently along with my statement, edited a two volume special issue of the Journal of Real Estate Finance and Economics where we have about 11 scholarly papers on subprime lending that have passed the peer referee process and will be published, and that particular exercise did demonstrate that economists can make some inferences about what is going on in the subprime market.

We have two independent studies; by the way of North Carolina that indicate insofar as we can test indirectly the regulations there significantly reduce the availability of credit.

These are in a peer referee journal, as opposed to the papers that were referred to previously, and I share my colleague's comments on their academic merit.

Okay, now, in terms of subprime lending, what can we infer even if the data was imperfect? Well the first thing is it sort of looks like the markets we teach our freshmen in economics.

That is, people with better credit scores tend to pay less. People with worse credit scores pay more. Some prime lenders are particularly profitable and there appears to be an active competition in subprime lending. All of that looks good.

And by the way, in addition to response to lending appears to be to withdraw from the markets. So all that looks like just what we teach our freshmen.

There are some strange features of the subprime markets but some of them you can understand with a little bit of economic theory like the fact that subprime lenders have a higher rejection rate and a higher interest rate. But, you can actually work that out and you can see why that is the case.

So, a lot of features of the subprime market sort of look okay as a market. I have two concerns. The first one hasn't been mentioned: that is a home equity trap and the demand for subprime mortgages.

We encourage Americans to mortgage themselves up to their eyeballs and then spend the next 20 years pre-paying their mortgage and building up all sorts of wealth in their home.

What happens if you lose your spouse, lose your job or lose your health? Well, guess what? You have all that equity in the home; you don't qualify for prime credit any more. So you have to go to the subprime market. Part of what is happening is a sort of got you.

Because we have got a lot of households in America who have bought the home equity lie. They shouldn't be maximizing home equity. They do it at their peril. It is not liquid and you can easily get in a home equity trap and there is a lot of tragic stories there.

[The prepared statement of Anthony M. Yezer can be found on page 267 in the appendix.]

Chairman NEY. You ran over the time.

We will move on to other witnesses then we will come back and I want to pick up that thought about I might be in that equity trap so I want to ask you about that.

Ms. Garcia.

STATEMENT OF NORMA GARCIA, SENIOR ATTORNEY, WEST COAST REGIONAL OFFICE OF CONSUMERS' UNION

Ms. GARCIA. Good afternoon, Mr. Chairman, members of the staff.

My name is Norma Garcia. I am a senior attorney with Consumer's Union's West Coast office in San Francisco, California.

Consumer's Union believes that home ownership is a critical priority for our country and that protecting the equity that citizens have accumulated in their homes is critical to every state's prosperity and well being.

People who own their homes and have built up equity in their homes have a real financial stake in their communities. They are the glue, oftentimes, that holds communities together and it is their home equity that often forms the greatest source of their personal wealth.

It is no secret that families in America have a lot of equity built up in their homes. As the previous witness just said, that equity for many represents the greatest wealth they will ever know.

It is very significant for all homeowners with 45.2 percent net worth as a figure that home equity represents for the average homeowner and for Latino and African American families home ownership is even more vital as it represents approximately 60 percent of net worth for people from those communities.

So the nation as a whole home equity accounted for 44 percent of the nation's total net worth. That is a lot of money of our economy tied up in home equity.

And it is for this reason that Consumer's Union is very concerned with protecting home equity. There is been a lot of discussion today about the subprime lending market being available to help homeowners get into homes, and that is a fine thing.

To the extent that homeowners aren't paying more for their mortgages than they should, definitely the subprime market is serving a need.

But there is a bigger concern here that no one has really made a distinction about, and that has to do with how does the subprime lending market effect the existing equity that homeowners have built up over the years.

And it is for this reason after asking this question that we looked at the question of what does the growth in the subprime market mean to preserving home equity and to preserving home ownership.

You have heard statistics today that have told you about how large this market has grown nationally, and I want to focus in on a couple of states that Consumer's Union actively works in. We have advocacy offices in Texas and in California.

In the State of Texas, the subprime and refinancing market has grown substantially. In 1997, there were 2512 subprime refinance

loans made in Texas. In the year 2000, there were 23,353 loans made.

In California we have seen a similar growth in the subprime lending market. In 1998 it is estimated there were approximately $18 billion in subprime loans made in California. In 2002 that number has ballooned to over $62 billion.

A recent study by the UCLA Advanced Policy Institute established that the number of refinance loan applications received by subprime lenders in California increased at an average annual rate of 27 percent from 1993 to the year 2000. That is comparable to 4 percent for prime lenders.

Our Texas office took a closer look at who are the subprime borrowers in Texas. And our Texas office looked at publicly available data available through HMDA and available through the census bureau.

This is information that is readily available and subject to peer review; it is information that anyone can access, it is not proprietary and it is useful in terms of discerning certain trends in the marketplace.

Our office in Texas found that income is a factor that predicts when someone is likely to get a subprime loan in a particular neighborhood, but even when controlling for other factors, the number of elderly people in a neighborhood and a borrower's rate can be key to determining who gets a subprime loan.

In Texas, the older residents in an area predict the greater likelihood of subprime lending in that area and that is consistent with the findings established by AAARP.

HMDA data for Texas also demonstrates that the growth of the subprime refinance market has increased overall statewide but that the percentage of loans to African-Americans and to Latinos that are made through subprime lenders has also increased

Those numbers are substantial. In 1997, 7.6 percent of all refinanced loans sought by Latinos were subprime. In 2002 that number jumped up——

Chairman NEY. I am sorry, did you say 70 percent?

Ms. GARCIA. Seven point 6 percent.

Chairman NEY. Oh, I am sorry. Okay.

Ms. GARCIA. In 2002 that number jumped up to 39.7 percent. For the African American community, those numbers are in 1997, 19 percent of all refinanced loans for African Americans were subprimed.

In the year 2002, that number jumped to 57 percent.

In California, cities have confirmed that subprime refinance lending is concentrated, highly concentrated in Latino and African American communities. And this is of great significance.

I heard a comment earlier that perhaps this is just an urban problem but it is not just an urban problem, it is also a rural problem.

In California, we had a few of the largest subprime growth areas that are actually in rural counties, so we know it is growing substantially in cities but it is also growing in fast-growing rural counties.

Subprime lending can reduce or eliminate home equity. This is one of the reasons why we are extremely concerned about the

growth in the subprime market to the extent that that also triggers a growth in predatory lending and everyone has heard the discussion today about what would be considered predatory.

To the extent that it contributes to that growth, there is a lot at stake here. There is a lot of home equity at stake, there are a lot of communities at stake and there is a lot of home equity that could be easily siphoned off.

Chairman NEY. I would note that time is expiring; we can move on to the last two witnesses and Mr. Clay may have some questions.

Ms. GARCIA. Thank you.

[The prepared statement of Norma Garcia can be found on page 150 in the appendix.]

Chairman NEY. Then we will come back. I am going to let you go before me. I just thought I would point that out to you.

STATEMENT OF GEOFF SMITH, PROJECT DIRECTOR, WOODSTOCK INSTITUTE

Mr. SMITH. Thank you for the invitation to testify before this hearing. My name is Geoff Smith and I am project director at the Woodstock Institute.

The Woodstock Institute is a 30-year-old Chicago based non-profit organization that works locally and nationally to promote reinvestment and economic development in lower income and minority communities.

With that we have been extremely active in the area of subprime and predatory lending policy, conducting research that illustrates the scope and impact of predatory lending and working to develop and promote local, State and federal policy that addresses this problem.

My testimony today will focus on the findings of the research report recently released by Woodstock Institute that quantifies the relationship between skyrocketing neighborhood foreclosures and increased levels of subprime lending in preceding years.

The results indicate that subprime lending was the dominant force in the increased and highly concentrated levels of neighborhood foreclosure.

In Chicago, a foreclosure led to staggering problems and the regions leading housing issue for local government and area community development organizations.

From 1995 to 2002, Chicago-area foreclosure starts increased by 238 percent.

Traditionally, FHA loans have been primarily associated with troubling foreclosure rates and lower income and minority communities. Over the course of the late 90s conventional foreclosures skyrocketed to take over this role.

Between 1995 and 2002, FHA-related foreclosures increased 105 percent. Over the same period, conventional foreclosures starts increased by 350 percent, three times the rate of FHAs.

These increased conventional foreclosures are not distributed evenly across the Chicago region, however. Rather, they are spatially concentrated in highly minority communities.

Neighborhoods greater than 90 percent saw an increase in financial foreclosure starts of 215 percent, while neighborhoods with 90

percent or greater minority populations experienced an increase of 544 percent.

Neighborhoods 90 percent or more minority residents accounted for 40 percent of the 1995 to 2002 increase in conventional foreclosure starts and tracked the 50 percent or greater minority populations accounting for more than 61 percent of the increase in foreclosure starts.

Neighborhoods of 90 percent or more minority residents in 2000 accounted for 37 percent of 2002 area conventional foreclosure starts, but these same communities only accounted for 9.2 percent of owner-occupied housing in the region.

The above illustrates that conventional foreclosures rapidly increased in the Chicago area from1995 to 2002 and that a disproportionate share of this growth occurred in highly minority communities.

The question we asked is "What factors drove these increases?"

What we found is that after controlling for changes in neighborhoods of economic and demographic conditions, subprime lending was the dominant factor of increased neighborhood foreclosure levels.

Our results show if every 100 additional subprime loans and under occupied properties made in the neighborhood from 1996 to 2001 that resulted in additional nine foreclosure starts in the community in 2002 considering that the average tract in Chicago had about 11 foreclosure starts in 2002 this represents a 76 percent increase in foreclosure levels.

Breaking down lending at loan purpose, we found that a tract with 100 additional prime home purchase loans from 1996 to 2001 could be expected to have about .3 additional foreclosures in 2002.

All tracts at 100 additional subprime home purchase loans are expected to have almost nine additional foreclosures. Thus, the contribution of subprime home purchase loans in the neighborhood foreclosures is 28 times that of prime home purchase loans.

In the case of refinance loans, the higher number of owner occupied prime loans actually leads to a reduced incidence of foreclosure levels.

A tract of 200 more owner-occupied prime refinanced loans from 1996 to 2001 is expected to have one fewer foreclosure than 2002.

Conversely, a tract with 200 additional subprime refinance loans can be expected to have 16 additional foreclosures.

The findings of our study clearly indicate that subprime lending is a dominant drive where the increase in highly concentrated neighborhood foreclosure levels of recent years, while responsible subprime lending may bring important benefits to families that have difficulty obtaining credit elsewhere, the cost associated with a lightly regulated subprime lending industry are too high to go unnoticed.

These economic, social and emotional costs accrue not just individual borrowers but also to modest income neighborhoods fighting for success and stability and cities struggling to provide public services and balanced budget deficits.

Neighborhoods and cities external to the foreclosure transactions lose hundreds of millions of dollars every year in decreased property values, lost tax revenue and increased service burdens.

The findings of our study indicate significant economic and social costs associated with portions of the subprime lending industry and the need for stronger controls at the federal and state levels. Thank you.

[The prepared statement of Geoff Smith can be found on page 209 in the appendix.]

Chairman NEY. We have our last witness. Mr. Staten.

STATEMENT OF MICHAEL STATEN, DIRECTOR, CREDIT RESEARCH CENTER, MCDONOUGH SCHOOL OF BUSINESS, GEORGETOWN UNIVERSITY

Mr. STATEN. Thank you, Mr. Chairman.

I appreciate the committee's efforts to gather information that will better describe the operation of subprime mortgage markets.

It is a daunting task, and those of us who are professional researchers and economists, as three of us on the panel are, have been spending some time over the last 3 years trying to do this very thing.

Part of the reason it is a daunting task is because there really is no comprehensive database of subprime loan activity.

I have submitted for the written record empirical evidence that we put together at the Credit Research Center using a large and unique database of about three million subprime loans made over the last 7 or 8 years.

And I will let that evidence stand for the written record. But let me just step back and talk at a 30,000-foot level about what data say and what they don't say and how it pays to be careful about the interpretations you make from these databases.

For example, we have heard time and time again this morning apparent alarm at the fact that there is a disparity in the incidence of subprime lending across certain geographic neighborhoods, in particular a higher incidence of subprime activity relative to prime in minority neighborhoods.

On the surface of it, that doesn't particularly alarm me. And that shouldn't shock you to hear that.

Because it may just be the case that this is symptomatic of greater access to credit. I understood from one witness this morning the primary problem we confronted 25 years ago. Now all of a sudden there is a flood of access to credit.

And so, perhaps the greater activity that we are seeing in terms of mortgage originations in traditionally less served neighborhoods, minority neighborhoods, lower income neighborhoods have is simply a reflection of the fact that the markets taken notice and are making credit available.

What you really should be asking of the databases that you examine is whether the price that is being offered to borrowers in those areas is appropriate to their risk. And it is not just the borrower's personal risk, it is also the whole package of risks embedded in the loan application, as we heard from our corporate representatives this morning.

Without that information you can't tell whether borrowers are being abused, whether they are being unfairly targeted and unfairly priced or gouged, however you want to phrase it.

The most commonly used database of all the studies that have been cited this morning is the HMDA data and the HMDA database is singularly unsuited for addressing that question.

The HMDA database is very good at telling you where the loans are made and the race of the person to whom they are being made. That is precisely what it was exactly designed to do.

But it doesn't tell you anything at all about the risk profile of the person getting the loan and it doesn't have any information about price.

That is a serious shortcoming in the entire discussion of subprime lending and whether activity is appropriate or not.

You can't begin to understand how the market is functioning in terms of matching loan and borrower risks to loan pricing and features unless you have that information.

Now that is going to change; it is going to change in 15 months because part of the additional disclosure requirements put on mortgage lenders, is to start providing information on price.

But that information won't be available to researchers until mid-2005 and until then all we have are the same HMDA data that we have been living with and trying to analyze subprime for the last 10 or 12 years.

And it is simply not up to the task. Not up to the task, not up to the task of addressing the questions that ought to be addressed, by this committee and any committee that is contemplating trying to legislate for the entire market based on basically the anecdotes and the horror stories that we don't deny are out there but don't give us any indication of how frequently those are occurring.

So what I have submitted for my written record is some discussion of the limits of the databases that are out there and a good deal of information about analysis of one database that is a large database comparable in size to what HMDA claims is the subprime component and also contains price information and borrower risk information that begins to allow you to assess whether the market is behaving as my colleague, Professor Yezer suggested, pretty much as we would expect a competitive market to behave as we teach it in introductory economics.

Thank you very much.

[The prepared statement of Michael Staten can be found on page 174 in the appendix.]

Chairman NEY. I want to thank the entire panel. I think you are a wonderful panel and have given great testimony.

Mr. Clay?

Mr. CLAY. I thank you, Mr. Chairman, I appreciate your indulgence.

Let me quote for the entire panel the comptroller of the currency made the point and I quote: "There is a danger that broad-based laws, however well-intentioned, may have an unintended adverse impact on the availability of non-predatory subprime credit."

This view was supported by other studies and for that and evidence subprime lending has declined in states and localities following adoption of predatory lending legislation.

From your research, can you determine if the flight of the business is because of the loss of exorbitant profits, from predatory laws, or other reasons? And I will just start here.

Please elaborate for me if you would please.

Mr. CALOMIRIS. Well, actually, I am going to be very brief because I think that Mr. Staten has done more empirical research on this but I have read empirical research on it.

What I would say is that I am convinced that the research that I have seen shows that certain high-cost subprime lending has declined. Now, there are two different interpretations of that decline.

One of them is that lenders are finding the legal risks and the transactions costs of meeting these State or local laws so onerous that they have decided to withdraw and that therefore some people who would like to borrow and can only borrow at very high rates are finding that there is not the opportunity.

Another interpretation is that the market wasn't functioning properly in advance and that those rates never should have happened and that those kinds of loan terms are almost by definition predatory.

That is basically why you can get two different views of this. My own view is it probably is a mix of the two.

Mr. CLAY. But sir, I only get five minutes of questioning and——

Mr. CALOMIRIS. My answer would be it is a mix of the two.

Mr. CLAY. Okay, thank you.

Mr. Yezer?

Mr. YEZER. Yes, let me put this is another context. When in consumer credit we have had experience with usury regulation and other regulation. Part of the problem with usury regulation is that there are always loan sharks.

There is always another resource. Now in the case of any credit market regulation, the group that we are not observing is the Brand X lender who may very well move in when other credit is restricted.

So, I would want to test that carefully before I passed a regulation.

Mr. CLAY. Thank you.

Ms. Garcia?

Ms. GARCIA. Yes, there is an assumption here when people talk about the restriction of credit that more credit is better? This isn't about more is better; it is about quality credit for communities that need it.

And so to the extent that some of the laws, local and state laws, have resulted in fewer subprime loans being made, we look at that as an indication that the law is working.

And there has been a lot of discussion about terms being onerous. I have had lenders come up to me and say, in the City of Oakland, "Well if such and such lender isn't going to lend here, I am more than happy to move in because I realize there is a viable market here that I want to tap into."

Now, maybe that is competition at work. Maybe that is the kind of competition that needs to be stimulated by these types of laws.

Mr. CLAY. I thank you for that response.

Mr. Smith?

Mr. SMITH. As I see it, laws are passed in states because abuse is identified in the lending market and by passing those laws you are addressing those abuses thus you would expect some sort of de-

cline in lending related to those types of loans and it is to be expected, I think.

And I think that over time you would see the market adjust.

Mr. CLAY. Before you answer, Mr. Staten, I know I would like to add a caveat to that question for you.

You brought out the fact about the market takes notice and that is why credit becomes available and of course you are right the market is 48 percent of African Americans own their own homes compared to 68 percent of the rest of the population. So, you talk about the price of appropriate risk.

Now, we are still talking about a house, a structure, right? I mean perhaps you can elaborate on what you mean by appropriate to the price to the risk.

You say a house is worth $100,000 or it is worth $200,000 or whatever. I mean, where does it stop where somebody receives some economic chances or just plain fairness?

Mr. STATEN. I am not sure I follow all of your question. What I referred to by pricing appropriate to risk is simply when a lender takes a look at a loan application walking through the door; a lender is trying to decide what is the likelihood that this loan is going to be repaid?

And what are the costs associated if it doesn't?

Part of the determinate of risk is the collateral value, part of it is how much the borrower puts down in terms of equity, part of it is the borrower's personal risk is reflected in FICO scores and other risk attributes.

Part of it is the apparent stability of the borrower's income. All of those things roll together. And those borrowers who have good track records in the past, have good equity in the home, good stable income, should get a lower price in a competitive market.

Mr. CLAY. How does that account for the fact that African Americans are five times more likely to be steered to the subprime market?

Mr. STATEN. Well I don't know what you mean by steered. What you are probably saying is that in some jurisdictions they are five times more likely to be taking subprime loans than prime loans.

Mr. CLAY. Yes.

Mr. STATEN. Okay. Do we know that that is not appropriate for the risk that they present?

Mr. CLAY. Well, it tells they have very similar payment histories, credit histories, backgrounds, what have you.

Mr. STATEN. Yes, which studies are those?

Mr. CLAY. Harvard just released one this week, I have not, I don't have it in front of me, but would like to share it with you.

Mr. STATEN. I would be happy to look at it.

Mr. CLAY. What is your response, because doesn't that number stick out? That African Americans are five times more likely?

Mr. STATEN. I don't think that is true everywhere.

Mr. CLAY. This is a national study.

Mr. STATEN. Are you representing that to be a national figure?

Mr. CLAY. Yes.

Mr. STATEN. I would have to take a closer look.

Mr. CLAY. We will get you that study, share it with you. I would love to talk more to you about it. I thank you, Mr. Chairman for the time.

Chairman NEY. Thank you and if you also, Mr. Clay, if you would like on the last couple of questions if you would like to ask some more it would be fine with me, too. It just depends on your time.

I wanted to start with 00; I don't know where to start but I think it is a fascinating conversation also from the point of view of looking at it statistically and academically.

I think Mr. Calomiris you had made a statement about statistics and they weren't accurate and statistically it hasn't been looked into with preciseness in a lot of cases, the studies that are out there.

Mr. CALOMIRIS. Well, I was referring to a few different things, two different kinds of problems. Because we are seeing a lot of discussion of studies here today, I was here for the whole first panel and listened to the discussion of studies that control for income which is not a sufficient statistic for an individual's risk.

And so some of the studies that were cited earlier really are just controlling for income, and that is not good enough. So some of the issues have to do with whether you are controlling for all the things you would want to control for.

FICO scores and loan to value ratios are the two most important things but they are not the only things.

I am not here as a banker, I am here as an academic but I am a banker.

And I can tell you that the FICO score is the beginning, not the end of risk analysis along with loan to value ratio, so part of it is that the studies are using data that are not complete but part of it too is that there may be what we call in statistical jargon cross sectional unobserved heterogeneity.

Okay, what does that translate into? That translates into the fact that there may be a variable left out that you can't observe that is correlated with a variable that you can observe. In that case, it could be race.

And so race may be picking up statistically things that just aren't in your data set and that may be correlated with the thing you are not observing. So you have to be careful.

That is not saying that that is the answer that is just saying you have to be careful when you are looking at these studies to make sure they are being done in a good and objective way.

Chairman NEY. You touched on information I think you are correct. You know I have recently done some financing last year and I sat there and I am trying to like get on with it and she is going through it and I always ask do I have a pre-payment penalty?

It is too much money, things I have been taught over the years. But I do like to get on with it.

And what I am getting to the mail on the information from the credit card companies that they are now required, under the law to send out is being discarded as most people discard three to four to five sheets.

I kind of like it simplified so I think we have probably informationed people to death to the point where I doubt they are

sitting down and looking through things. I think that would be definitely simplified a lot.

I just want to throw out a couple of statements to anybody. More than free to answer. All I want is one thing: your comment about equity. I am sorry. First, I think that Dr. Yezer had a comment about equity and——

Mr. YEZER. If you take a class in economics or if you look at economic research you will conclude American homeowners are holding far too much equity. And that the current mortgage interest instruments are 30-year fixed rates self-advertising instrument is a dinosaur and a disaster for American households.

And basically we encourage people and unfortunately in the African-American community it is all too common if you look at the numbers, they are just going to pay off the mortgage, right? And they are holding no, you know, they are holding a little bit of government guaranteed assets, usually bank accounts.

And they have got home equity. They have got no stock or bonds, mutual funds, no accountant or broker dealer. And again if something bad happens in their lives they initially max out their credit cards and then they want to tap their home equity and it is got you.

They are not going to get in the prime market. They are going to go subprime and they are going to pay really high rates of interest despite the fact that they have built up all this equity.

If instead of course they had an interest only mortgage or they had a mortgage instrument, which automatically swept out equity, which we could do, in modern design into a mutual fund.

By the way, they have initiated them in the U.K. Then if something bad happens, they could tap those funds.

And they wouldn't have to go through all the cost and trouble of refinancing and being thrown through a major got you into the subprime market. This is a major problem for American households.

Chairman NEY. What do you think about home equity loans?

Mr. YEZER. Home equity loans are one way, especially to the extent that people are getting around some of this problem. But remember those are largely for the people who have good credit risks and for whom the got you has not been too bad.

If you are a lower income person, generally speaking, and/or less knowledgeable about the use of credit, then you are much more likely to fall into the home equity trap. And it is very unfortunate.

Again, we are sitting here. We are the leader in financial economics in the world. The rest of the world comes here to study.

You take our classes, and we tell you how a household ought to manage their balance sheet. We tell you that the 30-year fixed rate self-advertising mortgage is a dinosaur. Right?

And then you go out and look what the government recommends and they recommend all the wrong things.

So it is kind of frustrating. But you know if efficiency broke out in the U.S. economy you wouldn't need economists so that is what we rely on.

Ms. GARCIA. Well I think that it is probably true that homeowners shouldn't accumulate all their wealth in their home equity.

The fact is that they do and we know that there are cultural considerations at play here that merit a deeper understanding but I can testify from first-hand experience that in the Latino community, at least if you have ever come from a Latin American country you understand there is no such thing as a mortgage.

And you don't own your house until you pay for the whole thing. And so to the extent that that practice is prevalent in the Latino community it is definitely culturally based.

I don't think that that eliminates our incentive here to protect against practices that siphon off equity unnecessarily. I think it informs the discussion and is something that we should consider when we talk about what we need to do here today.

Chairman NEY. I was chairman of insurance and banking committee. Because there was insurance companies, the banks, and the savings and loans at the time.

And none ever mixed. And the huge food fight we had which was tremendous was its unbelievable concept that the State of Ohio would ever enter into interstate banking was something that just wouldn't happen because interstate banking was going to destroy our state.

Because if you got a loan you went to you know Bank One or the Huntington Bank and that was all there was to it.

And of course years before that, the government said well you can have one of those drive through or branch banks. But it is got to be kind of close to the main bank.

But I just think back and it brings my point to a national standard. I don't even call it preemption any more. It is a national standard.

And I think now it, the OCC was what they are looking at in their ruling will create a two-tier system and people will be under that rule but this whole group of financial institutions that aren't national and so therefore you are going to have a two-tier process.

But, and I was always opposing the rule and if you would have asked me years ago about interstate banking at the time it would be the fact that we have to have armed protection in our State and we can't intermingle.

If you asked me about preemption we wouldn't dare with Ohio's home rule thinking pre-empt something. But all of a sudden everything changed and those also were the days where you didn't link up to a computer and have ditech.com or whatever you know you either went right into your State or you didn't.

There wasn't the technology so I think all of that has changed to where you know it is time to talk about a national standard otherwise you know you will have inequities for people across this county and we could say, "Well, look, Georgia had a mess down there and then it came back and we straighten part of it out because people were actually kicked out of the subprime market."

And Georgia? What does it have to do with Ohio? Or California? Well it does these days. It is different.

You know money is moving and money is money so I just think that you know if somebody would have asked me would I be offering this bill 15 years ago, I would have said no. Absolutely not.

But times have changed and technology has changed, which makes it interesting about Mr. Calomiris' comment about you have

been wanting to say about this kind of wait and solve it with a chart. Which may be so simplistic but look at that and see if that does it. It spells I think a lot of things out.

The one question I wanted to ask you Ms. Garcia is the one statement you made was sort of on the basis that maybe we ought to look at the quality and but not have some people in subprime because it is too costly.

Something to that effect, I think. Is it a bad thing or a good thing and I think we have to look too at the person that is out there and they can because of risk factors they can only get into the subprime and if you ask them they think they can pay that mortgage, they are going to want to be in there versus us telling them for the good of the order you know it is kind of better to start your house for a while.

And that is because maybe they have had a credit problem. So that is been the intent of in my opinion this bill is standardized some issues to protect some consumers.

You know, look, there is a lot of things that ought to be spelled out and we have got Mr. Scott and Ms. Velazquez the counseling issues because I think people have to be educated.

Those are just a few of the thoughts I had about national standard and why I think we should embark on it.

If you don't have a national standard then you do have you know the State of Ohio and then Cleveland and then Cambridge has its own and Dayton, Ohio and then Toledo and it just keeps going to where people can't get into the market and they have got bad credit and subprime in Cleveland, Ohio but if you move to Toledo maybe you can.

And I just——

Ms. GARCIA. May I respond to that?

Chairman NEY. Yes. Sure I am just throwing this out there.

Ms. GARCIA. Well we think a national standard is a good thing but we also believe that it is important for states to have some flexibility to legislate where the national standard doesn't meet the needs of people in particular states.

We think the national standard sets the floor, not the ceiling of what should happen with respect to how subprime lending is regulated in this country.

There has been a lot of discussion about local ordinances in Oakland and in Los Angeles and I would be happy to comment about that since I have been involved with both those processes as well as with the establishment of the State law in California and I can tell you that the State law in California was in response to holes seen in the federal law and it was also response to the severity of predatory mortgage lending in California.

I don't know that every state shared that experience but that has been our experience and that is what motivated the impetus for a statewide law in California.

Now, we looked a local ordinances and what is that all about? You know why if we have a state law in California why would local governments want to come in and do something else?

Well, the fact is that the local governments analyzed the State law and realized that people in their jurisdiction needed more protection.

The City of Oakland proceeded very carefully with their ordinance and I have heard a lot of discussion here about the Oakland ordinance and how it might impact upon the purchase money market but I want to mention also that no one mentioned that one of the triggers for the Oakland ordinances, the triggers are different for purchase money loans versus refinance loans.

Recognizing that there is a benefit to subprime lending in the purchase money market, there is also been an attempt by the city attorney's office; it is an ongoing discussion that they are having with the ratings bureaus about the assignee liability issue. And no one mentioned that.

There are some distinctions to be looked at here. I think one of the things we need to think about is what drives the State movement, what drives local ordinance movement and it is the gaps.

And unless and until the federal law can address those gaps you are going to have local governments interested in being more protective.

Chairman NEY. So you would support a national standard?

Ms. GARCIA. I would support a national standard as a floor to what needs to happen——

Chairman NEY. Of course that limit was a floor.

Ms. GARCIA. And you know there are a lot of good things in HOEPA, but 10 years later, we still have problems.

Chairman NEY. I mean, in one way I mean one of the witnesses previous I think would support a national standard if it was one they liked. I mean, if it did certain things.

I just think taking since things have changed as I said earlier and taking an objective look at it. The other thing I will tell you and I am not saying that by any stretch of the imagination the U.S. House is void of politics but when I was in the State senate I used to do the usury amendment.

Nobody ever wanted to do it and we had Democrat and Republicans, it is not a partisan statement stand up on the floor and says let us make usury 4 percent in Ohio.

Knowing of course that in those days major companies could just bomb us out in Michigan and take 3,000 jobs and still you could go get your credit with them at a higher interest rate.

Or the fact that some of the federated change would in fact just cut people off of credit.

Now, nobody likes these bills that make usury at 17 or 21 percent but we would have these emotional gimmick amendments to make it 4 percent.

One day I said, "We ought to just pass one of those and watch the people that introduced it pass out."

And I think that nationally there are a lot of good people all over. I applaud people who run for office but I think also nationally there is a lot of emotion to this, a lot of politics.

You stand up on the floor of a council, maybe it hasn't been looked at in some aspects and you do an amendment that is just going to kill people with kindness you know and keep them in apartments.

I think that is a potential and you have them all over the country, so I think just take another look at it. I mean when we even dared to do this bill a few years ago, it was like it was almost

something criminal to even talk about predatory lending, but I think Georgia and the problems came to the forefront and that is why I think we are having a decent discussion by the way about this issue, I really do.

Of people from all sides but I think, too, out in the hinterlands you had a lot of emotion on this issue and it would tend to do a lot of politics, and some people in certain towns aren't going to have the ability of what they should.

But, again, you have to get down also to the root of real predatory practices of terrible things that are done to people and I use the Cleveland example where they mandated predatory lending counseling, which is great.

And this poor guy thought his mortgage was $447; it was $600 and some. And the counselor who was hired under this law created in Cleveland, as I read in "The Plain Dealer" said I stayed $79 bucks, I sat down with the guy.

And, so, you know you do counseling a certain way in Cleveland and a certain way in Des Moines, Iowa and you know I just think some national standards even on that I think would be a healthier idea when people send for it.

Ms. GARCIA. Well, one other thing that I wanted to mention also that was not stated about Oakland and Los Angeles is that those ordinances do not prohibit high cost lending or borrowing. They only provide for certain protections for the borrowers of the highest cost loans.

And so, to that extent they are not limiting lending and many of the provisions of those ordinances are some of the things that we have been talking about here today, and there have been a number of statements made about the value of counseling and the value of an informed borrower.

Well, those ordinances have provisions that require counseling for borrowers who are taking out the highest cost loans. And that benefits everyone, it benefits the lender, it benefits the borrower.

Chairman NEY. I wanted to ask, because we are running out of time, regulated mortgages that are priced too high would probably, I assume, likely prevent high risk borrowers from getting loans.

Because those high-risk borrowers are the most likely to default on their loans, do you see any positives in essentially barring the high-risk borrowers?

Do you see any positives in that or——

Mr. SMITH. I think that that is a good point. I mean, I think that there is been this perception that everyone in some ways everyone should have access to credit and I think that sounds bad.

I think that there are borrowers out there that are too risky for certain mortgages and I think that that is manifested in these high foreclosure levels.

Something had to be driving the increases in foreclosures of 544 percent in predominantly minority communities and it is not——

Chairman NEY. Can I ask you has anybody factored any credit cards and——

Mr. SMITH. Well, we didn't consider other consumer debt in our research. That data just given the nature of the data it is not available at the level that we use for analysis.

Mr. STATEN. I just want to jump in here to say I am imagining a different world. I am imagining that we are sitting here today and that we are all complaining at how inefficient the market was because all these people pay such high interest rates on subprime loans but the foreclosure experience was the same as on prime loans.

And they obviously were cheated, right?

Because they weren't so risky after all but they paid really high interest rates and so we are not here with that discussion, we are here with a different discussion, an unsurprising discussion which is that when we had an enormous boom in subprime lending with very high interest rates being charged because most subprime loans are riskier, we got more risk.

What a surprise.

Mr. SMITH. Well I don't think that it is a surprise necessarily that higher risk loans default and foreclose at higher levels than prime loans but the magnitude of the relationship I think is what I would categorize as surprising and I just think that that is what is really significant not just that subprime loans lead to higher rates of foreclosure than prime loans.

That is to be expected. But that they lead to higher rates of foreclosure 28 times prime loans. I think that is unacceptable.

Mr. DAVIS. Well let me just say because I talked to Standard & Poors in my Senate testimony of 4 years ago I asked them to tell me what their estimates were of what the foreclosure rates would be. And they estimated they would be 23 times in some categories, 1,000 times and I think the average was for subprime relative to prime about 24 times.

That was an anti-estimate. So it sounds like we priced them based on an ex-anti-estimate that looks a lot like the ex-post experience. What is surprising here?

Mr. SMITH. Well perhaps it is not surprising then but I think it is unfortunate then that that is an acceptable risk. If seeing foreclosures increase by 544 percent is an acceptable risk then that is too much risk.

Mr. DAVIS. Now we have really come to the heart of the issue.

The heart of the issue is whether and this is why I call these self-usury laws. The heart of the issue is whether some grandmother who is sitting on a house, has a lot of home equity and her grandchild would like to go to an expensive college and she is trying to decide whether to get a subprime loan because she can't qualify for a prime loan to basically take some of the equity out of her house and finance that education.

It is going to be really expensive and there is a significant chance that she is going to actually not be able to make it and there is going to be a foreclosure.

Now the question is do you want to stop her from doing it or do you want to let her do it? And I will tell you where I stand on that. I think I am going to let her do it. And he wants to stop her.

Chairman NEY. Well, if are you stopping grandma? Why don't you comment on that?

Mr. SMITH. If grandma is going to foreclose, then yes I would stop her. I mean, I think one of the things that we are also missing on this quick discussion is that subprime loans aren't evenly dis-

tributed across space; they are concentrated in highly minority communities——

Chairman NEY. How do we know that she is going to foreclose, though, just because it is a higher? How do we know that? I am just curious.

Mr. SMITH. Well we don't know that she is going to foreclose but if we——

Chairman NEY. I can have a low rate and hey I go out and you do this and you spend that and I run up credit cards and you know et cetera and all of a sudden I just I lost my home so my imagine so hey let us do a background profile on the bar because that person gambles or might gamble or makes that investment.

I am just saying, if it is a couple of points higher on interest we say well, you know they are for sure going to default down the road.

Mr. SMITH. It depends on how much risk you are willing to tolerate. You can make a loan that is 99 percent likely to go into foreclosure and there is that 1 percent there that maybe she can make it and if you are willing to tolerate that risk then that is okay.

I mean that is acceptable risk then fine but I think that there has to be a threshold where we say that is too much risk and the impact that foreclosures have on communities not just individual borrowers but cities and neighborhoods is too much to accept.

Chairman NEY. I know Mr. Staten also talked about calculating risk I think earlier in your testimony if you want to jump in.

Mr. STATEN. I Just want to make one point and that is that she can sell the house, okay, because that is what she would be forced to do if she really wants her grandchild to go to college, so she can sell the house.

You know that is an option and so do we want to force her to do that? The other option of course it there is lots of other sources of credit. As I said, there is all these Brand X mortgages out there.

We don't even know who these people are; they probably are the most abusive lenders and you guys aren't regulating them or talking about regulating them and nothing you do will regulate them.

Is that clear in my testimony? Okay, is it clear?

I can get financing without going to a home brokerage lender or a regulated lender, okay? So the real question is what do we want the person to do? Sell the house, go to a subprime lender or go to Brand X lender.

Chairman NEY. You know one of the issues is I think that the average lender that is out there is not going to sit and say okay well first of all you are going to have to go to subprime and you see that they make $1,000 a month.

I don't think your average lender is going to walk in there and say well let us make payments $800 a month and finance you $800 a month knowing they are going to default and popular thinking is everybody wants to get that house and I have found; at least I have seen statistically a lot of places don't like to mess with that because they got to go in, clean the house up, have somebody manage it, try to sell it.

Now I am not saying that there aren't people out there that haven't today that don't do those practices. I am sure some people

sit there and they might say we know this person is going to fail we are going to try and take this house.

But I just don't think a lot of the reputable ones will do that so therefore let us try to find the ones that aren't reputable and weed them out.

I just don't think a lot of people in the business are going to sit there and say, "Okay. Now let us bring them all in and manage all this property."

Some people would do that, I am not saying that that doesn't happen in the country and we have got to correct that.

Mr. SMITH. It doesn't have to be doomed to fail to trip these high cost thresholds. Let us just talk through an example.

Suppose that you are talking about a pretty small mortgage like a $50,000 mortgage and there is only a 10 percent chance there is going to be a foreclosure, okay? A 10 percent chance, but my foreclosure costs are going to be $20,000 as a banker.

If my foreclosure costs are $20,000 then that means that I might not get back $30,000 let us say on that house. So I might charge a 15 percent interest rate or 20 percent interest rate on a small mortgage even if there is only a 10 percent default probability and that might be the fair interest rate to charge.

And so in my grandmother example, grandma may say there is a 90 percent I am not going to get foreclosed.

And my point is that that kind of a loan will trigger the effective stealth usury triggers that are no longer these state laws and so its nuts talking about the 99 percent chance of foreclosure that seems so obvious or the example we had in the previous panel where somebody unscrupulously had a loan payment that is equal to the social security payment.

Those are clear cases that we don't want to see but my case is a tough one. You can't just back off from that case because that is realistic.

A lot of people are paying high interest rates that aren't going to get access to credit and a foreclosure might only be 10 or 20 percent. High, significant but you have to decide, are you going to make their decision for them?

Some people are willing to do that. I am not.

Chairman NEY. Yes.

Mr. SMITH. Let me give you another example that is part of the home equity trap that indicates how insidious it really is.

Okay, I am employed in the town; there is a major industry in the town, major industry declines. I am laid off. I have got all my money in home equity. I can't get a prime mortgage so what do I do?

Well, I can sell my house at the very time in which the housing market is in the toilet and everybody else wants to sell?

Oh, good I am in great shape then. Or I can get a subprime mortgage and hope the industry rebounds or I can get a job someplace else.

The subprime mortgages come back very fast if that person does get a job or if the community revives they are going to refinance back into a prime mortgage just as soon as their FICO score improves.

That is what we see; by the way, subprime refinancing is very, very high and has no relationship to interest rates particularly at all.

When folks have a bad experience because they were caught in the home equity trap and then they temporarily can only get this credit or they have to sell their house in a declining market or an unsatisfactory situation and after a short period of time, a year or 2, they cure this situation they can refinance back into the prime market.

Now what is wrong with that? This is the way we teach our kids in freshman economics. You have to be careful.

I agree there may be all sorts of provisions just with credit practices that you can say, this is a bad thing. And get rid of it.

But you need to have solid research by good economists before you go out and do those things and try to regulate. Charles posed a disclosure notion.

I actually am so old that I actually advised on the APR regulations, but anyway, that is how bad it is. I look a lot younger of course.

But before you pass these, one of my colleagues also worked on the Susan B. Anthony half-dollar.

So one of the things I know is you have to have solid research before you decide what you can regulate and what would be a practice that someone abusive would use and someone who was not abusive wouldn't want. And then go after it.

Chairman NEY. So you feel the home equity loans are something that should be suffered together?

Mr. SMITH. No. I think what has happened with home equity is a substitute for what is going into the subprime market and trying to attach as equity. I talk to the mortgage bankers and I tell them you know you are all one in done business.

I mean, it is mortgage bankers, brain surgeons and morticians. The one and done consumer model. They should be providing people with financial services for a lifetime.

Okay, that is what they should be doing. And there should be, if there were different kinds of mortgage instruments that were really being pushed and the American people were being told that in fact they should get into equity market.

I mean Australia is upside down but they still have a mortgage, which is selling which allows you to miss the payment each year. This is we just want to maximize our home equity, this is entirely wrong.

And as I say but if we are going to do that, then we need a liquid market so that people can bail themselves out when the local economy goes in the toilet, because otherwise they are really in trouble.

Chairman NEY. I am sorry we are out of time but I could go on. Fascinating panelists each and every one of you.

One statement I did want to touch on was that what you said about freshman economics and I just think that I am a teacher by degree and some of my teaching colleagues would be upset with everything is laid on the school systems. I think too much, you know, in a lot of ways.

That happens to be moms and dads and you know helping with the family things that should be done at home but that is the way life is.

But somewhere along the line I think at an earlier age across this country if we could teach some kind of basic this is how a checking account happens, if you go buy a $1,000 worth of clothes and you have that credit card. And by the way and it is only $10 a month it is going to take you 10 years to pay it off.

Somewhere along the line you could get some basic life reasoning, even if it is a two-week course in eighth grade or whatever.

I think honestly it would help at a younger age to give a little bit of education so people would. Because, when we passed the mandatory seatbelt law in the State of Ohio and I mean if you want to hear people you know screaming to high heaven about it and people are still upset about it but the young kids are raised with it?

And they buckle up, it is no problem, there are no problems; they are not offended by it.

But people are still debating it to this day 12 or 15 years later. And I think if we can get into the somehow education system and that would be a remarkable way, whichever side of the issue you all are on or anybody.

It would be a remarkable way early on counseling and warning and dangers of predatory lending and not having been able to have them become bank closing and finance officers or counselors but some kind of basic knowledge I just think would be so helpful at a younger age.

All the way around.

I want to thank you. You have just been a magnificent panel. Thank you very much.

The chair knows that some member may have additional questions for the panel, which they may wish to submit in writing.

Without objection the hearing record will remain open for 30 days for members to submit written questions to these witnesses in place to response to the record.

The hearing is adjourned.

[Whereupon, at 3:27 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 30, 2004

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity

"Subprime Lending: Defining the Market and Its Customers"
March 30, 2004

Let me begin by thanking Chairman Ney and Chairman Bachus for convening this joint hearing of their two subcommittees in the attempt to better understand the dynamics of the subprime market as well as the customers who use it.

As we heard time and again in the exhaustive set of hearings that Chairman Bachus chaired last year on reauthorizing the Fair Credit Reporting Act, in the last two decades we have witnessed a revolutionary "democratization" of our nation's credit markets. Consumers who once found themselves shut out of the financial mainstream now have access to a wide array of products that can help them achieve the American Dream for themselves and for their families.

Nowhere has the democratization in credit availability been more pronounced than in the mortgage finance area, where historically low interest rates have combined with other economic and demographic factors to produce record levels of homeownership, now approaching 70 percent.

Growth has been particularly explosive in the nonprime segment of the mortgage market, where home equity loan originations are estimated to have exceeded $300 billion in 2003, representing about 10 percent of all mortgage originations. This increase in lending to previously underserved Americans has been accompanied by concerns about the vulnerability of low- and moderate-income consumers to unscrupulous lenders seeking to saddle them with high-cost loans that the consumers may lack the ability to repay.

Reported instances of such "predatory lending" have prompted a number of States and localities to pass laws or ordinances designed to protect consumers from abusive practices. Predatory lending laws were introduced in 42 states during the calendar year 2003. The public policy merits of these State and local efforts have been the subject of intense debate. Some hailing them as strong pro-consumer initiatives, while others contend that the measures have had the unintended consequence of limiting credit availability to nonprime borrowers, by driving up lenders' costs to the point where it no longer makes economic sense for them to make the loans.

The goal of any solution to the predatory lending problem must be to target sharp practices while at the same time ensuring that low- and moderate-income consumers continue to enjoy the benefits of readily available mortgage credit. To combat predatory lending, we must demand that the banking regulators and, where appropriate, law enforcement authorities aggressively enforce consumer protection and fair lending statutes against those who would prey upon the unsophisticated borrower. We must also continue to emphasize the importance of achieving higher levels of financial literacy among all Americans, particularly those who present higher credit risks and who are therefore more likely to face higher credit costs. Consumers who have been armed with the basic tools to manage their finances wisely are far less likely to fall victim to damaging loan terms or other financial scams designed to strip them of home equity while generating huge fees for lenders or their agents.

Before action can be taken, however, it is imperative that we understand the subprime customers and the market in which they participate. It is my hope that the hearing today will help to further educate and enlighten us on this important issue.

Let me again thank Chairman Bachus and Chairman Ney for their work in putting together a balanced hearing on an issue that elicits strong passions on both sides. I look forward to the testimony of our distinguished witnesses, and I yield back the balance of my time.

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OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS
"SUBPRIME LENDING: DEFINING THE MARKET AND ITS CUSTOMERS"
MARCH 30, 2004

Thank you, Chairman Ney for convening this joint hearing of our two subcommittees to review issues related to the subprime mortgage lending industry in the United States. This is the second in a series of hearings on subprime lending. In November we held a hearing which examined ways to eliminate abusive lending practices in the subprime lending market while preserving and promoting affordable lending to millions of Americans. This hearing will focus on the dynamics of the subprime lending market and its ability to offer more customized mortgage products to meet customers' varying credit needs. This hearing should help us to identify the typical subprime borrowers and the advantages and disadvantages the market poses to the financial security of these consumers.

Over the last decade or so, with low interest rates, a competitive marketplace, and various government policies encouraging homeownership, a record number of Americans have had the opportunity to purchase homes. A large number of these new homeowners have enjoyed one of the many benefits of homeownership -- using the equity in their homes for home improvements, family emergencies, debt consolidation, etc. Many of these consumers were able to purchase and use the equity in their homes because of the subprime lending market which provides millions of Americans with credit that they may not have otherwise been able to obtain.

Many borrowers are unable to qualify for the lowest mortgage rate available in the "prime" market — also known as the "conventional" or "conforming" market — because they have less than perfect credit or cannot meet some of the tougher

underwriting requirements of the prime market. These borrowers, who generally are considered as posing higher risks, rely on the subprime market which offers more customized mortgage products to meet customers' varying credit needs and situations. Subprime borrowers pay higher rates and servicing costs to offset their greater risk.

Nationally, subprime mortgage originations have skyrocketed since the early 1990s. Finance companies, non-bank mortgage companies and to a lesser extent commercial banks have become active players in this area. In 1994, just $34 billion in subprime mortgages were originated, compared with over $213 billion in 2002. The proportion of subprime loans compared with all home loans also rose dramatically. In 1994, subprime mortgages represented 5 percent of overall mortgage originations in the U.S. By 2002, the share had risen to 8.6 percent.

Unfortunately, the increase in subprime lending has in some instances increased abusive lending practices that have been targeted at more vulnerable populations, i.e. minorities and the elderly. These abusive practices have become known as "predatory lending." Predatory loan features include excessively high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flippings, loan steering, mandatory arbitration, and unnecessary credit life insurance. Predatory lending has destroyed the dream of homeownership for many families while leaving behind devastated communities. Hopefully today's hearing will help us to distinguish legitimate subprime lending, i.e. loans that compensate the lender for the enhanced risk posed by the borrower, from predatory lending.

In closing, I want to thank Chairman Ney and Congressman Ken Lucas for their tireless efforts on this issue over the past year. They, along with Congressman Kanjorksi, are passionate about coming up with solutions and deserve a great deal of credit for all of their work on H.R. 833, the Responsible Lending Act. I also want to commend Congressman David Scott for his work on H.R. 1865, the Prevention of Predatory Lending through Education Act, and Congressmen Mel Watt and Brad Miller, who recently introduced H.R. 3974, the Prohibit Predatory Lending Act of 2004. I look forward to working with Chairman Ney, Congressmen Lucas, Scott, Watt, Miller and my other colleagues as we continue to examine this complicated issue.

I yield back the balance of my time.

March 30, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
Joint Hearing entitled, "Subprime Lending: Defining the Market and its Customers"

I would like to thank our Subcommittee Chairmen for calling this important hearing and allowing us the opportunity to discuss issues related to the subprime mortgage lending market. Since the early 1990s the subprime market has greatly expanded with just $34 billion in subprime mortgages originated in 1994 and $213 billion in 2002.

I look forward to our discussion today of the subprime market and the millions of American consumers with less than perfect credit that rely on subprime lenders for access to the mortgage market.

While subprime lending has increased access to credit for many worthy Americans it has also, in some cases, enabled vulnerable populations to be targeted by abusive or "predatory" lenders. In response to such practices many states and localities have enacted "predatory lending" laws requiring new consumer disclosures, prohibiting certain terms, and creating new legal protections for borrowers who are victims of abusive lending practices.

In my home state of Ohio, the city of Cleveland passed a law restricting high loan rates and other subprime practices intended to prohibit "predatory" activities. However, as was detailed in a Cleveland Plain Dealer article, this law only served to drive lenders out of Cleveland during the 14 months before it was found unconstitutional. Residents who had less than perfect credit found it almost impossible to find a home loan in the city of Cleveland.

I am happy to be an original cosponsor of HR 833, the Responsible Lending Act of 2003, legislation to establish a federal standard to combat unfair and deceptive practices in the high-cost mortgage market, establish a consumer mortgage protection board, and establish licensing and minimum standards for mortgage brokers. This legislation would

establish a balanced federal standard to combat "predatory" lending practices while maintaining access for consumers to the subprime market.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative session.

Opening statement
Congressman Luis V. Gutierrez
March 30, 2004
Hearing on Subprime Lending

Thank you, Chairmen Bachus and Ney and Ranking Members Sanders and Waters, for holding this hearing on the important issue of subprime lending.

Not all subprime lending is predatory lending, but most predatory lending practices and abuses occur in the subprime sector. And this sector contains a disproportionate number of minority and elderly home loans.

I am troubled that we have not yet been able to enact a strong federal law to outlaw the most egregious of these practices. Several of my colleagues have been working on legislation in this area, and their efforts should be commended and I hope this issue will be addressed soon by the Committee. I believe that legislation in this area is long overdue.

As you are aware, the states have been making the most progress in this arena, and we should ensure that they are allowed to continue their innovative work in a meaningful way. Their legislation is protecting local consumers

immediately and providing valuable guidance for the eventual federal law. In fact, if it weren't for the Illinois legislature's work on banking and insurance law, we would have no financial modernization. The Illinois law served as the model for that statute.

The OCC's preemption rule threatens to stifle that innovation, while denying consumers valuable protection. The mantra in real estate is 'location, location, location,' and local jurisdictions are best positioned to respond quickly and effectively to trends that are unique to their location.

I believe that we should be informed by the choices the states are making and work toward a strong, federal law that combines the best of these principles. The federal predatory lending law, like the privacy provisions in Gramm-Leach-Bliley, should act as a floor, not a ceiling, to permit states to provide greater protections to their citizens.

Thank you again for holding this hearing. I look forward to the testimony of the witnesses.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
JOINT HEARING
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUBCOMMITTEE ON HOUSING
"SUBPRIME LENDING: DEFINING THE MARKETS AND ITS CUSTOMERS"
MARCH 30, 2004

Chairmen Ney and Bachus and Ranking Members Waters and Sanders,

I want to thank you for calling this very rare joint hearing of two important subcommittees on a topic of particular concern to me and to my constituents: subprime lending and predatory lending. I hope that this will be the first in a series of hearings that you will hold on this subject in both subcommittees and then the Full Committee.

As many of you are aware, subprime lending has increased abusive lending practices particularly aimed at vulnerable populations, such as the Hispanic population in my district. These constituents do not qualify for prime loans and must trust subprime lenders not to impose unnecessary fees or to trap them into schemes where they end up losing their homes, thereby transforming a subprime lending into a predatory lender.

I was concerned to read in Mr. Smith's testimony that a study by "ABT" and Associates in Atlanta found that foreclosures attributed to subprime lenders accounted for 36 percent of all foreclosures in predominantly minority neighborhoods in 1999, while their share of loan originations was between 26 and 31 percent in the preceding three years.

However, I understand that lenders need to maintain appropriate capital levels and to weigh the risk of the loans they make to lenders. The need exists for a subprime lending market for individuals that pose more of a risk to the lending institution. However, "subprime lending" has yet to be defined, and some claim that it is impossible to define. If that is the case, then I wonder if we are chasing our tails here today. Perhaps we should wait to act until it is defined.

Regardless, legislation has been introduced on subprime lending and predatory lending by my esteemed colleagues Congressmen Ney and Lucas and Congressmen Miller and Watt. I intend to review their proposals carefully prior to taking any positions on the legislation. It is also my understanding that our Ranking Member Kanjorski is working on draft legislation that will be available in 30 to 60 days on this same subject.
My staff has already expressed to his staff my desire to work with him on his legislation to ensure that it addresses the needs of the Hispanic population, and other minority populations, in the United States to ensure that my views are protected under its clauses and provisions to every degree possible.

My ultimate goal is to protect my constituents from predatory lenders while ensuring that they receive fair subprime loans if they do not qualify for prime loans. I have yet to review the preemption issue at any great length.

Mr. Chairmen, I yield back the balance of my time.

STATEMENT BY REP. BERNARD SANDERS ON PREDATORY LENDING

I would like to thank Chairmen Bachus and Ney for holding this important hearing.

According to the Coalition for Responsible Lending predatory lending is costing U.S. families $9.1 billion each year.

Mr. Chairman, in the richest country on earth, the record-breaking number of housing foreclosures in this country is a national disgrace. Between 1980 and 1999 both the number and the rate of home foreclosures in the United States have skyrocketed by 277%. According to an article in the *New York Times*, over 130,000 homes have been foreclosed in the spring of 2002 alone with another record-breaking 414,772 foreclosures in the pipeline. Many of these foreclosures are a direct result of predatory lending practices through the sub-prime market that must be put to an end immediately. In fact, according to the Mortgage Bankers Association, while subprime lenders account for 10% of the mortgage lending market, they account for 60% of foreclosures.

Predatory lending is a growing problem across the United States. Desperate for homeownership or home improvements, more and more people are being tricked into home loans with high interest rates and fees that are impossible to pay and eventually lead to foreclosure.

Predatory lending is being perpetrated by the likes of CitiGroup and Household International. As a result of legal actions filed by the Federal Trade Commission, CitiGroup agreed in September to reimburse consumers $215 million for predatory lending abuses – which represents the largest consumer settlement in FTC history. Due to the good work of State Attorneys General, Household International has agreed to pay $484 million

to reimburse victims of predatory lending – representing the largest direct payment ever in a state or federal consumer case.

Homeownership is the American Dream. It is the opportunity for all Americans to put down roots and start creating equity for themselves and their families. Homeownership has been the path to building wealth for generations of Americans. It has been the key to ensuring stable communities, good schools, and safe streets.

Predatory lenders play on these hopes and dreams to rip people off and rob them of their homes. These lenders target lower income, elderly, and, often, unsophisticated homeowners for their abusive practices.

But, let us not forget, when we are talking about predatory lending we are not just talking about mortgage lending – we are talking about auto-financing and credit card companies as well. Mr. Chairman, I appreciated the opportunity to work with you against what I think is one of the most egregious predatory lending practices -- the credit card interest rate bait and switch – in which credit card companies double or triple your interest rate because you made one late payment on a student loan three years ago, even though you never missed one credit card payment. I think that is an outrageous practice that must be stopped, and I look forward to continue working with you on that issue. Mr. Chairman, just last week Rep. LaTourette and I sent you a letter requesting a hearing on the credit card interest rate bait and switch issue, and I am hopeful that we could have a hearing on this egregious practice as soon as possible.

Finally, Mr. Chairman, I know that there is an effort to pre-empt states and localities from passing strong anti-predatory lending laws. I am strongly opposed to this effort. It seems to me that this Committee is trying to do everything it can to erode the rights of states and localities to set their own laws. First, we had to permanently ban states from passing stronger

consumer protection laws in terms of credit reports and financial privacy. This Committee is also trying to make it more difficult for states to take strong enforcement action against Wall Street firms that defraud investors. More efforts are underway for this Committee to ban states from passing laws to protect consumers against Rent-To-Own companies and now some will be talking about what a good deal it would be to ban states from passing stronger anti-predatory lending laws. I am beginning to wonder if this Committee should be re-named to the State Pre-emption Committee. Mr. Chairman, call me a conservative again on this issue because I believe we should be protecting the rights of states and localities to set their own consumer protection laws – not the opposite. If we can come to an agreement to set strong national standards to protect consumers – fine, I would love to work with you on that. But let's give states and localities the right to go further.

In terms of predatory lending, progress is being made on the state and local level. Beginning with North Carolina in 1999, some 19 states have enacted statutes or regulations to curb predatory lending abuses, with 10 states enacting comprehensive protections. In addition, at least 20 municipalities have also enacted anti-predatory lending ordinances since 1999. This is a good thing. For example, according to the Coalition for Responsible Lending, the North Carolina anti-predatory lending law saved homeowners $100 million in its first year alone.

We must continue to scrutinize predatory lending practices and protect American consumers who are easy targets for the predatory lending industry. But, we must not prohibit state and local governments from setting their own laws. Thank you Mr. Chairman, and I look forward to this hearing.

Statement of Teresa A. Bryce

Vice President & General Counsel
Nexstar Financial Corp.
St. Louis, MO

on behalf of

Mortgage Bankers Association

before the

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity

U.S. House of Representatives

Hearing on

"Subprime Lending: Defining the Market and Its Customers"

March 30, 2004

Good morning Chairmen Bachus and Ney, and members of the Committee. My name is Teresa Bryce, and I am General Counsel of Nexstar Financial Corporation, in St. Louis, Missouri. Today, I appear before you as a representative of the Mortgage Bankers Association (MBA).[1]

First, on behalf of our entire industry, I wish to thank the chairmen for their unwavering leadership on the important consumer protection issues affecting mortgage lending. We are committed to supporting the Chairman in achieving dual goals of strengthening protections for the more vulnerable consumers while at the same time allowing for the expansion of mortgage credit access for all persons.

In order to achieve these "twin" goals, we believe it is crucially important to understand the structure and composition of today's vibrant mortgage market. This is especially important in the area of subprime lending, which has attracted much attention because of reports of "predatory" and "abusive lending," terms that are ill-defined and driven by anecdote, as opposed to solid, market-wide information.

I will, therefore, focus my testimony on providing an overview of the structure of our industry, stressing the importance of the subprime segment of the mortgage market, and describing our concerns regarding the passage of an increasing number of

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,700 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

disparate and overly restrictive state and local laws that intend to address predatory lending.

The major points that I will expand on my testimony are as follows:

- The U.S. mortgage market has enabled 68% of all Americans to own homes; a direct result of Congress establishing a national mortgage market to replace a local mortgage market.
- Subprime lending is a legitimate segment of the financial services industry that gives consumers who are unable to obtain traditional financing the opportunity to achieve the dream of homeownership. Without subprime financing many consumer would be unable to obtain mortgage credit.
- The continued availability and growth of the subprime market depends on lender and investor confidence, which is being eroded with a patchwork of confusing state and local laws.
- The proliferation of overly restrictive predatory lending laws passed by certain states and localities disrupts our national mortgage market, increases the cost of credit and injures the very consumers it is meant to help.
- As states lower thresholds for coverage of predatory lending laws and increase liability, fewer subprime loans will be originated because of lender and investor reluctance to deal in "high cost" loans.
- MBA calls for a national uniform standard that provides strong consumer protections while maintaining the free flow of mortgage credit nationwide.

Before I begin, I want to make clear that MBA stands in solid opposition to abusive practices in mortgage lending. We understand too well that there are unscrupulous individuals that abuse our most vulnerable populations. As we battle these unscrupulous actors and search for better protections for homeowners, we also have the duty and obligation of ensuring that we do not act in a way that constricts the flow of capital to credit-starved communities. These consumers have been the benefactors of

our industry's great success in expanding access to mortgage capital and we cannot afford to reverse on these hard-earned advances.

I. A National Mortgage Market

America's mortgage finance system is, without question, the envy of the world. Capital from all over the world flows to our mortgage markets and provides Americans with the lowest possible mortgage rates and the greatest diversity of products. As we attempt to improve the effectiveness of our existing consumer protection laws, we must do so in a manner that does not cripple the very efficiency that has created our superior mortgage market.

As a preliminary matter, our national mortgage market is made up of a "primary" market and a "secondary" market. The primary market is signified by lenders lending money to borrowers for home purchases. It is generally characterized by a lender's interaction with a borrower in the origination, counseling, and negotiation for residential real estate finance. After lenders and borrowers close on loans, the majority of those loans are sold to a secondary marketing entity, i.e. Fannie Mae, Freddie Mae, Ginnie Mae and private investors. By selling their loans to secondary marketing entities, lenders replenish their funds with the proceeds of the sale, thereby enabling them to originate additional loans. The secondary market provides two important elements: (1) it provides lenders with needed liquidity, and (2) it removes certain risks of the loan from the lender. After purchase, secondary market entities will either hold the loans or pool them into mortgage-backed securities, which are sold to a wide array of investors, including pension funds, insurance companies and foreign countries. [2]

It is noteworthy that Fannie Mae, Freddie Mac and Ginnie Mae are creatures of statute created by Congress. Congress appreciated the importance of making the opportunity

[2] Our estimates reveal that, in 2002, over 75% of all U.S. residential mortgage production was securitized and sold into the secondary market.

of homeownership available to as many American as possible. This government-created national structure makes homeownership affordable and therefore accessible.

Moreover, a vibrant secondary market diversifies geographic economic risk and loss severity and thus tends to stabilize interest rates across the country. Because today's mortgage market is a national one, an economic recession in one region will not mean the flight of credit from or an increase in rates for that region.

There is no doubt that mortgage lending is conducted on a truly national and international scope. These national sources for mortgage capital serve to achieve great cost savings for consumers through great efficiencies and considerable economies of scale. Through aggregation or pooling of like mortgages from across the country, our national mortgage market facilitates the flow of capital from money rich areas to money poor areas. Standardization of mortgage characteristics and risks creates a commodity that facilitates the inflow of capital because investors know with relative certainty what they are buying and what risks are inherent with a particular pool of loans.

This truly amazing mortgage structure, one that has provided Americans with the best, cheapest, and most efficient mortgage capital delivery system in the world, is however, greatly dependent on legal certainty and predictability. Secondary market investors must have the confidence of being able to purchase and trade mortgage-backed assets without undue complications and without the transfer of excessive or unquantifiable legal risk.

II. "Subprime" Lending

Capital flows from secondary market sources have been especially important with regard to the so-called "subprime" market sector—the topic of today's hearings. This sector of the market focuses on portions of the population composed of consumers that, for various reasons, have less than stellar credit records and other flaws and/or special characteristics. This subprime segment of the industry has become an increasingly

important, and very essential, piece of mortgage lending. As the U.S. Department of Treasury and the Department of Housing and Urban Development acknowledge in a recent report, "[b]y providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes."[3]

It is important to understand that, for various reasons, this segment of the market poses elevated operational costs. First, since lenders in this segment of the market specialize in serving credit-impaired consumers, it is generally true that the loans in this segment of the market have higher default risks. In addition, subprime lenders are likely to incur higher originating costs. For example, subprime transactions require higher salaried specialists that are trained in quantifying the unique credit risks posed by applicants with poorer credit quality, and the files and records of subprime borrowers might require a more comprehensive and thorough examination in order for lenders to understand the true nature of the borrower's credit risks. Moreover, denial rates in the subprime market run about twice those of the prime market, and can be even higher in certain specific markets. Loan officers thus have to take many more applications in order to generate the same number of loans. There are also considerable expenses associated with higher delinquency rates, which amount to costs that are twice as high for subprime than for prime loans. Nor can we ignore that subprime loans pose higher risks for reasons other than credit flaws. Non-prime borrowers may, for instance, qualify for subprime products because they carry significant outstanding debt, seek 100% financing, or have difficultly demonstrating their income due to self employment. In the end, the "per-loan" cost of subprime transactions is generally 2-to-3 times higher than that of prime loans.

It is also important to realize that until a few years ago, this segment of the population did not have the option of obtaining mortgage financing from traditional lending

[3] United States Department of Treasury and Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000 ("HUD/Treasury Report").

institutions. In the not-so-distant past, lenders were simply not willing to risk their capital by lending large sums of money for extended terms to individuals with credit problems that statistically have a higher incidence of default. However, through innovations in the mortgage finance industry, and through various financing and risk enhancing tools created for the specific purpose of extending credit to our more needy communities, credit-impaired individuals now have ample opportunity to obtain loans through this "non-prime," or "subprime" market. Although riskier, subprime borrowers can now be considered very viable credit candidates through higher prices to cover the higher costs of the transaction, or with the assistance of financing options that serve to mitigate credit risks.

At present, subprime originations comprise approximately 9% of all mortgage originations. According to Federal Reserve Board estimates, subprime mortgage originations grew a stunning seven-fold over the 1994 - 2002 time period. This growth has disproportionately benefited low-income and minority borrowers, as these groups are much more likely to have credit blemishes and thus require access to subprime credit.

One clear and visible outcome of this expanded subprime lending activity has been an increase in homeownership rates for low-income and minority borrowers. According to Federal Reserve Governor Gramlich, "this represents a welcome extension of home mortgage and other credit to previously underserved groups—a true democratization of credit markets."[4] MBA agrees, and we fully appreciate the immense importance of subprime lending. Millions upon millions of low- and moderate-income families now own a home and have opportunities at building wealth and accessing credit through the availability and growth of the subprime credit market. There is no doubt that subprime credit must be protected—it is the only doorway to wealth and capital for countless consumers.

[4] Remarks by Governor Edward M. Gramlich at the Texas Association of Bank Counsel, 27th Annual Convention, South Padre Island, Texas (October 9, 2003).

III. Market Participants

I note, however, that despite the impressive growth of subprime lending, the subprime market is still in its infancy. Any significant disruption in the flow of capital could severely and permanently impair the sustainability of this market. Not all mortgage lenders are able to participate in this market. Indeed, only a small percentage of mortgage lending institutions offer loans to subprime customers. Our market analysis estimates that the 9% of loans in the United States that fall in the subprime category is served by about 150 lending institutions.

There are numerous reasons why this segment of the industry is served by only a few specialized institutions, and why it is therefore important to ensure they remain active in this market. We suggest a few below--

Risk of loss: First, as described above, there is the all-important "risk" factor in the sense that lenders are reluctant to lend in markets where lending history and underwriting experience demonstrate greater probability of default.

Barriers to Obtaining Secondary Market Capital: Subprime loans are not eligible for Fannie Mae, Freddie Mac or Ginnie Mae purchase or securitization. As a result, this product has historically lacked the ability to attract the same level of capital from private investors. Securitization of subprime loans is significantly smaller for a number of reasons, including the expense and complexity of issuing private label securities (i.e., a security issued by the lender). Only large companies with significant net worth have the capability of issuing their own pools. Pooling requirements, net worth requirements, registration requirements and expenses, rating agency standards, and collateral structure all create barriers to small originators issuing their own securities and attracting capital. Moreover, since subprime borrowers are by definition riskier, investors review the loans with greater due diligence and place significant obligations on originators and servicers of this product.

Legal Risk and Complex Regulation: Financial exposure is not, however, the only source of risk for lenders and investors. An equally significant source of risk is derived from the colossal legal uncertainties that now surround subprime mortgage transactions.

It is important to understand that the mortgage lending industry is one of the most heavily regulated industries today. Mortgage lending is subject to pervasive regulation and must comply with a wide array of federal consumer protection laws including the Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Housing Act, Fair Credit Reporting Act, Equal Credit Opportunity Act, Fair Credit Billing Act, Home Mortgage Disclosure Act, Federal Trade Commission Act, and Fair Debt Collection Practices Act.

Of particular relevance to today's hearings are the additional laws that apply to so-called "high cost loans." Pursuant to the Home Ownership and Equity Protection Act (HOEPA), mortgage loans that exceed specific cost thresholds must abide by more stringent rules that require additional disclosures, set additional protective provisions and strict prohibitions on certain financing tools, and impose additional penalties and liabilities for lenders and investors that participate in the origination of these loans.

The HOEPA law has a very fundamental impact on subprime lending—the harsh reality today is that practically very few institutions will make a loan that is covered by the HOEPA thresholds. The central point that policymakers must understand is that HOEPA's triggers serve as an absolute "ceiling" to mortgage lenders and secondary market participants. In effect, this law is a deterrent for every lender that must charge additional fees or higher prices in order to cover the higher costs of subprime loans. The reasons for the HOEPA "stigma" are multiple. First, there are real and very significant cost burdens associated with the making of HOEPA-covered loans. The stringent rules and requirements inherent in "covered" loans create complications in compliance that require specific management and due diligence attention. These include, for example, complex trigger calculations, additional disclosures, and

uncertainties created by the extended right of rescission. In light of HOEPA's significant penalty provisions, these added difficulties require significant time and resource allocations by lending institutions that engage in such loans.

In addition, today's reality is such that the mere origination of HOEPA-covered loans negatively affects a lender's reputation. The mere label of "HOEPA" infuses a pejorative connotation that associates covered loans with mortgage abuse. This stigma is extremely important for the lending industry since a lender's ability to attract and retain customers is directly linked to the trust and good reputation they develop in the communities they serve. Plain and simple, the label of "HOEPA" is used as a proxy for "predatory loan." Federal and state examiners, as well as public perception at large, equate HOEPA-covered loans with "predatory" transactions.

In light of all these difficulties, there are considerable burdens associated with HOEPA that come in the form of special assurances and limits imposed by the secondary market. Secondary market purchasers, including Fannie Mae and Freddie Mac, simply refuse to purchase HOEPA-covered loans, regardless of whether they are otherwise fully compliant with all relevant laws and regulations.

Proliferation of State and Local Predatory Lending Laws: As has been widely reported, there is currently an unprecedented level of legislative activity aimed at passing so-called "anti-predatory" measures at state and local levels. Although well-intentioned, these state and local laws are imposing very onerous restrictions that obstruct lending operations in the subprime market. More importantly, these state and local laws are confusing and difficult to decipher, and impose a veritable patchwork or rules and regulations that are impossible to implement in a way that ensures compliance with the differing standards. I'll be clear— all the problems I described above in relation to legal and regulatory risks under HOEPA are today being multiplied and replicated, in different permutations, on a state-by-state and municipality-by-municipality basis.

This "balkanization" of the legal system is an extremely serious threat. As noted above, secondary market investors provide the necessary capital to fund the vast majority of our industry's operations. As purchasers of mortgage assets and asset-backed securities, secondary market investors must have absolute certainty that the underlying mortgage assets are sound and compliant with all applicable laws and regulations. Legally defective assets can leave investors exposed to very large financial loss and, perhaps more importantly, to vast legal and administrative liabilities, including securities violations. In today's environment, where nearly 30 states have enacted unique and different sets of laws and regulations covering subprime lending, it has become utterly impossible to achieve the necessary assurances of absolute legal certainty.

To illustrate the concern, I note that secondary market transactions rely on sales and purchases of entire "pools" of mortgage loans. A typical "pool" of loans sold in the secondary market can contain 300 or more loans. Such pools typically contain loans of similar characteristics from several different states. Since these transactions are, in effect, negotiated in bulk, purchasers of such pools assume legal and financial risks associated with the entire bulk of loans purchased. Minor legal mistakes can be extremely costly. If the lender or originator of one of the loans included in the pool fails to make one material disclosure, or if there is an oversight that leads to a numerical miscalculation, the mistake can result in a legal defect that could potentially unravel the entire pooled transaction. This could be disastrous in terms of financial loss and liability. Although the purchasing investors have no role whatsoever in the miscalculation or the interface with the consumer, they could be saddled with all the losses and all the liabilities.

Diminution of Credit: In the end, MBA warns that subprime lenders are facing a muddled and very risky legal and regulatory environment that discourages operations and competition in this market segment. In their zeal to protect vulnerable consumers, state legislators and consumer groups are creating a very hostile legal regime that is causing lender flight and diminishing capital access for the most needy segments of our communities.

The proliferation of these laws creates massively complex compliance labyrinths that are entirely unwieldy. Multi-state lenders today find it extremely difficult, if not impossible, to formulate models for compliance in any one geographic location without the high probability of falling out of compliance in a different locality. In fact, the unending passage of these "predatory lending" laws at state and local levels is creating a situation where multi-state lenders are finding it almost impossible to comply, or even keep up with the full barrage of local rules and regulations that are continually enacted.

The fragmentation of legal requirements caused by differing state legislation imposes crippling confusion for purposes of purchasing and enforcing mortgage loans since every individual portfolio in a given pool of loans could carry differing legal requirements based on the particular state and/or locality where the loan was originated. In such an environment, secondary market operations are in disarray, as complex questions of compliance and enforceability stifle efficient flows of mortgage capital. In the current "balkanized" environment, secondary market players are now required to undertake extensive and costly due diligence analyses, and implement costly operating systems to comply with varying and ever-changing laws.

If that were not enough, these difficulties are now being exacerbated by recent enactments of state legislation that impose unlimited purchaser or assignee liability for the practices of an originator, broker, or even servicer. This trend has begun to draw a strong negative reaction by segments of the secondary market community. In the past several months, rating agencies such as *Fitch* and *Standard & Poor's* have refused to rate assets that contain loans originated in jurisdictions that impose liability on assignees. This trend is dangerous, as the agencies' refusal to rate assets is extremely alarming to investors, and will invariably dry up secondary market investment in the subprime market. It is likely that the agencies' refusal to rate covered assets will severely restrict funding for all loans covered by these laws.

In the end, we note that the clear impact of this burdensome, confused, and fragmented regulatory framework at the state and local level is lender and investor flight from the states and municipalities covered by these laws.

IV. Other Observations

This current legislative trend at the state and local levels, though well-intentioned, is costing the industry millions of dollars in compliance and legal fees, which in turn, leads to direct and dramatic effects on the price that borrowers pay for credit and the lenders' willingness to do business in particular markets.[5] There are however, other important effects that are seldom discussed.

First, it should be noted that lender and investor flight will not only decrease capital availability in affected markets, but will, with all certainty, raise the costs of the remaining sources of mortgage capital. If legitimate institutional players leave this market segment, the price of capital in those markets will skyrocket as supply is diminished relative to demand. If history is a lesson, supplies of capital could decrease to the point of pushing cash-strapped consumers to non-traditional, and indeed very costly, money sources.

Second, as set forth above, the liabilities and penalties that can result from non-compliance are so severe that simple mistakes can cost lenders thousands of dollars per consumer. These draconian penalties, in themselves, raise the costs of credit as they increase legal risks for even unintentional mistakes on the part of lenders. Equally important, they have the unintended effect of allowing only large financial institutions to operate in this market. It is clear that the massive uncertainties coupled with extremely high penalties and liabilities create a solid barrier for small entities since even unintentional mistakes can decimate small business operations. Only large entities possess the volume and reserves to be able to absorb the gigantic legal costs

[5] For an excellent description of the unintended harms of the GFLA, see "*Georgia Fair Lending Act: Unintended Consequences*," Georgia Credit Union Affiliates, Community Bankers Association of Georgia, Georgia Bankers Association (January2003).

associated with operating in this market. This is evident from the current scenario where small lenders are almost non-existent in this market segment—for small businesses, the legal risks are simply too great.

V. Uniform Standard

In light of all the challenges we describe above, MBA again reiterates the most important point—that the only way to ensure the proper and efficient delivery of subprime mortgage capital to our neediest populations is to develop a national solution to "predatory" lending. We are urging your committees to support us in the push for an efficient marketplace through the establishment of a uniform national standard to combat abusive lending practices.

MBA believes that a single standard through strengthened federal laws will encourage competition and will ensure that the entire mortgage lending industry complies with one set of rules while allowing consumers to have a greater grasp of the lending process to keep them from falling prey to unscrupulous practices. We believe that we can, and must, craft strong safeguards that afford effective levels of protection for all of our citizens and that preserve the efficiencies of a unified legal structure.

We ask this committee to listen to the urgent and combined calls for the development of national uniform standards to fight against "predatory lending." Our most credit-starved communities will be the principal losers if you fail to act.

VI. Consumer Education

As a final point, we cannot ignore the role of consumer education as an imperative element in the struggle to deter predatory lending abuse. An educated consumer in a competitive market place is the best solution to predatory lending. MBA contributes to this consumer education effort through our development and distribution of a 'Stop Mortgage Fraud' pamphlet and maintenance of the 'Predatory Lending Resource

Center' on our website. In addition, MBA is in the process of creating a website to walk consumers through the mortgage purchase process. We urge that your committees consider additional steps and additional funding to assist in the expansion of consumer education nationwide.

VII. Conclusion

In summary, we believe that subprime lending has served as a source of loans for a portion of the market that is very much in need of credit options. In crafting solutions for the problem of abusive lending, regulators must advance thoughtfully and carefully to assure that additional rules promote, rather than restrict, credit extension.

We thank you for devoting attention to the structure of this industry's operations, an industry that has achieved the most impressive and efficient mortgage market in the world. We urge that you recognize the serious perils being posed by the increasing balkanization arising from state and local legislative activity. MBA believes that we must focus on the development of a uniform national standard to effectively and efficiently combat abusive lending practices.

MBA appreciates the opportunity to appear before these subcommittees. I look forward to answering all your questions.

Testimony

before the

Subcommittee on Housing and Community Opportunity

and the

Subcommittee on Financial Institutions and Consumer Credit

at a Joint Hearing regarding

"Subprime Lending: Defining the Market and Its Customers"

March 30, 2004

Testimony Written and Presented by:

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Chairman Ney and Ms. Waters, Chairman Backus and Mr. Sanders, and members of both subcommittees, thank you for the opportunity to address you on the important issue of subprime lending. My name is George Butts, and I am the Program Director of the ACORN Housing Corporation of Pennsylvania. I was the national President of the ACORN Housing Corporation from 1991 to 2003.

ACORN Housing has offices in 34 cities throughout the United States. To carry out our mission, we undertake three groups of activities:

1. We build and rehabilitate homes to increase the supply of affordable housing.

2. We provide housing counseling services to more individuals than any other organization in the country. 50,000 of our clients have become first time homebuyers. Our program emphasizes the one-on-one approach to counseling that has proven to be most effective at giving clients the information and tools they need. We counsel clients on the full range of housing finance needs: pre-purchase, delinquency, refinance, home equity, subprime, and predatory rescue.

3. We educate local, state, and national policy makers on affordable housing and housing finance issues, and on the threats to personal and community stability that are posed by predatory lending and abusive financial service practices

ACORN Housing works closely with our sister organization, ACORN, the Association of Community Organizations for Reform Now. With over 150,000 members in over 60 cities, ACORN has been a leader in the fight to end redlining through a strong Community Reinvestment Act (CRA), to crack down on predatory lending through testimony, publicity, and direct action, and to win economic justice for our communities. ACORN fights to win a voice for our families to improve education, increase access to health care, and assure fair housing for all Americans.

Let me start by saying that much of the problem of lack of capital in low-income communities is caused by the abdication by mainstream financial institutions of their responsibility to provide loans in our neighborhoods. This left a vacuum into which the subprime lenders moved. In recent years, we have made progress in making these banks provide capital to our neighborhoods. But these banks did not just wake up and decide to become good corporate citizens overnight. Conflict and struggle, which led to laws like the Community Reinvestment Act, forced them to change their ways. Now it is a fight not so much over the quantity of capital in our neighborhoods, but the quality of that capital. Just as in previous years, we will need to continue to fight to make sure the subprime market is cleansed of discrimination and predatory lending.

We have spent years working for increased wealth and stability in low-income communities, and in particular for access to credit and homeownership. We are starting to see the results of this work. A good example is a consortium we are part of in Philadelphia, where homeownership counseling groups, local banks, and city government joined forces to offer an innovative product that allows people to get loans at reasonable

rates for home improvements. This means they can avoid refinancing their first mortgages, which often leads them into predatory loans.

We think that a well functioning subprime market has a useful role to play in helping to achieve the goal of access to credit for all. Unfortunately, there is a great deal that needs to be done to get from where we are now to a well-functioning market in this industry. Some of the steps taken in recent years--as a result of public scrutiny, regulatory action, and legal change in a some states--is helping us get there. For example, following embarrassing revelations about abuses in their subprime mortgage units, both Household International, now a subsidiary of HSBC, and Citigroup have eliminated most of the abusive product features and practices within those units, and have paid out large sums to compensate past victims. Both Fannie and Freddie have decided to bar the purchase of mortgages with abusive features, such as mandatory arbitration clauses and excessive points and fees.

However, for every reformed Household there is an unrepentant Wells Fargo Financial, and a dozen small subprime brokers who routinely engage in predatory practices. There remains a great deal that needs to be done to get from where we are now to a well-functioning market in this industry

In too many ways, the subprime market is still an unregulated "Wild West," with a dramatic lack of transparency and of competition. In order to construct a better marketplace for subprime loans, we need to eliminate the disparities and abuses in this market. I will focus on two problems that need particular attention. The first is the problem of predatory lending, which shows there is still not an effectively functioning market in subprime loans. The stories of thousands of people across the country tell us that predatory lending is still far too prevalent among subprime loans. The second problem is the rampant discrimination in the subprime market shown by our annual study "Separate and Unequal: Predatory Lending in America." I will conclude with some recommendations for policymakers.

Our goal should be that every person gets the loan they need and qualify for, and no one is tricked or pressured into taking a loan they later regret. Strong laws against predatory lending, combined with stronger enforcement of the Community Reinvestment Act, will allow low- and moderate-income communities access to the fair credit they deserve.

Predatory Lending and the Lack of an Effective Subprime Market

ACORN has talked to thousands of borrowers across the country, and investigation into their lenders has shown that the same predatory lending practices have affected hundreds of thousands more. These are more than just "regrettable incidents," as the industry would have it. These practices are systematic, and occur across the country, to people from all backgrounds and walks of life. They are particularly targeted at the most vulnerable: elderly, low-income, and minority homeowners.

Let me start with two stories, the first from Louisiana. An African-American couple named James and Doris bought a home through the GI bill – after James had served in the

Marines for twenty-five years – in 1994 with an interest rate of 8.5%, which was an 'A' rate at the time.

Wells Fargo Financial first contacted them by sending live checks in the mail, and they cashed one, which resulted in a very high-interest rate loan. Then Wells began pushing them to consolidate debts into their mortgage, promising lower monthly payments. In December 2001, Wells gave them a 9-year mortgage that the loan officer never told them included $10,700 in Wells' own financed fees – over 11% of the amount financed (compared to a typical 1% charged by banks). James and Doris were already adequately insured, but Wells told them it was required to finance in single-premium credit life and disability insurance policies, which stripped away another $6,400.

While 'A' rates had since fallen to 7.2% and despite all the discount points, Wells put James and Doris into an interest rate of 11.4%. The financed fees, credit insurance, and five-year prepayment penalty pushed them well over the house's appraised value of $90,000, preventing them from refinancing out of the loan. In addition, the loan officer told them only after closing that their new higher monthly payments of $1,490, unlike their previous mortgage, would not cover taxes and insurance, which cost them an extra $130 a month.

The much higher mortgage payments eventually caused James and Doris to fall behind, and they went back to Wells Fargo Financial, where the loan officer told them they could get a lower rate and lower payments. In October 2002, Wells made them a $104,000 loan that automatically refunded portions of the credit insurance but included a new single-premium life insurance policy for $2,560 that they did not want but were told was required. Without refunding any of the previous loan's fees, Wells financed in another $7,300 of their fees. 'A' rates had since fallen to 6.2%, but Wells not only broke their promise to lower the rate but increased it to 13.0%.

When they started hearing about neighbors refinancing to rates of 6%, they told Wells they were going to refinance with their credit union. Only then did the loan officer tell James and Doris that their loan had a five-year prepayment penalty for $10,000 (in reality, state law limited the penalty to a maximum of $5,000), but it still had the intended effect of discouraging them from refinancing.

When lenders claim they have to charge more because of higher credit risk, I would like you to keep in mind the experience of a couple from Minnesota who received a refinancing from Wells Fargo Financial. Kathleen and Thomas have owned their home since 1971, and their previous mortgage had a 7.8% interest rate. They have always had an excellent credit record; Thomas, who is the primary wage-earner, had 'A' quality credit scores last year of 682, 731, and 680.

In August 2002, Kathleen and Thomas received an unsolicited live check in the mail from Wells Fargo for a little over $1,000. After cashing the check, which resulted in a very high rate loan, they began receiving calls from Wells Fargo Financial offering more money and urging them to consolidate debts. At the time, Kathleen and Thomas did not know that

there was any difference between Wells Fargo Bank and Wells Fargo Financial, which is the company's primary subprime lending institution. Since they had been wanting to pay off some bills and buy new windows for the house, they started talking to Wells Fargo Financial about a debt consolidation.

The Wells Fargo loan officer came out to their house and told them that they could get a 6% interest rate and would close in ten days. A few weeks later, another Wells representative came out to their house. He said that because of their credit and debts, their interest rate would actually be closer to 8%. He said that he would see if he could get them a better rate.

After another couple weeks, Kathleen and Thomas went to the Wells office for the closing in September 2002. Once there, they found out that their interest rate would actually be 10.0% – at a time when 'A' rates were 6.0%. When they asked about why the interest rate was so high, the Wells representative said it was because of their credit. Despite the high rate, Wells financed their standard (at the time) seven "discount points" – stripping away close to $8,000 of their home's equity – into the $112,000 loan. Kathleen and Thomas thought about not taking out the loan, but they had been expecting to close earlier that month and so hadn't paid the bills that the refinancing was paying off, and they felt that they had no choice.

Last June, ACORN Housing Corporation helped Thomas and Kathleen refinance with another lender into a 5.3% interest rate, lowering their monthly payments by over $400.

These are just two stories among tens of thousands. Following the trail that begins with these stories has led us to the conclusion that these practices reveal systematic problems in the subprime market. Costs in this market are hidden to borrowers, and this allows predatory lenders to take advantage of people. Both large and small players in the industry have participated in this—it is not just a problem of a few "fly-by-night" operators. When large companies like Ameriquest and Household Financial are forced into settlements that make them change their lending practices, we know this is a widespread problem. The widespread nature of this problem has forced states to pass laws against predatory lending and has led state attorney generals and banking officials to act against violators.

Unfortunately, too many loan features that are totally legal are profoundly anticompetitive and nontransparent. These features prevent borrowers from knowing whether they are getting credit on fair terms. One of the most important, high financed fees, are easy to hide, strip equity from borrowers, and reward lenders and brokers for the number of transactions they complete rather than how many performing loans they set up. The fact that these fees are up-front gives lenders an incentive to repeatedly turn loans over, also known as "flipping." These fees, which are often more than 10% of subprime loans, do permanent damage to borrowers and their communities by taking massive amounts of equity from them. Financed fees are much more prevalent in the subprime market than among prime loans, and provide little or no benefit to consumers. In the prime market, for example, discount points paid up front help lower the interest rate on a loan. In the

subprime market, where they are invariable financed into the loan, they often only add to the interest rate, while immediately stripping equity from the home.

Another predatory feature in the subprime market is the widespread use of prepayment penalties. Like financed fees, these penalties are easy to hide in the blizzard of paperwork that accompanies a loan. Prepayment penalties trap people in loans and cost them thousands of dollars if they try to refinance out of the loan. While such penalties are uncommon in the prime market, they are a huge presence among subprime loans.

Substantial yield spread premiums give an incentive to brokers to charge higher interest rates to borrowers. Essentially kickbacks from lenders to brokers for putting people in higher interest rates, they are a main reason so many minority borrowers are charged higher rates than their credit would warrant, a problem I explore below. Yield spread premiums reward brokers for how much money they can take out of borrowers, rather than giving people credit at a fair price. This is another feature not seen in the prime market; where it is easy to determine the cost of a loan based on credit scores. Again, the lack of a clear and transparent market among subprime loans opens the door to abuses by unscrupulous lenders.

It is practices like these that need to be regulated, so that there is a more even playing field and a clear and competitive market can emerge

Stories of abuse are too common in the subprime market. While not all subprime loans are predatory, just about all predatory loans are subprime. Subprime loans are properly given to people who are unable to obtain a conventional prime loan at the standard bank rate because of credit problems or other circumstances. They are properly given when people actually need a mortgage loan, not when a lender can talk someone into a loan they may not need, just so the lender can make more money. Rates and fees on the loan should reasonably reflect the risk presented by the borrower, not how much the lender can get away with charging.

Such loans are predatory when loan terms are deceptive and abusive, or when people who qualify for prime loans are steered into higher-cost loans. Both of these practices are concentrated among the most vulnerable populations, among minority, low-income, and elderly homeowners. It is discrimination in the subprime market to which I now turn.

Discrimination in the Subprime Market: Separate and Unequal

The annual study we released earlier this month, "Separate and Unequal: Predatory Lending in America", shows that minority homeowners continue to be much more likely to receive a subprime loan than white homeowners. Among refinances—which accounts for nearly two-thirds of subprime loans—African-American homeowners were four times more likely to receive subprime loans, while Latinos were two and a half times more likely. This disparity was true even among borrowers of the same income level. 27.8% of the refinance loans received by middle-income African-Americans were subprime, as were

19.4% of the loans received by Latinos at this income level. Meanwhile, only 7.6% of the loans given to middle-income white homeowners were subprime.

These differences have huge effects on families' finances. A loan with a higher interest rate can cost a family tens or even hundreds of thousands of dollars over the life of the loan. What makes this particularly egregious is that a large percentage of these borrowers actually qualify for a prime loan. A recent report in *Inside B & C Lending* indicates nearly 83% of subprime loans went to customers with A- or better credit ratings.[1]

The Chairman of Fannie Mae, Franklin Raines, has estimated that as many as half of all borrowers in subprime loans could have qualified for a lower cost conventional mortgage, which could save the borrower more than $200,000 over the life of a thirty year loan.[2]

Freddie Mac's estimate, while somewhat lower, was still extremely high—they found that as many as 35% of subprime borrowers could have qualified for prime loans.[3] The CEO of HSBC, when discussing plans to purchase Household International, said that 63% of the subprime lender's customers had prime credit.[4] Huge numbers of homeowners with good credit, particularly people of color, are being steered towards subprime loans. This is itself a form of predatory lending. It also increases the risk of foreclosure, as borrowers are often paying hundreds of dollars more each month on their loan.

This brings us to another point. There has been a great deal of attention paid to the high foreclosure rate nationally. The increase in this rate—at 1.2%, it is the highest it has been since the Mortgage Bankers Association started keeping track of the figures in 1972—is driven by foreclosures in the subprime market. While only 1 in 100 prime loans leads to foreclosures, the rate is 8%--or 1 in 12—in the subprime market. The rate is even higher in certain states: according to the Mortgage Bankers Association, for example, nearly 16 percent of Ohio's subprime loans were in foreclosure in 2003.[5] In Pittsburgh, foreclosures have increased every year since 1997, and are three times more than they were during the steel mill closings in the 1980s.[6] Subprime foreclosures have increased dramatically since 1990, far exceeding the increase in subprime originations. These foreclosures damage not only families, but the communities they live in as well, leaving empty homes and harming efforts to rebuild our neighborhoods.

Some in the industry may claim that these foreclosure rates are to be expected, or in fact justify the higher rates on subprime loans – but when you look closely this argument is

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[1] "FICO Scores Hold the Line but Deep MI Drops in 4th Quarter" *Inside B & C Credit* Vol. 9 Issue 4 p. 9 (February 23, 2004)
[2] Business Wire, "Fannie Mae has Played Critical Role in Expansion of Minority Homeownership Over Past Decade," March 2, 2000.
[3] "Automated Underwriting," Freddie Mac, September 1996.
[4] "HSBC: Why the British Are Coming: Chairman John Bond Explains Why the Usually Cautious British Bank Paid a 30% Premium to Acquire American Lender Household," *Business Week Online*, November 18, 2002, Daily Briefing.
[5] "Pace Quickens on Foreclosures in Ohio," *The Columbus Dispatch*, March 25, 2003.
[6] "County Has Processed More than 4,000 Filings, a Record Year for Foreclosures" *Pittsburgh Post-Gazette*, December 1, 2003.

often backward. It's a cycle of bad loans that's an important part of what drives the foreclosures. These loans are made to people who cannot afford them, at high rates that increase the payments to unaffordable levels. Loan amounts are inflated by high fees, and borrowers' options are curtailed by huge prepayment penalties. Payments grow larger and larger because of multiple refinancings, with fees added every time. Discrimination in the subprime market—with minorities and others being steered into high-cost loans—not only takes money out of our communities, but contributes to the increasing foreclosure rate that is devastating our communities as well.

Next Steps: How to Create a More Effective Subprime Market

The experience of ACORN Housing has been that even people with impaired credit do well when they have affordable loans. Through a combination of innovative loan products developed in conjunction with banks and the housing counseling we provide, low-income borrowers have been put in homes and stayed there, with foreclosure rates well below the rates in the subprime market, even though many of our clients have credit ratings of A- or below.

The success of non-profits like ACORN Housing, as well as of that of many responsible financial institutions, shows that there is no excuse for the abuses in the subprime marketplace. There is no reason for rampant predatory lending. There is no reason for huge numbers of foreclosures. And most of all, there is no reason to accept industry's claims that fair regulation of the subprime market will lead to lenders leaving the subprime market.

Industry defenders have attempted to create a sense of crisis about state predatory lending laws. Apparently, their thinking is that if the subprime market is going to be adequately regulated, they want no part of it. They have tried to back this up with bogus claims of "capital flight" from states that have passed predatory lending laws. Their claims of ruin make Chicken Little look like an optimist. The truth is there is no such crisis. The real crisis continues to be that homeowners are being ripped off every day.

The example of North Carolina, the first state to adopt a predatory lending law, is instructive here. A June 2003 study by the Center for Community Capitalism at the University of North Carolina concluded the state's law reduced the incidence of loans with predatory terms, while not restricting access to capital. The report showed that subprime refinances that contained prepayment penalties that exceed three years, balloon payments, or loan-to-value ratios of 110% or more—all of which are features of predatory loans—declined dramatically. For example, there was a 72% drop in subprime loans with prepayment penalties of three years or longer. The law was having its intended effect of cracking down on predatory loans.

At the same time, loans to borrowers with substantially impaired credit increased 31%, and the interest rates increased less than the national average. The number of subprime home purchase loans continued to increase, and North Carolina remains the sixth most active state for subprime lending. But perhaps most interestingly, the number of subprime loans

to people with credit scores above 660—those who could most easily qualify for prime loans—declined by 28%, while loans by primarily prime lenders increased by 40%. This suggests that people—often African-Americans and Latinos—who were being steered to subprime loans despite good credit are now getting prime loans, thereby saving thousands of dollars and reducing the risk of foreclosure.[7]

Other states have followed North Carolina's lead, passing strong state laws that help ensure a fairer subprime market with less predatory lending. These laws, like North Carolina's have been crafted to deter exorbitant fees and other hidden ways of stripping equity, while encouraging costs to be openly displayed through interest rates. They are succeeding, and as state legislators, bankers, and community activists discover ways to improve these laws, they are being revised and often strengthened. It is this working of the states' "laboratories of democracy" that needs to continue, and not be cut off by hasty preemption of state laws by federal statute. More time for these laws to prove themselves is needed to assure a more effective federal law down the road.

States have not acted hastily or thoughtlessly in passing laws against predatory lending. They have acted because they saw their citizens being taken advantage of. It is these laws that have led many lenders to clean up their act. But many lenders continue to take advantage of people, and we need to allow states to continue to protect their citizens. This is especially true as the subprime market is dynamic, and new products are being developed all the time. States, which can act faster than the federal government, need to be able to develop new rules to protect consumers. The subprime market is also geographically diverse, with different procedures being followed in different areas. States need the flexibility to deal with these differences. For all of these reasons, federal laws that preempt states' ability to deal with predatory lending are harmful to consumers. Similarly, regulators' moves to preempt state laws, such as recent action by the Office of the Comptroller of the Currency, is ill-advised and needs to be reversed.

It bears repeating: the crisis in the subprime market is too much discrimination and too much predatory lending, not too much regulation by the states. This must remain our focus, and claims of a crisis of subprime lending in states with strong laws must be seen for what they are: a smokescreen behind which opponents of effective regulation are hiding.

There are other steps that the federal government can do to end predatory lending and make sure the subprime market serves those who really need it, rather than all those who unscrupulous lenders can steer into it. Perhaps most importantly, the Community Reinvestment Act (CRA) needs to be strengthened. Too many banks are getting satisfactory or outstanding ratings, even when they have instances of predatory lending. When 98% of banks are getting passing marks, yet our communities continue to be undeserved, something is wrong. A practice of predatory lending should disqualify a bank from such ratings. Regulators must also look not only at the quantity of lending in low- and moderate-income communities, but the quality of these loans as well. Banks should be

[7] *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment,* The Center for Community Capitalism, University of North Carolina, June 2003.

given more credit for prime loans in our communities than subprime ones. Finally, since so much lending occurs in non-deposit taking affiliates, these must be required to be included in CRA assessments as well. By strengthening the CRA, we can help create a flourishing market of legitimate and fairly price loans in underserved communities, which will help drive out predatory lenders.

No longer able to deny the existence of predatory lending, defenders of the banking industry have tried to highlight the importance of education in preventing predatory lending. I know about the importance of counseling and education of homeowners. I do it every day. But as a response to predatory lending, it is woefully inadequate. The response to an epidemic is not more education; it is strong action by authorities. The response to a crime wave is not more counseling; it is bringing the perpetrators to justice. We have an epidemic of predatory lending on our hands, and even though many of the features are legal, the effects are criminal.

Our views are shared by the US General Accounting Office, which recently released a report entitled "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending."[8] Some of the major findings include:

- Consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms.

- The role of mortgage counseling in preventing predatory lending is likely to be limited.

- Disclosures made during the mortgage loan process may be of limited usefulness in reducing the incidence of predatory lending practices.

- While the great majority of mortgage brokers are honest, some play a significant role in perpetrating predatory lending.

Our sister organization ACORN has taken the lead in taking on predatory lenders, individually and through legislative action. ACORN Housing has been a leader in helping low-income families get good loans so they can avoid predatory lenders. We know the importance of subprime loans. We know there is a need for access to capital for people with credit problems. But this can never become an excuse to allow abuses in the subprime marketplace. We need to eliminate discrimination and abuses from this market so that every American can share in the dream of homeownership. This will require struggle, but we cannot shy from this battle. As the great abolitionist Frederick Douglass once said, "If there is no struggle, there is no progress...Power concedes nothing without demand. It never did, and it never will." Thank you for the opportunity to address you today and I am happy to answer any questions you may have for me.

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[8] *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending"* General Accounting Office, January 2004.

Statement of Charles W. Calomiris

Before a joint meeting of the

Subcommittee on Housing and Community Opportunity

and the

Subcommittee on Financial Institutions and Consumer Credit

of the Committee on Financial Services,

U.S. House of Representatives

March 30, 2004

DRAFT OF MARCH 28, 2004

Chairman Ney and Chairman Bachus, thank you for inviting me to speak today before this joint meeting of the Subcommittees on Housing and Community Opportunity, and Financial Institutions and Consumer Credit, on the important topic of subprime lending.

In my July 26, 2001 testimony, "What to Do, and What not to Do, About Predatory Lending," before the U.S. Senate Committee on Banking, Housing and Urban Affairs, I provided a brief historical overview of the progress brought by the development of the subprime lending market, made specific recommendations for regulatory reforms to deal with predatory lending, and expressed concern that regulatory overreach, particularly by state and local governments, could threaten the recent improvements in the efficiency and fairness of our national mortgage market. Today I will briefly summarize and update that earlier testimony.

1. Subprime lending, and the development of a national market for financing prime and subprime mortgages, have been a great boon to consumers. The quantification of risk factors in mortgage and other consumer loan markets, and the securitization of these loans, have been especially beneficial developments, both from the standpoint of market efficiency and fairness. The development of quantitative scoring has been of fundamental importance to the pricing of risk and the democratization of finance. Instead of rationing credit to the favored few, suppliers of funds in the consumer lending market now can measure and manage risk better so that a much broader range of consumers can access credit when they need it. Securitization of consumer lending (which relies on the quantification of

risk) has broadened the sources of funding and increased competition in consumer lending, and has further facilitated the measurement and diversification of risk, all resulting in substantial cost savings for consumers.[1]

2. Many consumers have choices and opportunities in the market that they did not have even a decade ago. Houses can be used, and often are used, as a source of funding by people of all income levels, ages, occupations, and backgrounds to fund a variety of needs. Minority borrowers have been among those most benefiting from the democratization of consumer finance. According to Countrywide Financial Corporation, which describes itself as the largest mortgage lender in the United States to African Americans and Hispanics, it plans to lend $600 billion to minorities and low income families by the year 2010.
3. Although it is true that subprime lending has opened new opportunities for access to credit for low-income borrowers, subprime lending is not geared exclusively, or even primarily, toward low-income borrowers. In fact, Countrywide shows that the demographic characteristics of its prime and subprime borrowers are quite similar (that is, the age, income, and occupational distributions of the borrowers in the two categories are similar). Fifty-five percent of Countrywide's subprime lending involves loan balances in excess of $200,000.[2]
4. Why do middle- and upper-income people rely on the subprime market? Subprime loans can be the easiest form of credit for borrowers that are in urgent

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[1] Charles W. Calomiris and Joseph R. Mason, *High Loan-To-Value Mortgage Lending: Problem or Cure?* AEI Press, 1999; Charles W. Calomiris and Joseph R. Mason, "Credit Card Securitization and Regulatory Arbitrage" (with Joseph Mason), *Journal of Financial Services Research*, forthcoming.

[2] "Debunking the Myths: Who Are Non-Prime Borrowers?" Presentation of Debbie Rosen, Executive Vice President, Countrywide Financial Corporation, to the Housing Policy Council of the Financial Services Roundtable.

need of funds for medical procedures, or to finance a child's wedding or education, or for those who wish to borrow against a form of collateral not favored in the prime market (e.g., a condominium). Subprime loans are particularly useful for the self-employed, who tend to have a harder time accessing prime lending markets because they lack employment records. The new financing opportunities brought by subprime lending have given consumers much more flexibility in their spending and financing choices, especially by enabling people to satisfy important medical, educational, or other needs quickly.

5. The rapid progress in the development of the new subprime market has also brought with it some growing pains. I refer to various practices (which were summarized in my July 26, 2001 Senate testimony) that are collectively known as "predatory lending," although there is disagreement about what should be included in the definition of predation.
6. There have been a variety of statutory, regulatory and voluntary private industry responses to abusive market practices over the past several years, some at the federal level, some at the state and local government level. Many of these responses have been sensible and measured (particularly the actions taken by the Federal Reserve and the OCC). Those measured responses recognize the need to address undesirable practices "surgically" – that is, by preventing or discouraging them without undermining the vitally important role played by subprime lending.[3]

[3] For a recent review of consumer protection controversies and regulation in the area of subprime lending, see *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, AAO Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate, January 2004.

7. Other responses (particularly, overzealous prohibitive laws passed in some states and localities) have been unbalanced attempts to use state or local government authority as a means of instituting "stealth usury laws" which are intended to have a chilling effect on high-cost subprime lending. By stealth usury laws, I refer to laws that impose "poison pills" on high-cost subprime lenders, either through prohibitively costly procedures or highly uncertain legal liabilities which make it undesirable for lenders to continue to participate in high-cost mortgage lending.
8. In my view, those stealth usury laws constitute an undesirable encroachment on the legitimate authority of federal bank regulators to regulate the terms of lending by federally chartered institutions. For that reason, and because stealth usury laws are contrary to the public interest, I believe that the OCC was correct in January of this year to assert preemption over these various state and local government laws, which it did to preserve its appropriate oversight role over federally chartered bank lending practices.
9. In justifying that decision, Comptroller Hawke pointed out the importance of allowing lenders to continue to operate in a national mortgage market.[4] It is important to recognize that there are large gains from having a national market. It is highly efficient to be able to pool loans from a variety of locations, and to finance them with funds from a competing group of investors in the national capital market. Federally chartered banks that operate throughout the country help the market to realize those efficiency gains, as do the ratings agencies and

[4] "When national banks are unable to operate under uniform, consistent and predictable standards, their business suffers and so does the safety and soundness of the national banking system. The application of multiple and often unpredictable state laws interferes with [national banks'] ability to plan and manage their business, as well as their ability to serve the people, the communities and the economy of the United States."

other intermediaries that monitor the performance of securities placed into securitization pools, which are financed by debt offerings in the national capital market.

10. We have already seen tangible evidence that state and local government actions can cripple high-cost subprime lending, and that these laws can undermine the ability of mortgages originated in the jurisdiction covered by those state and local statutes to participate in the national market. My 2001 Senate testimony reviewed evidence from an empirical study by Michael Staten, which identified a severe reduction in high-cost subprime lending in North Carolina in reaction to its stealth usury law. We have also seen evidence of the positive effects of OCC preemption in preventing the fragmentation of the national mortgage market. In response to New Mexico's Home Loan Protection Act, Fitch announced that it would not be rating RMBS transactions containing high-cost home loans originated in New Mexico. Then, in response to the OCC's preemption policy, Fitch announced that it will rate, without additional credit enhancement, RMBS transactions in any state so long as they are originated by OCC-regulated national banks and their operating subsidiaries.[5]

Chairman Ney and Chairman Bachus, I hope that you and your colleagues, along with the OCC and the Fed, will help to maintain the efficient operation of the national mortgage market, and continue to support balanced efforts to protect individuals from predatory lending without undermining the progress that the quantification of

[5] "Fitch Ratings Addresses New Mexico Predatory Lending Legislation," Business Wire, January 15, 2004; "Fitch Ratings Addresses Preemption Statement from the OCC," Business Wire, January 15, 2004.

mortgage risk and the nationalization of the mortgage market have allowed. That progress has given people the freedom to make choices that have benefited millions of individuals. I hope that you and your fellow subcommittee members will agree that the overzealous and misguided agenda of those who wish to use stealth usury laws to effectively outlaw high-cost subprime lending, and undermine the authority of federal regulators to control the lending practices of federally chartered institutions, must not be permitted to succeed.

March 30, 2004

Testimony of

William M. Dana

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Housing and Community Opportunity

and the

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March 30, 2004

Chairmen Bachus and Ney, my name is William M. Dana, President and CEO of Central Bank of Kansas City, Missouri. I am pleased to testify before you today on behalf of the American Bankers Association. I serve on both the ABA's Community Bankers Council and on its Communications Council. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes

community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

Today's hearing topic, the subprime lending market and the customers it serves, is an important one for both consumers and lenders alike. I commend you for your attention to the complex issues surrounding the subprime market. Subprime lending is a vital source of credit to many individuals who would not have access to loans without it. It should not be confused with predatory lending, which is characterized by practices that deceive, defraud or otherwise take unfair advantage of consumers. The ABA strongly believes that predatory lending has no place in our financial system and that existing laws should be rigorously enforced. Practices that are routinely criticized – such as guaranteeing the borrower one loan rate and putting a second, higher rate in the mortgage contract are reprehensible -- and are already illegal. The vast majority of predatory practices are engaged in by unregulated, often fly-by-night lenders. In contrast, the banking industry is subject to strong oversight and examination by banking regulators to ensure that banks comply with all laws and regulations. Non-banks should be encouraged to lend responsibly and be held accountable for not doing so.

Subprime lending, or more precisely, lending to those with less than perfect credit ratings, is an extremely important part of my small bank's business. In fact, if we could not do subprime lending, our mortgage lending business would have difficulty surviving. My community is not a community filled with wealthy people who are minimal credit risks. However, we do have many individuals and families who need access to credit and look to our bank to provide it. In many cases, the loans for which they qualify are subprime. We provide full disclosure of all the terms of these loans and work very hard to make sure that our borrowers understand the obligations that they are assuming. It does our bank no good – and certainly our borrowers no good – if they do not fully understand this important financial obligation.

Care must be taken to effectively deal with abusive practices but not inadvertently shut off credit to deserving individuals. Laws that add additional requirements only raise the cost of these

types of loans. Complying with many different state and local requirements adds a regulatory burden, impedes efficiency, reduces credit and raises costs. In ABA's opinion, a national standard is an appropriate approach to consider.

In my statement today, I would like to make three key points:

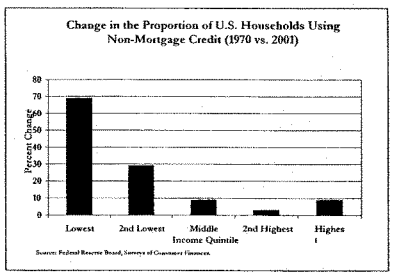
- Subprime lending is an important source of credit for many people who have less than stellar credit histories;
- Subprime lending should ***not*** be confused with predatory lending; and
- For consistency and efficiency, a national predatory lending standard is the most effective approach to curb abuse or fraud.

I will address each of these in turn in the remainder of my statement.

Subprime Lending is an Important Source of Credit for Many People

One of the keys to the strength and resiliency of the U.S. economy is the efficiency of the consumer credit markets. U.S. consumers have access to more credit, from a greater variety of sources, more quickly, and at lower cost than consumers anywhere else in the world. –Financial institutions have, over time, gradually expanded credit to borrowers who in earlier times could not have qualified for credit. This broadening of access to credit is a positive development, spurred by market forces and governmental actions, including the elimination of many regulations and limitations on lenders. In the days when deposit and lending rates were regulated or limited – as recently as 1980 – credit was rationed. Good or prime borrowers got credit; others did not.

These findings are confirmed by a recent study by professors Michael E. Staten and Fred H. Cate, entitled: *The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation.*[1] The authors document the positive impact of credit reporting on traditionally underserved Americans. They state: "One of the more remarkable achievements attributable to the development of comprehensive credit reporting is the increased access to credit down the household income spectrum in the U.S. over the past three decades." (See Chart.) The reasoning behind this finding is straightforward: detailed and reliable information on past payment behavior gives lenders confidence in assessing the creditworthiness of new borrowers and allows them to design products to meet the needs of previously underserved populations. Because the credit-reporting infrastructure helps to support broader access to credit, it can enhance asset and wealth accumulation – an effect particularly pronounced for younger households.



Borrowers with a history of always paying their utility, credit card, and other bills on time often qualify as prime borrowers, and are thus eligible for credit on the most competitive terms available. Many other borrowers, however, do not have perfect payment histories; others may not have significant assets to fall back on; and others may be self-employed and have wide fluctuations in their annual incomes. Borrowers in these categories may not qualify for prime status, but they are often eligible for credit in the subprime market, where, because of greater risks, the interest rates and fees can be higher, and the loan amounts lower, than those available in the prime market.

Thus, combined with the national credit histories, the other major innovation that facilitated the expansion of credit to subprime borrowers was the development of credit rating tools to

[1] Michael E. Staten is the Distinguished Professor and Director of the Credit Research Center at the McDonough School of Business, Georgetown University and Fred H. Cate is the Distinguished Professor and Ira C. Batman Faculty Fellow at the Indiana University School of Law-Bloomington.

measure the relative risks of potential default of different borrowers. These credit scores are now used by a wide range of lenders, depository and non-depository institutions alike, to help determine interest rates and other terms to offer to borrowers based on analysis of the risks of non-payment. This practice is known as risk-based pricing, and it is a tool that has made credit available to many consumers who had previously been left out of the marketplace. The development of the subprime market has assisted these borrowers tremendously. I would also like to note that for many institutions, like mine, a credit rating is a starting point, not a cut off point for many loans. We look at a potential borrowers' credit rating, but frequently we make loans based on broader criteria than those covered in the credit ratings.

Preserving the national credit system, as Congress did just last year was extremely important. In the same vein, preserving access to credit to those with less than perfect credit histories is equally important.

I am particularly proud of my institution's record of extending credit to subprime borrowers. I would like to share some examples of the kinds of lending we do and the impact it would have on our community if we ***did not*** extend these loans.

- We have helped people who have been victims of predatory loans, like a retired couple with a $19,000 annual income. They had taken a second mortgage against their home with a siding contractor paying 19 percent annual interest. Central Bank refinanced their home. We paid off the first and second mortgage. Our loan, on much improved terms, resulted in a lower monthly payment amount, allowing them to have a much better quality of life, and to not worry about losing their home.

- We have helped new businesses get started that enhance our local community. A borrower came to us seeking a loan to purchase (from a deceased owner) a tax services business targeted to Spanish-speaking immigrants. The applicant had a low credit score and multiple collections and her business partner had an even lower score. Nevertheless, Central Bank financed the acquisition at 8.5 percent fixed for 15 years, using the business and a personal residence as collateral. But for our loan, these women would not have been able to provide a needed service in this community with a large Hispanic population. They were both inviting targets for predatory lending by unscrupulous lenders, but instead they have a good loan, at a fair price, benefiting them and the customers they serve.

- We have helped those in trouble in our community. A local church came to us when they had a church van repossessed and another lender had begun foreclosure proceedings against the church. The pastor came to us, and even though he had bad credit, he agreed to guarantee a loan made by Central Bank. Working together we were able to help him to save both the church and the van.

Without Central Bank's participation in the subprime market, these borrowers and many more like them would not have these opportunities to help themselves and their community and would likely have been targets for predators.

Subprime Lending Should *Not* Be Confused With Predatory Lending

Subprime lending is an important category of lending. As with all lending, it must be done in a straightforward manner with all appropriate disclosures so borrowers understand the obligations they are undertaking. Abusive practices that use deceptive or fraudulent sales tactics, or that intimidate or mislead consumers into borrowing, should not be tolerated and there should be aggressive enforcement of laws and regulations designed to prevent such practices.

Depositories, like mine, are significantly regulated, and must meet strict reporting and other disclosure standards that ensure that credit is extended on a fair and equitable basis. Not all institutions serving the subprime market are regulated as intensely. Depository institutions are also examined on their history of extending credit to subprime borrowers under the Community Reinvestment Act – an obligation not shared by many other financial companies.

Abusive practices by some of these less well regulated lenders has caused Congress, as well as state and local lawmakers, to pay increasing attention to what has come to be known as "predatory lending." Although the term itself has not been precisely defined, it has come to refer to loans extended under terms that are more onerous to borrowers than if they were to be fully informed about the loans themselves and the alternative sources of finance that might be available to them. In response, the Congress has enacted laws like the Home Ownership Equity Protection Act

(HOEPA), and state and local lawmakers have enacted or considered various anti-predatory lending laws. These state and local laws, while well intentioned, often have the effect of driving legitimate lenders from a marketplace, or of balkanizing the subprime market by preventing the efficiencies and cost-savings of national markets from developing.

In effect, many of the state and local laws constitute a new type of "usury" statutes. Usury laws were once prevalent throughout the country, but have since been abandoned so that the market can work efficiently – except in this new guise as an attack on predatory lending. Moreover, the implicit connection drawn in many of these laws between "high cost" lending, which appropriately reflects the risks of lending to customers outside the prime market, and "predatory" lending, which is inherently abusive, is simply incorrect.

While the motivation behind legislation aimed at predatory lending is understandable and commendable, virtually all of the practices complained of are already against federal law. What is often lacking at the federal level is the proper enforcement. Furthermore, federal law already contains numerous disclosure requirements relating to mortgage loans generally, and especially high-cost loans. Additional statutory measures at the state and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers. This potential outcome is a very real concern and should be seriously considered by policy makers at all levels of government. There have been successful efforts, at the federal level in particular, to increase lending to minorities and low-income borrowers in recent years. Such lending should not be jeopardized by counterproductive measures at the state and local level.

For Consistency and Efficiency, a National Predatory Lending Law is the Most Effective Approach to Curb Abuse or Fraud

The best approach to address concerns over predatory lending without disrupting credit to the subprime lending market is the passage of targeted federal legislation setting a national standard against predatory lending practices.

There are a number of areas where Congress has determined that a federal approach to a given consumer protection issue is warranted, and the Congress has been able to enact appropriate legislation without undermining the dual banking system. We believe that such an approach would have the added advantage of leveling the playing field for all participants by bringing all participants under the same standard.

We do understand that real estate lending is in many ways a local issue, as real estate markets are, by and large, local. However, the huge impact of the secondary market on real estate lending is evidence that a national approach to predatory lending may be the best solution. In fact, several state and local initiatives have immediately run afoul of the national secondary market, with the result that those initiatives had to be changed.

Concerns about predatory lending should be addressed through a unified national standard, and we recommend that the Congress actively consider proposals for such an approach to predatory lending. Bills introduced by Representatives Robert Ney (R- OH), Mel Watt (D- NC) and Brad Miller (D-NC), may serve as good starting points for consideration of a national standard.

Conclusion

In conclusion, the ABA believes that the development of the subprime market has been a positive development for American consumers. To ensure that consumers receive credit on fair and equitable terms, it is vital that they be served by legitimate lenders with appropriate levels of regulation. A national standard to prevent predatory lending may be desirable to ensure that all lenders, whether depository or non-depository, operate under the same requirements. The ABA looks forward to working with the Members of the Financial Services Committee to explore these options.

Chairmen Ney and Bachus, I again thank you for the opportunity to testify here today.

TESTIMONY OF CONSUMERS UNION OF U.S., INC.
BY NORMA P. GARCIA, SENIOR ATTORNEY
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

"SUBPRIME LENDING: DEFINING THE MARKET AND ITS CUSTOMERS"
March 30, 2004

Consumers Union,[1] appreciates the opportunity to provide testimony to the House Financial Services Committee. The topic of today's hearing is particularly relevant to our efforts to promote and preserve homeownership and to provide consumers with unbiased information about personal finance. Consumers Union has been very active in this endeavor, nationally through our publication, *Consumer Reports*, and our advocacy work in Washington DC, and regionally through our Southwest Office in Austin, Texas, and our West Coast Office in San Francisco, California.

Preserving Home Equity Is Key to Prosperity and Stability

We believe that homeownership is a critical priority for our country, and that protecting the equity that our citizens grow through homeownership is critical to every state's prosperity and stability.

People who own their homes and have built equity in them have a real financial stake in the stability and quality of their communities. It is estimated that for every percentage increase in homeownership, property values for the neighborhood rise $1600 over 10 years.[2] Homeowners are more likely to be concerned that schools are good and government services are efficient, since they are supported by their property tax dollars. They have an incentive to work to keep property values up and crime rates down, since rising property values build their own wealth too. Long-time homeowners add important generational diversity and economic stability to neighborhoods, which is especially critical in areas experiencing economic hardship or decline.

It is no secret that the equity families build in their homes is a substantial portion of the net worth of the homeowner. For the typical homeowner, home equity makes up 45.2 percent of net worth, and it is much higher for Latino and African-American homeowners, making up 60.7 and 61.1 percent of net worth, respectively.[3] For the nation as a whole, home equity accounted for 44 percent of the nation's total net worth – far more than any other investments.[4] Home equity is wealth that can be used to start a business, to get an education, or to pass on to your children.

Subprime Lending Explosion Triggers Concerns in Texas and California

The growth of the conventional mortgage market has expanded the number of people who can purchase a home and build equity. But a more recent and disturbing trend has been the significant growth of subprime lending, particularly in the home refinance and home equity market. Because of the importance of preserving equity, problems associated with foreclosures, and terms and practices associated with high-cost loans, we are concerned with the tremendous growth in the subprime market,[5] particularly for refinance loans.

Our concern, which is shared by other consumer, housing, anti-poverty and civil rights advocates, is that while not all subprime loans are abusive, predatory lending is concentrated in the subprime market. Responsible subprime loans with somewhat higher interest rates that balance the greater risk of lending to borrowers with past credit problems fill an important need in the purchase money market. However, too many subprime loans include abusive terms or conditions, have rates and fees much higher than can reasonably be justified based on the borrower's credit record, serve primarily to strip equity from the home, or are simply unaffordable and destined to fail. Predatory mortgage loans, in particular those which are equity based, undermine homeownership and family wealth by stripping equity out of homes and entire communities.

Nationally, the subprime sector of the mortgage loan originations increased from less than five percent in 1994 to almost 13 percent in 1999. This represents an increase from $35 billion in 1994 to $160 billion in 1999.[6]

Similarly, the growth of the subprime refinance lending markets in Texas and California is notable. In 1997, there were 2512 subprime refinance loans made in Texas, in 2000 there were 23,353.[7] As a measure of the penetration of subprime lending in the Texas market, in 1997, refinance loans made by subprime lenders were six percent of all refinance loans made. Loans from subprime lenders now account for one-third – 33 percent – of all refinance loans across the state. The number of refinance loans is very important, since the refinance data includes home equity loans.

California has witnessed an explosion in subprime lending from an estimated $18 billion in 1998, to over $62 billion in 2002.[8] Also in California, according to a recent study issued by the UCLA Advanced Policy Institute, the number of refinance loan applications received by subprime lenders in California increased at an average annual rate of 27 percent (compared to just 4 percent for prime lenders) from 1993 to 2000. During the same time period, the market share of loans originated by subprime lenders grew five times from 4 percent in 1993 to 20 percent in 2000.[9]

Subprime Borrowers in Texas and California

Data that allows analysis of trends in the marketplace comes from Home Mortgage Disclosure Act data – HMDA – and provides some information about mortgage borrowers. In addition, by combining HMDA data with information from the Census, we are able to observe

trends in the mortgage market and make predictions about what factors predict the likelihood a person will get a subprime loan. Income, for example, is a factor that predicts when someone is likely to get a subprime refinance loan. But, even when controlling for other factors, the number of elderly people living in a neighborhood or a borrower's race appear to be factors that predict the number of subprime loans in a neighborhood.

In Texas, the more older residents in an area, the more likely that a borrower in that area will get a loan from a subprime lender, controlling for other factors like income and race.[10] This is consistent with a finding from AARP research that found older borrowers were three-times as likely to have a subprime loan than borrowers younger than 35 years of age.[11]

HMDA data available for Texas also demonstrates that not only has the growth of subprime borrowing increased overall statewide, but that the percentage of loans to African-Americans and Latinos that are made through subprime lenders has also increased. In 1997, 7.6 percent of refinance loans to Latinos and 19 percent of loans to African-Americans were made by subprime lenders, in 2000 the percentages were 39.7 and 57.7 percent, respectively.[12]

In California, multiple studies confirm that subprime refinance lending is most concentrated in Latino or African-American neighborhoods of low-socio economic status where certain neighborhoods and borrowers appear to be the targets of aggressive marketing efforts by subprime lenders.[13] The UCLA Advanced Policy Institute found that the result is the same, even when controlling for individual and neighborhood risks, and found a relationship between subprime lending and foreclosures.[14]

Subprime Lending Can Reduce or Eliminate Home Equity

The growth of subprime lending is cause for concern for two reasons – first, higher-cost subprime loans can reduce or eliminate equity building in homes; and, second, practices associated with subprime lending can result in equity being stripped from homes and communities and sometimes foreclosure.

The high cost associated with subprime loans means that subprime borrowers often pay more for less. According to Freddie Mac, in 2002, the average interest rate on a 30-year fixed mortgage was 6.54% and average points paid by the consumer were .6%. A November 2003 California Reinvestment Committee report found, "In contrast, in 2002, several subprime lenders originated loans in California with Annual Percentage Rates (APRs) that exceeded 15%, including: Citifinancial Services, Option One Mortgage, Household Finance, Beneficial, Washington Mutual Finance, and Wells Fargo Financial. Citicorp Trust Bank, FSB originated mortgage loans in California with APRs exceeding 20% in 2001, the last year for which data is available."[15]

Over the life of a loan, differences in the interest rate on a home-secured loan between a conventional and a subprime loan can make a dramatic difference in the amount of equity a homeowner builds in a home. It may mean that a homeowner builds no equity at all, or loses equity already accumulated in a home.

By examining the total interest payments a person would make financing an $80,750 loan for 30 years at eight, 11, and 14 percent interest you can see the effect. A person will pay about $132,000 in interest over the life of the loan for an eight percent loan, whereas a person would pay $196,090 and $263,692, respectively, for an 11 and 14 percent loan. The higher interest rate requires more interest to be paid overall, so a great portion of interest is paid, relative to the principle, in early years in the loan. So, not only is the monthly payment higher, but the overall amount of equity accumulated is less.[16]

Worse, loans where the borrower is unable to make payments results in foreclosure. Obviously, the loss of a person's home is devastating, but it is not only homeowners who suffer from such losses, it is estimated that between homeowners, lenders, mortgage insurers, secondary mortgage market makers like Fannie Mae, and communities, cities, and counties, as much as $73,000 per transaction is lost.[17]

Common Abuses Found in Subprime Loans Hurt Borrowers

In the conventional marketplace, borrowers can usually rely on rates to be competitive, terms to be fair, and for there to be no "gotchas" in loan paperwork. This is often not the case in the subprime market. This reality leaves consumers vulnerable to being overcharged and underserved. Consumers often reports bait and switch tactics. Additionally, there is growing awareness that mandatory arbitration agreements, which prevent consumers from obtaining judicial relief, are
ubiquitous in the subprime market, as evidenced by Freddie Mac's recent ban of such agreements from all mortgage loans it purchases.

Abuses found in some subprime loans are usually described as predatory lending. Predatory lenders target vulnerable consumers, including those with good credit, particularly the elderly, the poor and the uneducated, and use an array of practices to strip home equity from their homes. The abusive practices include excessive fees, high interest rates, costly and unnecessary insurance policies, large balloon payments, broker fees tied to interest rates, and repeated refinancing that steadily increase a borrower's debt.

In October 2001, the Coalition for Responsible Lending estimated that every year, borrowers lose $9.1 billion to predatory practices, including $497.9 million in Texas, and just under $1.9 billion in California alone. These estimates were based on equity stripping charges, such as financed credit insurance – often called 'single-premium' credit insurance, excessive fees greater than five percent of the loan amount, and prepayment penalties – and risk-rate disparities, where a borrower pays a higher rate than justified based on the person's credit history. While some of these things are prohibited in Texas home equity loans, and in some cases limited in California, many are relevant. The 2001 California Reinvestment Committee study estimated that one-third of subprime loans held by borrowers surveyed in four California cities are predatory in nature based on loan document review and borrower perception.[18]

Excessive fees and "packing" have been cited by the Department of Housing and Urban Development as an "all too frequent" abuse in the subprime market. The types of abuses found

for these loans include "packing" additional fees into loans – costs that are not found in conventional loans but are common for subprime loans.

Add-on fees, sometimes called "packing," do not increase the equity for the borrower. A couple in Austin made a loan at 13.16 APR which included more than $10,000 in unexpected charges, $4,160 for insurance and $6,213 for points. Points, which in the conventional market buy-down interest rates over the life of the loan, do not seem to have the same effect in the subprime market, where they are merely add-on costs financed over the life of the loan.

Conclusion

Legislators, policymakers and regulators should be concerned about the explosive growth of the subprime mortgage refinance market, because of the likely increase in predatory lending within that sector. We believe a more comprehensive fix is needed to address problems with home equity subprime loans in Texas. In California, we advocate for increased enhancements of the state's anti-predatory lending law passed in 2001, and for the establishment of more protective local ordinances, where needed.

I appreciate the opportunity to provide testimony today.

Endnotes

[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education, and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 4.6 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] Each percentage point increase in the homeownership rate of a tract would yield about $1600 increase in the property value of the average single-family home over a ten-year period. Rohe and Stewart (1996) p. 66.

[3] McCarthy, G. et al, *The Economic Benefits and Costs of Home Ownership*, Working Paper No. 01-02, Research Institute for Housing America, May 2001.

[4] *Buying a New Home: A Solid Investment*, National Association of Home Builders and Builder Magazine, data from 1993.

[5] The Department of Housing and Urban Development (HUD) identifies subprime lenders. According to HUD, a list of HMDA reporters that specialize in subprime lending is compiled primarily from industry trade publications and HMDA data analyses. Then, HUD contacts the lenders or reviews their web pages to determine if they specialized in subprime lending. In cases where lenders offer both prime and subprime, lenders were identified as subprime if they reported that at least 50 percent of their conventional originations were subprime loans.

[6] Stein, K., California Reinvestment Committee, *Stolen Wealth: Inequities in California's Subprime Mortgage Market*, December 2001.

[7] 2512 subprime refinance loans out of 41,572 in 1997, 23,353 subprime refinance loans out of a total of 70,616 in 2000.

[8] Stein, K., California Reinvestment Committee, *Who Really Gets Home Loans? Year 10*, November 2002, p. 3.
[9] Pitkin, B., et al., UCLA Advanced Policy Institute, *Subprime Refinance Mortgage Lending and Neighborhood Conditions: Evidence from California*, , Sept. 30, 2003, p. 1.
[10] Logistic Regression Analysis – Loans Originated by Subprime Lenders in Texas.

Number of Loans Analyzed: 353,042

Odds Ratio Estimates

Effect	Point Estimate	95% Confidence	
Percent of Tract 55 or Older	1.002	1.001	1.004
Percent of Tract Minority	1.006	1.005	1.006
Ratio of Tract to MSA Income	0.998	0.998	0.998
Population Density of Tract	>999.999	>999.999	>999.999
Improvement Loan	0.918	0.872	0.967
Refinance Loan	7.201	7.011	7.396
Amount of Loan	0.999	0.998	0.999
Loan As Percent of Income	1.033	1.025	1.041
Applicant Income	0.996	0.996	0.997
No Coapplicant	1.135	1.105	1.166
Applicant Sex is Female	1.116	1.083	1.149
Applicant Race is Black	3.326	3.202	3.455
Applicant Race is Hispanic	1.416	1.368	1.465

Note: The point estimate of the odds ratio can be interpreted as the number of times more likely the loan is subprime given a single unit increase in the effect variable and holding everything else constant. For example, a black applicant is 3.3 times more likely to get a subprime loan, holding the other factors constant. Model Correctly Predicts 77.7% of observations, predicts a tie for 1.0%. Data Sources: 2000 HMDA,2000 Census, U.S. Bureau of the Census.

[11] Calhoun, M., et al., Home Loan Protection Act, A Model Statute, November 2001, p. 5, citing Lax, H., et al., *Subprime Lending: An Investigation of Economic Efficiency*, (unpublished paper), February 2000.

[12] For African-Americans, 383/2031 subprime/prime refinance loans in 1997, 2937/5091 in 2000. For Latinos, 365/4772 in 1997, 4595/11,585 in 2000.

[13] Pitkin, B., p.2; Stein, K., California Reinvestment Committee, *Stolen Wealth: Inequities in California's Subprime Mortgage Market*, December 2001, p. 22.

[14] Pitkin, B., pp 2, 18.

[15] Stein, K., California Reinvestment Committee, *Who Really Gets Home Loans? Year Ten—Mortgage Lending to African-American and Latino Borrowers in 5 California Communities in 2002*, November 2003.

[16] Comparing the differences between the monthly payments and total payments over the life of the loan:

Interest rate	Monthly payment	Annual payment	Diff. from 8%	Life of loan
8%	592.51	7,110.18	N/A	N/A
11%	769.00	9,228.01	2,117.83	$63,535
14%	956.78	11,481.36	4,371.18	$131,135

[17] Source: McCarthy, G. et al, *The Economic Benefits and Costs of Home Ownership*, Working Paper No. 01-02, Research Institute for Housing America, May 2001:

Party	What is lost	Financial Loss
Homeowner	• Accumulated equity and all costs associated with acquisition of the home • access to stable housing of decent quality (and damage to credit score makes it difficult to buy or even rent other dwellings) • tax advantages of home ownership and face a potential tax burden for forgiven indebtedness	$7,200
Lender	• insured loans: non-reimbursable expenses (interest payments advanced to investors), expenses of holding and maintaining properties) • portfolio loans: full amount associated with foreclosure (legal fees, maintenance, brokers fees for resale) • revenue stream from servicing	$1,500 (FHA) - $2,300 (conv), $1,125 (servicers)
Mortgage Insurers	• difference between sale price at foreclosure and sum of outstanding debt and costs	$28,000 (FHA), $10,600 (VA), $17,300 (conv)
GSEs	• foreclosed properties with mortgages sold on secondary market	$6,400- $8,000
Communities, cities, counties	• tax revenue • unrecovered rehabilitation expenses • nearby properties suffer resale value losses, increased vandalism	$27,000 - avg city expenses, $10000 neighborhood (FHA)
Total		$26,000 (conv) - $73,000 (FHA)

[18] Stein, K., California Reinvestment Committee, *Stolen Wealth*, p. 4.

TESTIMONY OF

SANDY SAMUELS

Senior Managing Director and Chief Legal Officer

on behalf of

COUNTRYWIDE FINANCIAL CORPORATION

and the

HOUSING POLICY COUNCIL

of THE FINANCIAL SERVICES ROUNDTABLE

Before the

SUBCOMMITTEES ON FINANCIAL INSTITUTIONS AND HOUSING
UNITED STATES HOUSE OF REPRESENTATIVES

March 30, 2004

Good morning, Chairman Bachus, Chairman Ney, Congresswoman Waters, Congressman Sanders and members of the Subcommittees. I am Sandy Samuels, Senior Managing Director and Chief Legal Officer of Countrywide Financial Corporation. Countrywide is based in Calabasas, California and is a national leader in home mortgage finance through its main subsidiary, Countrywide Home Loans, Inc. We appreciate the opportunity to testify before the committees today on behalf of The Financial Services Roundtable and the Roundtable's Housing Policy Council.

In today's testimony, we want to give the committees a better picture of the nonprime borrowing market Countrywide and the member companies of the Housing Policy Council serve. While nonprime borrowers vary as much as prime borrowers do, some basic demographic information should help illustrate how and why we serve this market.

The member companies of the Housing Policy Council fund more than 60% of the prime mortgages in the United States every year, through origination or purchase. Council members also service more than 54% percent of all prime mortgages nationwide. Although nonprime figures are harder to quantify, we believe that HPC members fund and service about the same percentages of nonprime loans annually. HPC members, therefore, have experience making and servicing the nonprime sector of the housing market, and have contributed to the historic growth in credit availability that has made first-time homeownership available to so many families and individuals over the past decade.

Countrywide Home Loans is one of the nation's largest mortgage banking companies. In the fourth quarter of 2003, Countrywide became the largest home mortgage lender in the United States. Countrywide funded more than $435 billion in home loans last year. Since our founding in 1969, our mission has been to make the dream of homeownership possible for as many Americans as possible. Our business began with FHA and VA lending, and the vast majority of the loans we fund and purchase today still go to FHA, VA and Fannie Mae/Freddie Mac-eligible borrowers. As a mortgage banking company, Countrywide does not generally hold loans in its portfolio. Rather, we sell or securitize our loans in the secondary market – to Fannie, Freddie and other investors, as well as issue our own mortgage securities.

The existence of this secondary market makes liquidity available to the entire mortgage industry, and has significantly expanded access to and lowered the cost of home mortgage credit. We work closely with these secondary market investors to establish the predictive credit, documentation and collateral criteria that determine whether a borrower qualifies for a prime or a nonprime loan. Other members of the Housing Policy Council hold some or all of their loans in portfolio, and have created their own standards and automated underwriting procedures for their borrowers. Whether a lender sells loans into the secondary market or holds them in portfolio, lenders and investors all share a common goal of ensuring that borrowers have both the capacity and the willingness to repay. As holders, servicers and issuers, HPC member companies all have a financial and reputational stake in seeing borrowers succeed.

Lending to traditionally underserved markets is a priority for Countrywide, and we are proud of our accomplishments in this arena. Countrywide was the nation's largest mortgage lender to African Americans and Hispanics in 2002[1]. We are driven to maintain that distinction, and we believe we retained that position in 2003. Last year at this time, our CEO Angelo Mozilo set a goal to fund $600 billion in home loans to minorities, low-income families and low-income communities by 2010. We are well on our way to achieving this goal.

While the market knows us primarily as a "prime" lender, Countrywide entered the nonprime lending market in 1996 as part of our effort to make homeownership possible for the largest number of American families and individuals. We believed then, and believe now, that nonprime lending is a natural extension of our commitment to bring Americans who have traditionally been outside mainstream mortgage markets into their first homes. Our nonprime lending programs also have helped these families and individuals build equity and use this equity to send their children to colleges, start their own businesses, and gain control over their financial destiny.

We entered the nonprime market with great deliberation and care, and continually assess how best to participate in this market in a responsible manner. Nonprime loan originations still comprise less than 5 percent of our total loan production volume. Although nonprime lending represents only a small fraction of our business, Countrywide is now one of the top ten nonprime lenders in the United States. We originate these

[1] Based on a peer comparison of loans originated and purchased as reported by individual reporting entities under the Home Mortgage Disclosure Act for 2002.

nonprime loans through our retail subsidiary, Full Spectrum, and through our Specialty Lending Group and its network of mortgage brokers.

Despite the industry's effort to expand access to prime loans through the FHA, VA and the housing GSEs, a large segment of the borrowing public still does not meet the eligibility criteria for prime loans. The GSEs and the FHA work constantly with their lender partners to find new ways to stretch these criteria to qualify as many borrowers as possible, and HPC members that set their own underwriting standards are constantly reevaluating these standards. We have made tremendous progress in this area, as the current record levels of homeownership demonstrate. But the fact remains that not all borrowers qualify for prime mortgages.

The reasons a borrower does not qualify for a prime-rate mortgage are as diverse as the borrowers themselves. They relate to creditworthiness, of course, but also to issues regarding the type of collateral securing the loan, the amount borrowed, other financial assets, and the borrower's ability or willingness to provide the kind of financial documentation our secondary market investors require. The only element that these nonprime borrowers have in common with each other, in fact, is that they possess some attribute that does not conform to the standards that have been set by the FHA, VA, the housing GSEs or the rating agencies for prime quality mortgages. Some recent examples of actual Countrywide borrowers will illustrate this.

Mr. G. from Stockton, California, is a 48-year-old self-employed printer. He had a credit score of 565, because of a Chapter 7 bankruptcy within the previous 24 months. Although he had enough money for a 22% down payment on the home he wanted to buy, his low credit score and his inability to provide standard, full income documentation disqualified him from obtaining a prime loan. We were, however, able to make him a loan for $205,000 at a low 6.25% interest rate, with all loan fees and discount points totaling less than $3,000, or one and one-half points. Mr. G. chose an adjustable-rate loan with fixed payments for the first three years, which allowed him to purchase his home and reestablish himself after the bankruptcy. Without access to a nonprime loan, Mr. G. would have had to wait at least three years to boost his credit score and for the bankruptcy to age.

Had Mr. G. lived in New Jersey, instead of California, state law would have considered his mortgage a "high cost" loan. Because our Full Spectrum affiliate, like most major nonprime lenders, does not originate loans defined as "high cost" by state law, we would not have been able to provide him a loan with such a low rate and payment.

Countrywide made another nonprime loan to Mr. and Mrs. S. from Nicholasville, Kentucky, who were struggling to make ends meet. They had a high-rate second mortgage, at more than 14%. This and other consumer debts pushed their monthly debt service to over 50% of their $3,000 monthly income from Mr. S's job as a machinist. Although the S's had an excellent credit score of over 770, the loan-to-value ratio

necessary for them to consolidate their first and second mortgages exceeded the guidelines for a prime refinance loan. Full Spectrum was able to make Mr. and Mrs. S. a $94,000 loan at a loan-to-value ratio of 99%. The new loan had a 30-year fixed-rate of 7%, with points and lender fees totaling $2,500. It consolidated the high-rate second mortgage and lowered the couple's monthly payments by more than $200. Their monthly debt-to-income ratio is now a much more manageable 43%.

Had Mr. and Mrs. S. lived in North Carolina or New Jersey, this would have been a "high cost" loan and unavailable from Countrywide at these terms.

Mr. C. from Clovis, California, had a 510 credit score and monthly mortgage and other debt payments that exceeded 60% of the income from the tanning salon he owned. We helped Mr. C. consolidate his fixed-rate first mortgage at 7.75% and his adjustable-rate second mortgage into one 30-year, fixed-rate first mortgage at 6.875%, with total discount points and lender fees equal to 4 percent of the $264,000 loan amount. Mr. C. also opted to take a prepayment penalty in order to reduce his rate. This loan lowered Mr. C.'s monthly payments by more than $1,550, and reduced his monthly debt ratio to a much more manageable 43% of income. Mr. C.'s low credit score precluded any rate reduction refinance or debt consolidation with a prime loan.

Both New Jersey and North Carolina would consider this a "high cost" loan, so it would not have been available to Mr. C. if he had lived in either of these states.

Full Spectrum made a loan to another Mr. C. in San Dimas, California. This Mr. C. is a Senior Administrator in the medical sales business. He had a 509 credit score as a result of numerous recent collection actions on his credit report. He faced more than $75,000 in accumulated debts and expenses that were in various stages of delinquency or collection. We were able to make Mr. C. a $225,000 fixed-rate loan at 6% -- more than 2.5 percentage points lower than his existing mortgage rate – with lender fees and points of $5,200. Mr. C. used this money to refinance his existing high-rate loan and to borrow an additional $77,000 to pay off his mounting debts and other expenses. With our loan, he now has a clean slate on all his debts and expenses, and he still lowered his monthly payments by $50 per month.

Again, had Mr. C. lived in New Jersey, this loan would have been a "high cost" loan, and therefore unavailable to him.

There is no question that certain vulnerable segments of our communities are being targeted by unscrupulous scam artists, particularly the elderly, inner city residents, or families having exceptionally low income or credit scores. I will speak to this very important issue later. This does not, however, represent the Countrywide experience. Let me share with you some of the broad demographics of our prime and nonprime first mortgage borrowers, based on our most recent three months of production, through February 2004.

- The average age of our nonprime borrowers was 43, identical to the average age for our prime customers. Sixty-two percent of our nonprime borrowers were between the ages of 30 and 50. Only 6 percent of our nonprime borrowers were above the age of 60, compared to 10 percent of our prime borrowers.

- Not surprisingly, the average FICO score of our nonprime borrowers was 608, compared to 715 for prime borrowers. However, nearly 20 percent of our nonprime borrowers had FICO scores in excess of 660 – the banking regulators' cutoff point for their definition of nonprime. These borrowers have other factors – collateral, loan-to-value, documentation – that classify them as nonprime.

- The average amount borrowed was virtually identical between prime and nonprime customers -- $179,000 for nonprime, $182,000 for prime. More than one-quarter of our nonprime customers borrowed in excess of $300,000.

- Loan-to-value ratios (LTVs) were also remarkably similar between our prime and nonprime customers. The average LTV for nonprime loans was 82%, compared to 80% for our prime book. The slightly higher LTV ratio for nonprime loans reflects the fact that 17% of our nonprime loans have

LTVs higher than 95%, compared to only 10% of our prime loans. These loans often fall outside prime guidelines because of the elevated risk.

- Even the incomes between our prime and nonprime customers are remarkably similar. The average income of our nonprime customers was $69,000; the average for our prime borrowers was $74,000. Fewer than 3% percent of our nonprime borrowers earned less than $25,000, the same proportion as among prime borrowers.

- Although nonprime customers are more likely to borrow in order to tap their home equity for other financial purposes, a significant percentage of our nonprime borrowers are able to acquire a home. Over the three months ended in February 2004, nearly 30 percent of our nonprime loans went to purchase homes, compared to 49 percent of our prime loan originations.

- The average APR (which includes rate and the lender's points and fees, and other fees considered "finance charges") on our nonprime products for the 3 months ended February 2004 was 7.83%, while the average APR on our prime products was 5.44%. The average nonprime note rate was just over 7%.

This profile, which may seem counterintuitive, corresponds to the profiles of nonprime customers served by other Housing Policy Council member companies.

Countrywide's experiences are consistent with the results of a major study commissioned by The Financial Services Roundtable, "Servicing the Credit Impaired: How Subprime Lending Fills the Gap." This study found that nonprime borrowers span all demographic groups:

> They are often individuals who have experienced a temporary life-disrupting event, such as job loss or medical emergency. Subprime borrowers may also have a history of credit problems. A majority of these borrowers are married, have annual household incomes between $25,000 and $65,000, and are between the ages of 30 to 54. Their racial and ethnic demographics resemble that of the U.S. population as a whole.

The Roundtable study showed that origination costs of nonprime loans can be 30 percent higher than those of prime loans. Servicing costs for nonprime loans are more than double, and delinquency rates can be six times as high for nonprime loans. Nonprime loans, in the aggregate, tend to prepay more quickly than prime loans, which means that lenders must recoup their fixed loan production costs more quickly. Foreclosures, too, cost lenders money; lenders almost never realize a profit for either the borrower or themselves.

While prepayment penalties have been the target of vocal criticism in the predatory lending debate, we believe they have been unfairly maligned. Used properly, prepayment penalties offer significant benefits to borrowers. In today's market conditions, a three-year prepayment penalty on Countrywide's most popular product (a 3/27 adjustable rate

loan) provides the borrower with an interest rate reduction of 1 percent. This would reduce the monthly payment on a $150,000 loan by $125, a significant amount for any family trying to make ends meet. It is important to note that Countrywide, like many of our colleagues and competitors, offers borrowers a choice of products with and without a prepayment penalty, and we provide a very clear disclosure of both the benefits and drawbacks of a prepayment penalty. A copy of this disclosure is attached to our written statement.

As noted previously, several elements in addition to credit scores can move a borrower from "prime" to "nonprime" status: the borrower's ability or willingness to document income; the stability of the borrower's income; the loan-to-value or loan-to-equity ratio on the mortgaged property; and characteristics of the property that affect its collateral value, including whether it is owner-occupied, a vacation or investor property, or whether it is a condo or a single-family home. Nonprime products give borrowers more choices and make credit more readily available, because we and other lenders can price according to the level of risk. Before the advent of risk based pricing, the mortgage banker's only other choice was to reject those borrowers that did not fit the prime lending standards.

Credit problems that lead to delinquency and default do occur more frequently in the nonprime market. Interestingly enough, our experience indicates they occur for predominantly the same reasons they occur in the prime market: life disruptions that interfere with the borrower's ability to repay. A 2000 working paper from Freddie Mac

indicates that almost 30 percent of nonprime borrowers reported major medical expenses in the past few years, compared to less than 20 percent of prime borrowers. Approximately 23 percent of nonprime borrowers said they had had a major spell of unemployment; 31.5 percent reported a major decrease in income; and more than 12 percent said they had been separated, divorced or widowed in the past few years. All of these figures are more than twice the rate of these occurrences among prime borrowers.

It frustrates us at Countrywide that we most often see the entire nonprime lending market characterized by the activities of the scam artists who trap borrowers with fraudulently marketed loans. In fact, responsible nonprime lending can be a second chance for individuals to get their economic houses in order and reestablish good credit. Countrywide's internal data show that nonprime status is a temporary condition for many of our borrowers, just as many of these life disruptions represent temporary, not permanent, setbacks.

Of our nonprime customers that refinance with Countrywide, approximately 45 percent graduate into prime products. This is compelling evidence that nonprime loans do indeed provide a "second chance" for families who have experienced adverse life events.

The members of the Housing Policy Council represent the leading lenders in the nonprime mortgage market. The HPC members represent companies that serve both the prime and nonprime segments of the market, and have implemented practices designed to

ensure that borrowers get the best loan terms for which they qualify. We at Countrywide are particularly proud of our branch-within-a-branch program, which puts a "prime" desk in our Full Spectrum branches. This program ensures that all loan applicants are run through our automated underwriting engine and those applicants that appear to qualify for prime credit are flagged for further processing as a prime borrower. The system is designed to create the proper work flow processes and incentives to put prime borrowers who enter through the nonprime branch into the best loan product for which they qualify.

Countrywide and the HPC member companies recognize the black eye that some lenders, brokers and home improvement contractors have given the nonprime lending industry. Of even greater concern is the severe financial and emotional pain they have caused to those they ripped off. The HPC supports Congressional efforts to accomplish four major objectives:

1. Enactment of strong, uniform national standards to directly address these predatory practices;
2. Effective enforcement of those standards by federal and state regulators;
3. Stronger financial literacy programs that begin in our schools and reach to those who never got the chance to gain literacy skills in their formative years; and
4. Expanded access to high quality homeownership and credit counseling for those who seek it.

We look forward to working with the Financial Institutions and Housing Subcommittees' and hope that we can begin this dialogue in earnest with the kind of

hearings you are having today. The industry wants to support a strong new federal standard, but we must do so in a way that makes sure that we do not unduly increase costs, eliminate choices, or reduce the availability of credit to the types of borrowers I described in my testimony.

As we noted, the laws some states have enacted do not strike this balance. Unfortunately, this means that good loans to borrowers such as those described in our testimony are unintentionally tagged as "high cost" loans – loans that few, if any, legitimate nonprime lenders will make because of the heightened regulatory, legal and reputational risk.

Some will suggest that lenders can eliminate prepayment penalties, reduce other fees and increase the rate in order to stay within state "high cost loan" triggers. These actions, however, will result in significantly higher interest rates and monthly payments for borrowers who can least afford them, and could preclude some borrowers from obtaining credit altogether. As the debate on national standards moves forward, we hope to be able to provide the Subcommittees with additional analysis of the affordability impact of increasing interest rates in this manner.

Countrywide's nonprime lending programs and those of all the members of the Housing Policy Council expand access to credit for those who do not fit the "standard" credit or collateral profiles established by banks, mortgage insurers, Fannie Mae and Freddie Mac, or the FHA/VA. These standards include detailed income documentation

and stability requirements, low loan-to-value and debt-to-income ratio standards, and restrictions on unusual or high risk collateral, as well as limits on borrowers with low credit scores. Countrywide's nonprime loans play a crucial role in our mission of promoting homeownership and financial options to our customers, a mission the members of these two Subcommittees share. We look forward to working with the Congress to advance these mutual goals.

Thank you for your attention. I would be pleased to answer any questions the Committee may have.

DATE:
BORROWER:
CASE #:
LOAN #:
PROPERTY ADDRESS:

Prepayment Penalty Disclosure

The loan program you are interested in may be available both with and without a prepayment penalty. If you choose a loan with a prepayment penalty, your interest rate and/or fees will be lower, but you may have to pay a substantial penalty if you pay the loan off early.

It's important for you to understand the difference between a loan with and without a prepayment penalty. Below is an example based on interest rates we offered as of November 14, 2003, and a loan amount of $100,000[1] . Please note that other than points, the amount of fees for your loan is not affected by your decision about a prepayment penalty.

Compare the rate and points below:

	30 year fixed	3/27 ARM	2/28 ARM
Prepayment term	**Rate/Points/Payment**	**Rate/Points/Payment**	**Rate/Points/Payment**
5 year penalty	10.125 / 0 / 886.82	N/A	N/A
Penalty if paid off after 18 months	4007.81	N/A	N/A
3 year penalty	10.375 / 0 / 905.41	9.50 / 0 / 840.85	N/A
Penalty if paid off after 18 months	4108.94	3755.00	N/A
2 year penalty	10.500 / 0 / 914.74	9.875 / 0 / 868.35	9.625 / 0 / 849.99
Penalty if paid off after 18 months	4164.50	3906.67	3805.55
No penalty	11.125 / 1 / 961.78	10.25 / 1 / 896.10	10.625 / 1 / 924.10

I understand that I may have a choice between a product with and without a prepayment penalty.

Borrower Date

Borrower Date

Borrower Date

Borrower Date

[1] Example is based on a Premier borrower refinancing with a loan to value of 70% and a prepayment penalty of six months interest on the amount of your prepayment that exceeds 20% of the original loan balance.

United States House of Representatives

Committee on Financial Services

Hearing on
"Subprime Lending: Defining the Market and its Customers"

March 30, 2004

Testimony:

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United States House of Representatives
Committee on Financial Services
Hearing on "Subprime Lending: Defining the Market and Its Customers"
March 30, 2004

Testimony of Professor Michael E. Staten
Director, Credit Research Center
McDonough School of Business
Georgetown University

I. Introduction

Good morning Mr. Chairman and members of the Committee. My name is Michael Staten. I am Professor of Management and Director of the Credit Research Center at the McDonough School of Business at Georgetown University. The Center is a non-partisan, academic research center devoted to studying the economics of consumer and mortgage credit markets. Over its 30-year history the Credit Research Center has generated over 100 research studies and papers, most of which examine the impact of public policy on retail credit markets. Throughout its history, the Center's research program has been supported by a mix of grants from the public sector (e.g., National Science Foundation, Federal Trade Commission) and unrestricted private sector grants from foundations and corporations made to its host University on behalf of the Center. I have served as the Center's director since 1990.

I understand and appreciate the Committee's wish to gather information that describes the operation of subprime mortgage markets. Today I hope to contribute to the Committee's efforts by presenting data on who uses subprime mortgage loans and the relationship between the loan price and borrower risk. The evidence that I will present reflects the product of joint work with my colleagues Gregory Elliehausen and George Wallace at the Credit Research Center.

The subprime mortgage market is a relatively new but significant segment of the mortgage industry. The availability of mortgage and home equity loans to borrowers with blemished credit histories, high debt levels, and irregular incomes (i.e., "subprime" borrowers) has soared over the past decade. Subprime mortgage lending by subprime lending specialists who are required to report under the federal Home Mortgage Disclosure Act rose from $34 billion of originations in 1994 to over $213 billion by

2002.[1] By 2002, subprime originations accounted for about 8.6% of all mortgage originations in the United States.

Subprime mortgage customers are primarily households for whom the cost of mortgage credit would be significantly higher (possibly several hundred basis points) than the prevailing "prime" rate in the conventional mortgage market.[2] One hallmark of the market that has evolved to meet the needs of these borrowers is the application of more flexible underwriting standards and loan contracts than those observed in prime markets.[3] This means that subprime loan contracts tend to contain features not typically found in prime mortgage contracts (for example, prepayment penalties; balloon payments). Another characteristic of subprime loans is that they have a higher market share among low-to-moderate income households, as well as minority households, than is the case in the overall mortgage market.[4]

The higher pricing of subprime loans, the higher market share of subprime lenders (vs. prime lenders) in low-income and minority neighborhoods, and the higher credit risk of subprime loan customers have elevated concerns by consumer activist groups and regulators about the performance of loans and the incidence of abusive lending tactics and contractual features. Critics of subprime lending allege a significant failure in the marketplace, which they claim is characterized by excessive prices, unfair terms and so-called "predatory" practices. Proponents of subprime lending see a much narrower set of problems occurring in the context of a legitimate, efficient marketplace that generally provides significant benefits to most borrowers at an appropriate price.

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[1] U.S. Department of the Treasury, 2003 MMSA, as reported in "Economic Issues in Predatory Lending," OCC Working Paper, Global Banking & Financial Analysis, U.S. Office of the Comptroller of the Currency, July 30, 2003, p. 5.

[2] A blemished credit history is just one attribute that can tag a borrower as subprime. Banking regulatory agencies generally designate a subprime borrower as having one or more of the following credit history characteristics: two or more 30-day delinquencies in the past 12 months; one or more 60-day delinquencies in the last 24 months; a collection-related legal judgment, foreclosure, repossession, or account charge-off in the past 24 months; bankruptcy in the previous 5 years; a high default probability as measured by a Fair Isaac Co. (FICO) credit score of 660 or below; or a debt-service-to-income ratio of 50% or greater.

[3] "Lenders use standards (payment-to-income ratios, loan-to-value ratios, and credit history) to limit credit and prepayment risks. Because FHA lending standards are more lenient than prime lending standards, wealth- and income-constrained borrowers are more likely to use FHA mortgage financing. Subprime financing is even less strict than FHA financing with respect to maximum front-end and back-end payment-to-income ratios. ...In total, the mortgage market has the ability to provide mortgages for a wide range of borrowers, as lenders use a variety of approaches to compensate for weaknesses of an application. This flexibility is most visible in subprime lending, where credit scores and down payments can compensate for unverifiable income and high debt ratios." Anthony Pennington Cross, "Subprime Lending in the Primary and Secondary Markets," *Journal of Housing Research*, Volume 13, Issue 1, 2002, p. 33.

[4] Glenn B. Canner, Wayne Passmore, and Elizabeth Laderman, "The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers," *Federal Reserve Bulletin*, November 1999, pp. 718-719. The data used in this study are derived from Home Mortgage Disclosure Act (hereafter, "HMDA") data. The Department of Housing and Urban Development Office of Policy Development and Research has likewise conducted a national study using HMDA data that finds similar results. Randall M. Scheessele, "Black and White Disparities in Subprime Mortgage Refinance Lending," (Office of Policy Development and Research, Department of Housing and Urban Development, April 2002).

It seems that the resulting public policy debate has increasingly lost sight of the fact that there is little disagreement over ultimate goals. Most critics and most suppliers of subprime loans agree that credit should be available to as many borrowers as possible. Likewise, many agree that loans should be priced by the marketplace to reflect the actual risk of the borrowers. Major terms and conditions of the credit should be understood by the borrower and should provide flexibility, so that the credit product can be configured to provide the mix of price and repayment terms that best suits the borrower's desires and needs. There is also agreement that abusive and fraudulent practices should be effectively combated, although there appears to be some disagreement over what conduct should be viewed as "abusive" and "fraudulent."

The real disagreement is over the facts: How well the subprime market is working and the impact of some of the regulatory efforts recently implemented. The wide disparity in perception reflects a basic reality about subprime lending. Although lending to borrowers who do not qualify for "prime" credit has a long history in this country, subprime *mortgage* lending in its present form is only a decade old, and little careful empirical work has been done to identify its benefits and costs.[5]

Lack of Comprehensive Data

The fundamental obstacle to doing empirical work on subprime mortgage lending is that there is no comprehensive database of subprime loans. The universe of subprime loans is hard to define, in part, because there is no central collection point that captures all subprime mortgage lending activity.

By far, the most common data used in various studies of subprime mortgage activity are derived from reports by financial institutions to the government in compliance with the federal Home Mortgage Disclosure Act (HMDA). HMDA requires that depository institutions, bank holding company subsidiaries, and for-profit mortgage companies report certain information about their residential mortgage lending, whether prime or subprime, to the government. The resulting data are annually compiled and made publicly available.

HMDA mandates collection of mortgage application activity data in order to help public officials evaluate how well financial institutions are meeting the housing needs of their communities. Since 1989, covered institutions have been required to report the disposition of each mortgage loan application (both accepted and rejected) as well as the race, sex, and income of applicants and borrowers. These data have been used by regulators to identify potentially discriminatory lending patterns. Coverage of mortgage lending institutions has expanded several times over the past decade, so that for calendar

[5] "Despite the recent growth in the subprime mortgage market, little is known about subprime borrowers, their default experience, or subprime lenders' underwriting practices." Lawrence L. Thompson, Foreward to Kenneth Temkin, Jenifer Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs and Risk-Based Pricing* (U.S. Department of Housing and Urban Development, Office of Policy Development and Research, March 2002), at iii.

year 2002 there were approximately 31 million loan records reported by 7,771 financial institutions.

However, when used as a source of information about *subprime* mortgage lending activity, the HMDA database in its present form has a number of significant difficulties that sharply limit its accuracy and usefulness. First, despite apparently broad coverage, not all mortgage lenders have to report HMDA data, and many of those lenders not required to report (notably, finance companies) are quite active in the subprime mortgage business. Second, the HMDA database does not provide the interest rate (price) for the loan, or risk characteristics of the borrower other than the borrower's income. Thus, price and risk, the two factors that define whether a loan is subprime, are not reported. As a result, HMDA data cannot provide accurate information about what loans are subprime nor about whether subprime borrowers are paying more than their risk level warrants.[6]

Alternatives to HMDA Data

Two other databases with information at the individual loan level have been used by some researchers: the Loan Performance System (formerly Mortgage Information Corporation) subprime database; and the American Financial Services Association subprime mortgage database. Both of these databases were assembled with the cooperation of participating companies that agreed to supply loan-level data on a confidential basis. Loan-level observations from participating companies were pooled to form a database for benchmarking and analysis. Both databases contain several million loans originated over a period of several years.

The Loan Performance System (LPS) subprime database is now reported to cover 2.5 million subprime loans, compiling information from approximately 20 servicers over several years of originations but predominantly 1998 and thereafter. The information includes loan amount, interest rate, indices of credit quality of the borrower, as well as extensive information on delinquency and foreclosure.[7] Information is not available on racial or ethnic identity of the borrower.

The LPS database is proprietary and its various analytical reports and products are widely purchased within the industry to develop and improve marketing and management decisions. It has been used at least once for published research on the regulatory issues

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[6] The usefulness of the HMDA data for analysis of subprime lending activity will improve substantially in the future. Starting in 2004, new regulations implemented under the Federal Reserve Board's Reg C will alter HMDA data collection so that virtually all mortgage lenders will be required to report. Equally important, reporting companies will be required to provide interest rate information for all first mortgage loans with an APR more than 3 percentage points over comparable treasuries, and for all subordinate mortgage loans with an APR more than 5 percentage points over comparable treasuries. However, these data will not be available to researchers until mid-2005.

[7] See Dan Feshbach, "Trends in Mortgage Data and Analytics," www.loanperformance.com (February 21, 2002).

raised by subprime lending.[8] The LPS database, however, does not purport to cover all subprime loan originations, nor does it appear to be representative of all subprime loans. Indeed, the group of researchers who used the LPS database to examine regulatory issues suggested that one weakness was that it failed to capture the riskiest loans that were being made.[9]

Still another view of subprime mortgage activity can be gleaned from the American Financial Services Association (AFSA) subprime mortgage database. Nearly three million loans in this database were collected from 10 AFSA-member companies. The data consist of all residential mortgage loans originated by the subprime units of the participating companies between July 1, 1995 and March 31, 2002. Data include both closed-end loans and open-end home equity lines of credit. Individual loan records provide the annual percentage rate (APR), the borrower's FICO risk score at the time of application, loan amount, property ZIP Code, whether the loan is a first or subordinate lien, information on delinquency, foreclosure and write off, prepayment, and other information.

Of the three loan-level databases (i.e., HMDA subprime, LPS subprime, AFSA subprime), which is most appropriate for analyzing subprime lending activity? There is some overlap across the three databases, but none of them captures the entire market. Based solely on the criteria of number of loans and scope of coverage there is no clear winner.

All three databases appear to capture 2.5 to 4 million subprime loans originated between 1995 and 2002. For example, the number of refinance loans in the AFSA database in 1999 is similar to the number of loans flagged by HUD as subprime refinance loans in the HMDA database for the same year. But, we know there is only partial overlap between the two databases, so that each provides only a partial snapshot of all subprime activity.

However, since the AFSA and LPS databases contain information on loan price, borrower risk, and loan performance, it is possible to inspect each loan to determine whether it is, indeed, subprime in terms of rate and/or credit risk. Consequently, the AFSA and LPS databases are more useful than the HMDA subprime database for examining various dimensions of the economics of subprime mortgage markets, such as the degree to which pricing correlates with loan risk.

In the remainder of my testimony, I present a variety of data that describes the operation of the large segment of the subprime loan market captured in the AFSA database.

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[8] See, e.g., F. Phillips-Patrick, E. Hirschhorn, J. Jones, and J. LaRocca, "What About Subprime Mortgages?" *Mortgage Market Trends*, Volume 4, Issue 1 (Research and Analysis, Office of Thrift Supervision, June 2000). The article provides a good description of the database as it existed as of end of 1999.

[9] Phillips-Patrick et al. (June 2000).

II. Who Uses Subprime Mortgage Loans?

Income and Age of Subprime Borrowers

The AFSA database provides information on the income and age of subprime mortgage borrowers, which can be compared with population statistics on all mortgage borrowers in the United States from the Federal Reserve Board's 2001 Survey of Consumer Finances.[10] The results of this comparison show that nearly all subprime borrowers are in moderate income and relatively young age groups, in which mortgage borrowing is generally prevalent. This finding contrasts sharply with much of the anecdotal evidence often cited by industry critics that creates the perception that subprime borrowers are poor or old.

At the outset of any discussion of subprime mortgage lending, it is important to recognize that subprime mortgage borrowers are homeowners. The economic circumstances of homeowners differ significantly from those of the general population. First, relatively few homeowners have low income. A bit more than 20% of U.S. homeowners had incomes less than $25,000 in 2001, compared to nearly one-third of all U.S. households overall (see Table 1). Homeowners are predominately moderate and higher income consumers.

Since only a small percentage of homeowners have low incomes, it is not surprising that relatively few subprime mortgage borrowers have low incomes. Only 15.7% of borrowers taking out subprime first mortgages between 1997 and 2001 had incomes below $25,000. During the same period, an even smaller proportion of borrowers obtaining subprime second mortgages (5.5%) had incomes below $25,000.

Subprime mortgage borrowers are predominately from moderate income households. Between 1997 and 2001, 48% of subprime first mortgage borrowers had incomes between $25,000 and $49,999 (compared to 23.7% of first mortgage borrowers overall), and another 23.1% had incomes between $50,000 and $74,999 (compared to 24.1% for all first mortgage borrowers). Among borrowers who obtained subprime *second* mortgages during the same period, 37% had incomes between $25,000 and $49,999 (compared to 25.2% of second mortgage borrowers overall), and another 30.7% had incomes between $50,000 and $79,999 (compared to 21.8% overall).

These data belie the common belief that subprime mortgage borrowers are predominately poor or that subprime mortgage lenders "target" the poor. To be sure, some subprime borrowers have low incomes, but the percentage of low income borrowers in the subprime market is not much greater than in the mortgage market overall. Subprime mortgages are primarily a middle-class product.

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[10] Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, (January 2003), pp. 1-32.

Relatively few subprime mortgage borrowers are old. Ten percent of subprime first mortgage borrowers and 5.6% of subprime second mortgage borrowers taking out loans between 1997 and 2001 were 65 years of age or older. These percentages are not much different than the proportion of all borrowers taking out new first and second mortgages of any kind during the same period and who were 65 years of age or older (6.4% and 5.2%, respectively).

Indeed, most recent subprime borrowers were young. A large percentage (38%) of all subprime first mortgage borrowers between 1997 and 2001 were less than 45 years of age. About 52% of subprime second mortgage borrowers during the same period were less than 45 years of age.

To summarize, these data do not support claims that lenders across the subprime mortgage market "target" the elderly. Like mortgage borrowers generally, some subprime borrowers are old. However, as we would expect, subprime mortgage lending is heavily concentrated in age groups in which life-cycle considerations create a high demand for credit. About 71% of subprime first mortgage borrowers and over 80% of subprime second mortgage borrowers between 1997 and 2001 were under the age of 55.

Table 1. Income and Age of Household Heads, Homeowners, and Mortgage Borrowers, 2001
(Percent)

	All households	Home-owners	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001	Has second mortgage	Obtained second mortgage 1997-2001	Obtained subprime second mortgage 1997-2001
Income								
Less than $15,000	16.7	9.6	3.6	3.7	2.9	3.1	2.6	0.9
$15,000-24,999	14.8	12.2	7.7	8.1	12.8	2.2	2.6	4.6
$25,000-34,999	13.2	11.2	8.4	8.6	18.2	9.7	9.5	11.2
$35,000-49,999	14.5	14.7	15.7	15.1	29.5	14.4	15.7	25.9
$50,000-74,999	17.5	21.0	24.3	24.1	23.1	22.1	21.8	30.7
$75,000 or more	23.3	31.3	40.3	40.4	13.5	48.5	47.8	26.7
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Age								
Less than 25	5.6	1.2	1.6	2.5	0.6	0.0	0.0	1.1
25-34	17.1	12.2	17.3	23.6	10.7	16.9	18.0	17.5
35-44	22.3	22.3	30.8	32.9	26.7	33.1	34.3	33.3
45-54	20.6	23.4	27.8	24.3	32.8	33.1	34.3	29.3
55-64	13.2	16.2	13.7	10.3	18.9	11.0	8.2	13.2
65-74	10.7	13.1	6.9	5.2	8.1	5.8	5.2	4.5
75 or older	10.3	11.6	1.9	1.2	2.2	0.0	0.0	1.1
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database.

Home Value as an Indicator of Subprime Borrower Wealth

The home is the largest asset in most households' portfolios.[11] Thus, evidence of the wealth of subprime borrowers is provided by the distribution of their house values.

[11] The median house value of all U.S. homeowners in 2001 was $122,000. This amount was 71.1% of these homowners' median net worth. See Aizcorbe, Kennickell, and Moore (January 2003), pp. 7, 19.

Again, we use distributions for homeowners and mortgage debtors from the Federal Reserve Board's 2001 Survey of Consumer Finances as a benchmark.

The values of the majority of subprime borrowers' homes, on both first and second mortgages, were between $50,000 and $149,999 (see Table 2). Subprime first mortgage borrowers' homes were about as likely to have a value less than $50,000 as homes generally, but subprime second mortgage borrowers' homes were much less likely to have a value less than $50,000.

However, subprime mortgage borrowers do borrow more heavily against their houses than mortgage borrowers generally. Only about a fifth of subprime first mortgage borrowers from 1997 to 2001 had loan-to-house value percentages of 70% or less, compared to about half of all first mortgage borrowers during this period (see Table 3). Sixteen percent of subprime first mortgage borrowers had "high" loan-to-house value mortgages (loan was 100% or more of house value), which was about twice the frequency of such mortgages among all first mortgages obtained during the 1997-2001 period.

Table 2. Home Value of Homeowners and Mortgage Borrowers, 2001
(Percent)

	Home-owners	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001	Has second mortgage	Obtained second mortgage 1997-2001	Obtained subprime second mortgage 1997-2001
House value							
Less than $50,000	12.3	6.2	5.4	11.3	3.5	3.3	4.5
$50,000-74,999	12.4	11.6	12.2	21.9	6.9	6.7	9.5
$75,000-99,999	14.8	14.5	14.5	20.4	10.3	9.4	15.9
$100,000-149,999	20.1	22.8	21.6	24.1	20.8	20.3	28.3
$150,000-199,999	12.7	14.2	12.3	11.7	15.2	13.7	17.1
$200,000-249,999	7.3	8.1	9.4	5.5	11.5	11.8	9.1
$250,000-349,999	9.2	9.7	9.0	4.3	16.3	18.5	9.2
$350,000 or more	11.3	13.0	15.6	0.8	15.5	16.4	6.3
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database.

Table 3. Loan-to-House Value Percentage

	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001
Loan-to-house value			
70.0% or less	59.0	49.1	20.8
70.1-80.0%	16.1	19.7	27.5
80.1-90.0%	11.4	13.4	26.0
90.1-99.9%	7.6	10.6	9.9
100.0% or more	5.9	7.3	15.9
	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database.

Summary

Anecdotal evidence may have created an impression that subprime lending is concentrated among the poor and the aged. Examination of the characteristics of subprime borrowers in the AFSA database, which covers a large part of the subprime mortgage market, suggests that the anecdotal evidence is misleading. The subprime borrowers in the AFSA database are largely young or middle aged and have moderate incomes. The majority of subprime borrowers have moderately valued homes, but they borrow more heavily against their homes than mortgage borrowers generally.

III. How Closely is Subprime Mortgage Pricing Correlated with Risk?

At the core of the public policy debate over the incidence of abusive mortgage lending practices in subprime lending is the allegation that many subprime mortgage borrowers are overcharged for their loans. For example, federal Home Ownership and Equity Protection Act (HOEPA) regulations use loan pricing as a signal of *possible* abusive behavior that triggers additional restrictions on loans and lenders, although Federal Reserve Board officials have repeatedly noted that not all high-cost loans are abusive.

Community activists have apparently interpreted the observed higher incidence of subprime vs. prime mortgage lending in lower income and minority neighborhoods as a signal that these borrowers are being systematically overcharged. A recent study by Calvin Bradford on subprime lending patterns in 331 metropolitan areas found "widespread" racial disparities in subprime lending across the nation, regardless of income.[12] Specifically, a higher proportion of African-American homeowners had subprime mortgage loans in a given geographic area than did white homeowners, regardless of income. The title of a 2000 U.S. Department of Housing and Urban Development (HUD) report, "Unequal Burden: Income and Racial Disparities in Subprime Lending," also appears to suggest that race and income are responsible for some groups getting less favorable loan pricing than others.[13] Organizations such as the Association of Community Organizations for Reform Now (ACORN) explicitly define predatory lending as the act of targeting higher cost loans at certain categories of borrowers, many of whom would qualify for credit on better terms.[14]

Ironically, the positive aspects of the growth in subprime lending (i.e., increased availability of purchase-money and mortgage refinance loans to minorities and lower income households) are increasingly overshadowed by the suggestion that, because these higher priced loans are used more often by vulnerable or protected classes of borrowers,

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[12] Calvin Bradford, "Risk or Race? Racial Disparities and the Subprime Refinance Market," A Report of the Center for Community Change, Calvin Bradford & Associates, Ltd. (May 2002).
[13] U.S. Department of Housing and Urban Development, "Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending," Washington, D.C., (April 2000).
[14] "Separate and Unequal: Predatory Lending in America," Association of Community Organizations for Reform Now (ACORN), (November 2002), p. 2.

these groups are being abused. And, even though the many studies that have observed higher incidence of subprime lending in minority and lower income neighborhoods seldom offer evidence that these borrowers' loans are unfairly priced, the suggestion that they might be has been enough to drive legislative action to curb predatory lending at the state and local level.

Empirical Evidence Linking Pricing to Underlying Risk

A study released in 2000 by the Office of Thrift Supervision research staff concluded that subprime loan pricing was consistently related to borrower risk. The study used the proprietary LPS database that provided performance information for approximately 1.8 million subprime loans up to the end of 1999. The price of subprime loans was correlated with the delinquency and default experience. Looking at pricing, delinquency rates, and the risk level at which the lender classified the loan using an A-, B, C, and D scoring system, the study concluded that "...most of the evidence from the [Loan Performance System] subprime data is broadly consistent with a well-functioning market. Coupon rates, for example, increase steadily as grade and credit scores decline."[15]

To these findings we now add evidence from the AFSA database. The following discussion and charts focus on the relationship between borrower risk and the loan price (APR), as well as the relationship between the loan price and subsequent loan payment performance. In an efficient, smoothly functioning market, competitive pressures will enable consumers to find loans at the lowest price appropriate for their risk. Thus, the price for a loan rises with measured borrower risk and will be positively correlated with measures of delinquency and foreclosure as the loan seasons over time. The AFSA database offers another opportunity to see if this describes the subprime mortgage market in recent years.

A. Loan Price, Borrower Risk, and Payment Performance

This analysis correlates the prices charged for subprime first mortgage loans in the AFSA database with the delinquency and default experience on those loans.[16] Because mortgage interest rates vary over time with the overall cost of funds, unrelated to

[15] Phillips-Patrick et al. (June 2000) at 12. The study did find that 16% of A- rated mortgages had FICO scores over 680, leading the study to observe that "...we cannot determine whether overpricing exists [in the loans with 680 score or higher], but the data certainly raise the issue." *Id.* at 10.

[16] Although we focus here on delinquency and default costs, we of course recognize that lending involves other risks and costs that must be carefully managed if a lender is to be successful. It is important to note that subprime loans are not just prime loans with a higher price and somewhat more risk. They have a different cost structure. In part, this is because subprime loans have higher delinquency and default experience than prime loans. Delinquency increases servicing costs; default losses obviously also raise the cost of providing the loan. Subprime loans also prepay at a different rate than prime loans. They prepay not only when mortgage rates fall (like prime loans) but also when a borrower's credit risk profile improves. Prepayment risk raises the cost of funds for subprime loans relative to prime loans. Consequently, prepayment risk is an important factor in determining the price investors will pay to purchase subprime loans.

underlying borrower risk, the risk "premium" component of the loan price is the relevant focus for the analysis. In the following analysis, the risk premium for each loan was calculated as the difference between the loan APR and the yield on U.S. Treasuries of comparable maturity as of date of loan origination. Loans were grouped into pricing categories based on that difference. The risk premium on loans should be positively correlated to measures of borrower risk if the subprime market is operating efficiently.

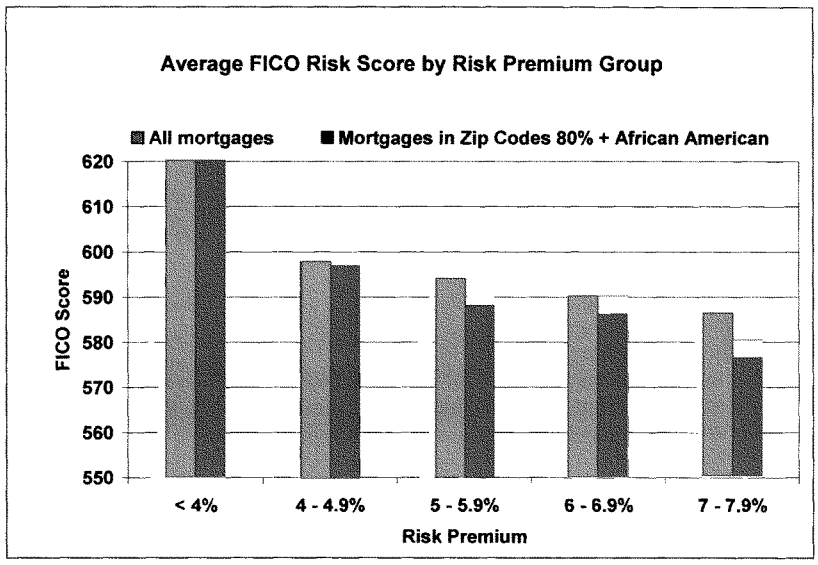
One measure of risk is the FICO risk score.[17] The FICO risk score is derived from a statistical model that uses information on credit use from credit bureau files to predict the likelihood that a consumer will have a serious delinquency, bankruptcy, or other major derogatory event in the next two years. The resulting risk score ranks consumers from highest risk (the lowest score) to lowest risk (the highest score).[18]

Figure 1 displays the relationship between the FICO risk score and risk premiums for over 900,000 subprime first mortgages originated nationwide between July 1995 and March 2002. The average FICO risk score falls (indicating increasing risk) from 620 in the lowest risk premium group to 585 in the highest risk premium group. That is, higher risk borrowers (as indicated by their lower FICO scores) received, on average, mortgages with higher risk premiums, a relationship that is consistent with risk-based pricing in a well-functioning mortgage market.

Figure 1 also provides some insight into loan pricing in minority neighborhoods. One limitation of the AFSA database is that it does not contain loan-level information about the borrower's race. However, it does contain the ZIP Code of the collateral property securing each loan. We can, therefore, examine the relationship between risk and risk premiums in ZIP Code areas dominated by minority residents. Figure 1 displays the relationship between FICO risk score and loan risk premiums on approximately 50,000 first mortgage loans that were made in ZIP Code areas in which 80% or more households are black. The relationship between subprime borrower risk and loan pricing in predominately black neighborhoods is strikingly similar to that for all subprime loans nationwide.

[17] A FICO risk score is a widely used statistical risk scoring product developed and sold by Fair Isaac Corporation.
[18] See www.myfico.com for discussion of the FICO risk score.

Figure 1

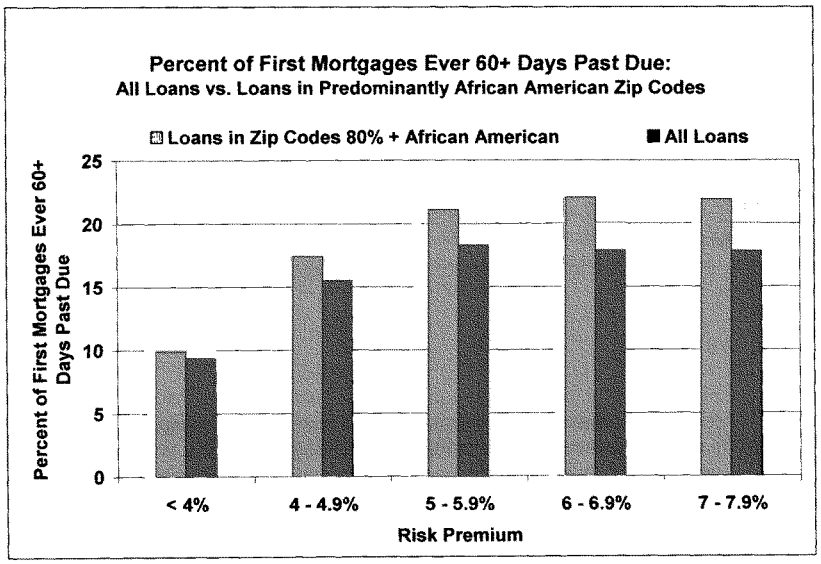


Next, consider the relationship between loan pricing and subsequent loan performance. The AFSA database reported the performance and current status of all loans as of March 31, 2002, providing nearly seven years of payment experience on the oldest loans in the database. The relationship between the loan pricing premium and subsequent loan payment performance provides insight into whether, over a period of years, the subprime mortgage lenders in this study were accurately pricing the loans they made relative to delinquency and foreclosure risk, as should be the case in an efficient marketplace. Weak or no correlation between the risk premium and subsequent performance is essentially the allegation of industry critics who claim that lenders often exploit vulnerable borrowers by opportunistically charging higher rates, regardless of the borrower's risk.

Figure 2 displays the percent of first mortgages ever 60 days or more delinquent over the life of the loan, for each risk premium category. Delinquencies of 60+ days are a widely recognized indicator within the industry of serious delinquency and a proxy for escalated servicing costs. Indeed, some of these loans resulted in foreclosures. The figure illustrates that the incidence of repayment difficulty across all loans rises with the loan risk premium. Moreover, even subprime borrowers with relatively low risk premiums experienced significant incidence of serious delinquency (9.3% of all such borrowers) sometime during the first few years of their loan.

Figure 2 also demonstrates that the same general pattern holds for loans in predominately black ZIP Code areas. That is, in predominately black neighborhoods there is a higher incidence of serious delinquency on loans with higher risk premiums, a sign of rational loan pricing. Interestingly, within a given pricing category, the incidence of serious delinquency on loans in predominately black neighborhoods is somewhat higher than the average for all loans in the database. However, it is possible that the clustering and distribution of loans within what is admittedly a fairly broad (100 basis points) price category accounts for the observed difference between the two groups in the level of serious delinquency. It is also possible that the incidence of less serious delinquencies differs. In any case, without more precise measures of the associated collection costs/losses (e.g., number of times and length of time delinquent; whether a foreclosure action was started; whether foreclosure was completed), no statement can be made about whether the difference in delinquency levels *within* a price category is meaningful.

Figure 2



B. *Performance of Subprime High-FICO Loans*

Despite the evidence that higher risk premiums are closely correlated with risk, the extension of credit by subprime lenders to borrowers with FICO risk scores that are above or near levels required to qualify for prime loans raises the question: Could these

borrowers have qualified for prime credit? To address this question, we compared performance of high-FICO risk score mortgages with that of all conventional mortgages, as reported in the Mortgage Bankers Association's (MBA) National Delinquency Survey (NDS). For these purposes, conventional mortgages are essentially prime loans.

Table 4 presents the results for first mortgages.[19] As one would expect, high-FICO subprime mortgages were less likely to be 60+ days past due or in foreclosure than subprime mortgages overall as of the first quarter of 2002. However, high-FICO subprime mortgages were far more likely to be 60+ days past due or in foreclosure than the conventional mortgages in the MBA's NDS. It is also notable that about one in ten high-FICO subprime mortgages were 60+ days past due at some point during the life of the loan. Clearly even for subprime loan recipients who had relatively high FICO scores at the time they received their loan, repayment problems are common and much more frequent than for prime borrowers.

Table 4. Performance of High-FICO First Mortgages, Subprime Mortgages, and All Mortgages
(Percent of loans)

	AFSA subprime mortgages			
	FICO score 640 or greater	FICO score 680 or greater	All	*MBA, all mortgages*
Open mortgages, Q1 2002				
60+ days past due	4.7	4.1	7.5	0.7
In foreclosure	2.8	2.2	5.1	0.8
All mortgages				
Ever 60+ days past due	11.2	10.1	15.8	n.a.

n.a.: Not available
Sources: American Financial Services Association (AFSA) and Mortgage Bankers Association (MBA).

IV. Summary

Evidence from a large database of subprime loans indicates that the large majority of subprime borrowers are in moderate income and relatively young age groups—the same demographic groups in which mortgage borrowing is generally prevalent. This finding contrasts sharply with much of the anecdotal evidence often cited by industry critics, which creates the perception that the subprime borrowers are poor or old. In addition, the data indicate that the majority of subprime borrowers have moderately valued homes, but they borrow more heavily against their homes than mortgage borrowers generally.

Although critics of subprime lending have argued that many subprime mortgages are priced "too high," our analysis of the AFSA subprime mortgage database finds that subprime mortgage prices correlate closely with delinquency and foreclosure experience,

[19] Inclusion of second mortgages would not substantially alter the results shown in Table 4.

as we would expect in an efficient marketplace. Mortgages with relatively lower prices have, on average, a significantly lower delinquency and foreclosure experience than higher priced mortgages.

There is no evidence in the AFSA database that lower risk borrowers (as measured by FICO score at the time of application) are *routinely* paying more than borrowers who present significantly greater risk, as has been alleged by critics of subprime lending. Moreover, when we look deeper and examine only high FICO borrowers (borrowers with "prime" or "near-prime" FICO scores), again prices and actual delinquency and foreclosure experience closely track. When a high FICO borrower is charged at the upper end of the range for subprime loans, that borrower is generally part of a group of borrowers with a high incidence of delinquency and default. This reinforces the point that the riskiness of a loan is determined by more than just the borrower's initial FICO score. Matters such as the value of the property, the extent of the borrower's equity, overall debt load, job and income stability, and so on all play a role in the actual likelihood of the borrower repaying without difficulty.

The available evidence from this large database suggests that the subprime market is working as a competitive market should. To be sure, some people are charged more for loans than others, but all the evidence indicates that, on average, they have a higher risk of delinquency and foreclosure than borrowers who receive lower prices.

I thank you for the opportunity to share these results with you today and would be happy to answer any of your questions.

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Joint Hearing Entitled "Subprime Lending: Defining the Market and Its Customers"

March 30, 2004

Prepared Testimony of Eric Stein,
Senior Vice President, Center for Responsible Lending

Chairman Bachus and Chairman Ney, Ranking Member Sanders and Ranking Member Waters, thank you for the opportunity to testify today on the promise and challenges of the subprime market. I am here representing the Center for Responsible Lending (CRL), which is a nonprofit, nonpartisan research and public policy organization working on predatory lending issues and an affiliate of Self-Help. My positions with both CRL and Self-Help provide me with both the perspective of an experienced lender and an understanding of market failures inherent in today's subprime home lending, along with policy solutions that have been crafted to address these failures.

Self-Help is a North Carolina-based nonprofit community development lender that includes a credit union and a loan fund. Initially founded to improve access to credit for communities that could not obtain the financing they needed from traditional financial institutions, we are committed to the idea that ownership allows people to improve their economic position and provides communities with a solid foundation on which to grow and prosper. In particular, we have found that homeownership is the bedrock for economic security, as homeownership has been the primary way for families to build wealth. In the U.S. today, one-half of all homeowners hold at least 50 percent of their net worth in home equity.[1] And home

[1] See, e.g., Joint Center for Housing Studies of Harvard University. State of the Nation's Housing 1997: p.18.

equity comprises over 60 percent of the net worth of minority and low-income families.[2] This equity is used by families to send children to college, start new businesses, or weather crises such as job loss or extended illness.

Self-Help has provided more than $3.5 billion in financing to borrowers in 47 states since its founding in 1980, and has enabled more than 38,000 families to become homeowners. Through our commercial loans, we have created or maintained approximately 20,000 jobs, allowed child care providers to create space for 20,000 children, and enabled more than 9,000 students to attend public charter schools. Because we seek to serve those who have traditionally been denied access to credit, Self-Help's loans go disproportionately to women, African Americans, Latinos, and rural borrowers. However, we are not in the business of giving money away. ***Our overall loan loss rate is less than one-half of one percent per year, and our assets have grown to more than $1 billion.***

Self-Help has succeeded because of our high-quality lending process and the fact that our borrowers are determined to succeed. Our loan officers are trained to encourage borrowers to ask questions, and to take the time to provide clear answers and complete explanations of borrowers' options and actual loan terms. Self-Help has also learned that low-wealth borrowers buying their first home who become late on their payments almost always recover. We have learned that a mother will work three jobs before she will give up her children's home.

In the late 1990s, we and others in North Carolina became increasingly aware that, while subprime lending presented unprecedented opportunities for borrowers who lacked access to credit from traditional sources, it also presented substantial dangers. We began to see borrowers come through our doors in search of help in staving off foreclosure. However, to our dismay,

[2] "Net Worth and Asset Ownership of Households, 1998 and 2000," at 15 tbl. I (U.S. Census Bureau, P70-8, May 2003).

abusive terms in their existing loans routinely prevented us from refinancing their loan. We recognized that unscrupulous lenders were taking advantage of vulnerable homeowners to strip equity and steal hard-earned wealth, using terms of credit that were not commensurate with risk-based pricing.

I'd like to offer a story that illustrates the examples of abusive lending we saw in North Carolina. Mrs. V., a Durham Public School System employee, was contacted in 1998 by Green Tree Mortgage Services and encouraged to refinance her existing home loan into a debt consolidation loan. Green Tree charged her over $16,000 in fees on a $99,000 loan (16%), including a $5,002 loan origination fee (4.5%), a $2,142 loan discount fee (2.17%) and a $9,089 credit insurance premium. Mrs. V. was unaware of the credit insurance policy until she met with an attorney, and could not refinance the loan for three years without incurring a substantial prepayment penalty.

As a result of this widespread understanding of the problems in the subprime market, a remarkable coalition of bankers, credit unions, brokers, mortgage bankers, consumer advocates, the NAACP, AARP, and other community organizations came together from 1998 to 1999 to develop a state law of strong standards to preserve the important benefits of the subprime market while weeding out the worst abuses.

The coalition operated on two principles. First the coalition agreed that consumer education and disclosures could not correct the market abuses we were witnessing. As recently explained in report issued by the Government Accounting Office, "Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms."[3] Moreover, in the

[3] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending" GAO-04-280 (January 2004), 13.

blizzard of paper generated for a home loan closing, even lawyers can lose track of what they are signing. Disclosures often offer nothing more than a defense for unscrupulous lenders. Second, the coalition recognized the need to deter exorbitant (often hidden and confusing) fees and to encourage lenders to instead garner their compensation through interest rates, which are more transparent and easy-to-shop for. By reshaping the subprime market in this way, North Carolina could rely on competition among lenders to protect borrowers. Lenders who overreached would lose market share to those that charged reasonable risk-based prices for credit.

The law passed almost unanimously in 1999. We could not help Mrs. V. with a refinance when she came to us because she had no equity left in her house. However, we see cases like hers much less often today, since the abusive products and terms that were included in her loan are either illegal or have been driven out of the North Carolina market by the law.

Since enactment of the law, Self Help has established an affiliate, the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL draws on Self-Help's experience as a lender in advocating common-sense approaches to market failures and lender abuses that harm homeowners--and those who want to become homeowners--in their pursuit of security and opportunity.

I hope today to be able to touch on the key benefits promised by an efficient subprime home loan market, highlight the abuses that too often take place without clear standards, and, in connection with each abuse, briefly explain how North Carolina and other states have balanced strong standards with a vibrant market.

I. An efficient subprime home loan market provides homeowners with opportunity through risk-based pricing.

The U.S. mortgage market for "prime" loans – those loans made to borrowers with solid credit – is the envy of the world. The market for prime mortgage loans is marked by intense competition among lenders on the basis of rates and terms. The market competition has led to innovative loan products and technological advancements to reduce costs to borrowers. This market competition works to enable more borrowers to afford homeownership.

The "subprime" market is intended to serve those who do not qualify for these "prime" loans, primarily due to impaired or limited credit histories. To account for less-than-stellar credit, responsible subprime lenders charge a premium in the form of higher interest rates to compensate for the increased risk associated with their lending activities. Accordingly, when the subprime market operates efficiently, it offers an opportunity to expand homeownership opportunities to borrowers that would otherwise be unable to obtain credit in the prime market. Unfortunately, the subprime market is not as efficient as the prime market and is marred by market failures that severely undermine its potential benefits. Unlike the prime market, there is little evidence that subprime lenders compete on the basis of price. In fact, evidence shows that a substantial portion of borrowers with subprime home loans would actually qualify for prime loans.[4] In addition, the prevalence of certain abusive loan terms and lending practices in the subprime market not only have limited the equity-building potential for homeownership, but have led families to lose their homes and their accumulated life savings.

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[4] Freddie Mac, a federally chartered corporation that purchases mortgages, found that 10% to 35% of the borrowers in its subprime portfolios should have received loans in the prime market and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families. Washington, D.C. September 1996. See also Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why? Washington, D.C.: Research Institute for Housing America, Working Paper 00-03 (finding that probability of

As a result of these abusive practices in the subprime market, Self-Help's original focus to increase access to homeownership credit has been supplemented with CRL's concerns about the terms on which credit is offered. We have seen our borrowers first-hand build their family wealth by playing by the rules – making their mortgage payments every month – only to have that wealth stolen through abusive refinances. Without strong standards in place to encourage responsible lending, the subprime mortgage market will fail to fulfill its potential to help low-wealth families achieve and maintain economic security.

Some industry representatives are apparently threatened by the legislative activity in a number of states that wish to deter the worst abuses. However, the subprime market continues to grow rapidly. Both subprime lending and the securitization of subprime loans increased by over 50 percent in 2003 over 2002 – volume increased to $332 billion from $213 billion, while subprime securities rose to $203 billion from $235 billion.[5] As reported by an industry publication, "Subprime lenders should continue to see strong demand for their product in the secondary market this year, analysts predict."[6] Furthermore, "Fitch anticipates few problems from 'pending or existing' predatory lending laws, as both sellers and issuers have significantly stepped up their due diligence efforts."[7]

II. Abusive terms and practices common to the subprime market strip hard earned equity, result in risk-rate disparities, and lead to needless foreclosures.

While by no means are all subprime home loans predatory, most predatory home loans are subprime. Without standards in place, the subprime market often malfunctions in three primary ways. First, lenders can strip equity from homeowners through excessive fees, often

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African American borrower receiving subprime loan increased by 1/3 compared with white borrower, controlling for risk). See also note 17, infra.

[5] Inside B & C Lending. Jan. 12, 2004, p.3 and Feb. 9, p.1. The growth rate over ten years has been astounding: in 1994, subprime lending totaled just $34 billion, while only $11 billion of that was securitized.

[6] Inside B & C Lending. Jan. 12, 2004, p.3.

financed into the loan. Excessive fees can be in the form of single premium credit insurance, exorbitant origination fees, discount points that do not reduce interest rates, or hidden "back-end" prepayment penalties that function as a deferred fee when a borrower refinances into a better-priced loan and pays off an existing loan early. Second, brokers and lenders can overcharge borrowers through interest rate steering, pricing loans on the basis of perceived financial sophistication rather than risk. Third, lenders can engage in a range of practices, including asset-based lending, that lead directly to the high foreclosure rates that are currently devastating neighborhoods across the country. I will address each of these problems in turn, and then I will describe how the standards enacted in North Carolina have been helpful in addressing some of the worst abuses to the benefit of homeowners and responsible lenders.

A. *Exorbitant and anti-competitive fees can strip home equity and prevent borrowers from accessing better priced loans.*

At the outset, it should be noted that the subprime market is predominately a refinance market—approximately three-quarters of subprime originations in 2001 and 2002 were refinances.[8] In fact, "a majority of mortgages in the subprime market are used for consumer debt rather than housing purposes."[9] Homeowners rarely confront the costs of refinance loans directly, since the fees are taken from the equity in their homes, making refinance loans particularly susceptible to equity-stripping practices. High fees are deceptively "costless" to many borrowers because the borrower does not feel the pain of counting out thousands of dollars in cash at closing. The borrower parts with the money only later, when the loan is paid off and the equity remaining in his or her home is reduced by the amount of fees owed. In addition, the fees last forever, because the borrower's wealth is permanently stripped away even if he or she

[7] Id. at 4.
[8] SMR Research Corp., Analysis of 2001 and 2002 Home Mortgage Disclosure Act data.

manages to refinance just one week after closing. Not satisfied with high interest rates, abusive lenders charge excessive fees—often equal to five percent or more of the loan amount, five times the average fees associated with prime loans.

One of the most prevalent and disturbing trends in the subprime market is the startlingly high percentage of subprime loans with exorbitant prepayment penalties. Prepayment penalties are fees that borrowers are obligated to pay if they choose to pay off a debt before the end of the scheduled term of the loan—for example to refinance at a better rate. Some of the worst charge six months' interest for five years. In the context of a subprime loan with an interest rate of 12 percent, this means that the prepayment penalty amounts to approximately 5 percent of the loan balance. For a $150,000 loan, this fee is $7,500, which is about 40 percent of the total net wealth of the median African-American family as of 2001.[10]

The cost of prepayment penalties in subprime home loans is actually three-fold. First, paying the penalty strips equity from a borrower's home. Second, the penalty itself can trap a borrower in a bad loan when he or she could otherwise refinance into a better-priced product. Finally, collecting the fee facilitates kickbacks that encourage brokers to place borrowers in higher interest loans than those for which the borrowers qualify.

Unfortunately, prepayment penalties have become increasingly prevalent in the subprime market since 1996, at a level far out of proportion to the conventional or "prime" mortgage market. In contrast to an 80 percent prevalence of prepayment penalties in subprime home loans,[11] in the competitive, conventional market, less than 2 percent of borrowers accept

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[9]Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (April 20, 2000), p.3.

[10] Aizcorbe, Ana M., Arthur B. Kennickell, and Kevin B. Moore, January 2003, ***Recent Changes in U.S. family finances: Evidence from the 1998 and 2001 Survey of Consumer Finances***, Federal Reserve Bulletin, 1-32.

[11] See Standard & Poor's, NIMS Analysis: Valuing Prepayment Penalty Fee Income, at http://www.standardandpoors.com (January 3, 2001); see also Standard & Poor's, Legal Criteria Reaffirmed for the

prepayment penalties.[12] The disparity is particularly telling, since a subprime borrower should logically be more interested in refinancing into a better rate once his or her credit score improves. According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their home loans—and pay the penalties—during the typical five-year lock-out period. [13]

In short, subprime prepayment penalties in home loans decrease consumer options and diminish competition in the marketplace. The rate at which subprime borrowers supposedly "choose" loans with prepayment penalties also demonstrates the tremendous asymmetry of information and bargaining power that characterizes the typical subprime mortgage transaction.

Finally, equity-stripping is exacerbated by unscrupulous lenders who not only charge high fees, but also "flip" loans through repeated refinances that generate income without providing the borrower with a tangible net benefit. Products that may be used responsibly in other lending contexts, such as balloon payments or adjustable rates, can in some contexts be used to facilitate flipping. Predatory lenders initially disguise such features in order to create the impression of an affordable loan through low monthly payments, only to inform the borrowers of a feature soon after closing to convince them to refinance into a new and "better" loan. A study of California subprime borrowers found that 40 percent had refinanced their homes six times in the two-year period before receiving their current loan,[14] a strong indication of significant flipping. Flipping is a particular problem with mortgage brokers, who often engage in push

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Securitization of Prepayment Penalties, at http://www.standardandpoors.com (May 29, 2002); Prepayment penalties prove their merit for subprime and 'A' market lenders, http://www.standardandpoors.com (January 3, 2001).

[12] See Freddie offers a new A-, prepay-penalty program, Mortgage Marketplace, at 1-2 (May 24, 1999); see also Joshua Brockman, Fannie revamps prepayment-penalty bonds, American Banker at 16 (July 20, 1999).

[13] *See* A. Chu & K. Kwan, Lehman Brothers, *Asset-Backed Securities*, MBS and ABS Weekly Outlook, at 2.

[14] Kevin Stein and Margaret Libby, Stolen Wealth: Inequities in California's Subprime Mortgage Market. California Reinvestment Committee, Nov. 2001.

marketing; an AARP study of elderly borrowers found that 56 percent of those receiving brokered loans reported that the broker initiated contact.[15]

B. Brokers secure bonus payments for steering borrowers into loans with excessive interest rates, exacerbating rate-risk disparities.

The substantial growth of predatory practices in the subprime market has had a disproportionate impact on low-income homeowners, particularly members of minority groups. After analyzing almost one million mortgages reported to HMDA in 1998, HUD found that subprime loans are five times more likely in black neighborhoods than in white neighborhoods. Homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans.[16] Part of what lies behind these numbers is the practice known as steering. In brief, some lenders and brokers provide borrowers with unnecessarily costly loans when they think they can get away with it—by steering customers to certain lenders and/or to selected products. In fact, studies show that a significant percentage of subprime borrowers could qualify for mainstream, "prime" loans.[17]

In part, rate-risk disparities in the subprime market are due to the increased use of brokers in making loans and compensation methods that encourage brokers to take advantage of less savvy customers. Brokers account for 48 percent of subprime originations, versus 28 percent of

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[15] Kellie Kim-Sung and Sharon Hermanson, Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans, AARP Public Policy Institute, Jan. 2003.

[16] "Unequal Burden: Income & Racial Disparities in Subprime Lending in America," U.S. Department of Housing and Urban Development (April 2000).

[17] "A study using an industry survey of mortgages with subprime pricing found that almost 29 percent of subprime-priced loans had credit scores above 640, generally considered the point at which prime lenders become quite comfortable with loans." Dan Immurgluck & Geoff Smith, "Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures," Woodstock Institute (March 2004), pp. 1-2 (citation omitted). A recent Joint Center for Housing Studies at Harvard University study cites numerous studies concluding that African American borrowers receive subprime loans at a greater rate than risk can justify, and conducts its own econometric analysis leading to the same conclusion. See "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," (March 9, 2004), pp. 36-59. See also note 6, supra.

conventional loans.[18] The high percentage of loans that are originated through a broker contributes to abuses. While borrowers may believe that a mortgage broker has a legal duty to find them the best loans available, in most states, a broker has no fiduciary duty to the borrower. Rather than looking out for the borrower's interest, the broker is generally looking out for his or her own bottom line.

This fundamental misunderstanding of the broker-borrower relationship is perpetuated by compensation that encourages brokers to take advantage of less-knowledgeable customers. Brokers are frequently paid indirectly by the lender/investor based on the yield of the mortgage loan through a "yield spread premium" (or "YSP"). A yield spread premium is a back-end kickback paid to a broker by a lender based on the difference between the interest rate of the loan the broker entered into with the borrower, and the par rate offered by the lender to the mortgage broker for that particular loan. In other words, such payments create an incentive to steer certain consumers—those viewed as unsophisticated—into particularly costly loans.

In testimony before the Senate Committee on Banking, Housing, and Urban Affairs in January 2002, Professor Howell E. Jackson of Harvard Law School discussed the conclusions of his research into yield spread premiums. According to Professor Jackson, borrowers "never understand that the interest rate is higher than it needs to be or that the higher interest rate is used to finance a payment to the mortgage broker." Despite arguments that yield spread premiums allow borrowers to bring down closing costs, "With the highest degree of statistical confidence, [Professor Jackson's] studies refute the proposition that borrowers receive a dollar for dollar offset for yield spread premiums.... [B]orrowers, on average, enjoy 25 cents of benefit for each dollar paid in yield spread premiums."

As one study recently stated:

[18] Inside B&C Lending, March 22, 2004.

> Disturbingly, the tendency of brokers to charge excessive fees or present misleading information is not 'corrected,' but rather priced in the market. . . In a world in which the broker is detached from the lender and the lender is detached from the investor, market feedback loops are broken, or at best are slow to operate. Rather than work to root out abuse under the current industry structure, some buyers pay more, brokers earn a premium return, and investors are compensated. . . . The result is that the impact of foreclosures to borrowers and communities is ignored by the capital markets. [19]

C. ***Predatory practices should be of the utmost concern because, in addition to stripping wealth from individual families, they lead to heightened foreclosures that harm entire communities.***

For some years, researchers have reported a high correlation between an increased number of subprime loans and foreclosure rates. Unfortunately, foreclosure is the ultimate consequence of abuses such as equity stripping and steering. In its recently released study, the GAO noted that foreclosure patterns are an indicator of the prevalence of predatory lending.[20] Harvard's Joint Center for Housing Studies recently reviewed and summarized this body of research:

> To date there have been over ten studies of foreclosure activity in individual metropolitan areas. Though economic factors obviously play a role, these studies paint ***a remarkably consistent picture of the rising incidence of foreclosure in a period of strong economic growth, led in large measure by the relatively high incidence of foreclosure among subprime loans in lower-income and minority neighborhoods.***[21]

The increase in subprime foreclosures, the so-called "smoking gun of predatory lending,"[22] could hardly be more clearly established.

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[19] "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Joint Center for Housing Studies, Harvard University (March 9, 2004), p.33 &44 (citation omitted).

[20] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," overnment Accounting Office (GAO-04-280) (January 2004).

[21] "Credit, Counseling and Communities" at p. 67.

[22] See Bunce, Harold et. al., *Subprime Foreclosures the Smoking Gun of Predatory Lending*? U.S. Department of Housing and Urban Development (Feb. 2001). Available at: http://www.huduser.org:80/publications/pdf/brd/12Bunce.pdf

A very recent study of the relationship between subprime lending and foreclosure rates---a study that controls for variables that have frequently been blamed for the increase in foreclosures--further drives home the dangers of assuming that more loans are always better than fewer loans. Dan Immergluck, of Grand Valley State University, and Geoff Smith, of Woodstock Institute, recently found that ***"after controlling for neighborhood demographics and economic conditions, subprime loans lead to foreclosures at twenty or more times the rate that prime loans do."***[23] In fact, an increase in prime loans may actually decrease foreclosures by crowding out more problematic subprime loans.[24] The differential impact of subprime and prime loans is true for purchase, home improvement, and refinance loans. Clearly, lending practices are at least partially responsible for the number of families that are losing homes to foreclosure.

A recent study of foreclosure records in one Kentucky county directly links foreclosure to predatory loan terms. In a study conducted for the Louisville Urban League, court documents were examined for more than 1,500 mortgage foreclosures that resulted in court-ordered auctions between January 2000 and December 2002. This examination resulted in the conclusion that "About one-third of those foreclosures appeared to involve loans with predatory characteristics. This suggests that predatory lending probably accounts for a significant part of the growing foreclosure rate in Jefferson County."[25] Of the loans with predatory terms, 73 percent had prepayment penalties combined with high interest rates (defined as at least 4 points higher than the 30-year Treasury rate) and 29 percent had balloon payments.[26]

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[23] Immergluck and Smith, Risky Business -- An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures, Woodstock Institute, March 2004.
[24] Immergluck and Smith at p.22 i.
[25] Steve C. Bourassa, "Predatory Lending in Jefferson County: A Report to the Louisville Urban League," 2 (Urban Studies Institute, University of Louisville Dec. 2003).
[26] Id.

As many others have pointed out, the cost of foreclosures is not borne only by the families who lose their homes. Rather,"[f]oreclosed homes are often a primary source of neighborhood instability in terms of depressed property values and increased crime."[27] One estimate of direct costs is $37,000 in expenses to the city and neighborhood per foreclosure.[28] Whole communities are affected. Trust in our financial system is eroded, and belief in social mobility is strained.

III. The North Carolina anti-predatory lending law successfully set standards that encouraged responsible lending and drove out bad loans.

A. The North Carolina law has decreased the incidence of equity-stripping loan terms.

When Self-Help helped champion a state anti-predatory lending law in 1999, we pushed for provisions that would encourage lenders to limit fees and reflect credit risk accurately in interest rates. When the cost of credit is reflected in rates rather than fees, shopping is much easier for homeowners—and homeowners can also rectify mistakes through refinancing. The North Carolina law—passed virtually unanimously with the support of industry, consumer groups, and civil rights organizations--prohibits or discourages unfair and abusive fees and prohibits the flipping of loans solely for fee generation purposes. Because of the law, in North Carolina today, the best defenders of borrowers from excessive interest rates are responsible lenders eager to refinance them to an appropriate rate.

Empirical research shows that North Carolina's approach has led to a drop in abusive refinance loans. After analyzing the effects of North Carolina's law on the home mortgage market, researchers from the University of North Carolina concluded, ***"although the total volume of subprime originations in North Carolina declined, the number of home purchase loans was unaffected by the law. While refinance originations did fall, about ninety percent of the decline***

[27] HUD/Treasury Report at p.51.

was in predatory loans."[29] More specifically, the UNC study noted a decline in the incidence of subprime home refinance loans containing prepayment penalty terms that exceed three years. In fact, there was a 75 percent decline in North Carolina, compared with a 30 percent increase nationally in extended prepayment penalty loans. In addition, the authors found a decline in subprime balloon payments and loan-to-value ratios of 110 percent or more. The study appropriately viewed such loans as of little or no benefit to the borrower and therefore as a subset of flipping.

CRL estimates that the new law saved consumers at least $100 million—in its first year—by preventing predatory loan terms that would have been expected to occur in the law's absence.[30]

B. The North Carolina law has improved the operation of risk-based pricing in the prime market.

The UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. One would have expected that rates would rise more than elsewhere since the intention of the law was to clamp down on fees and shift lender compensation to rate. This result suggests that the fees being charged before the law's implementation were not genuinely priced to account for the risk of default, but rather function as a vulnerability tax on North Carolina families.

In a separate finding, the UNC researchers noted that subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—

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[28] Moreno, The Cost-Effectiveness of Mortgage Foreclosure Prevention, Minneapolis: Family Housing Fund, 1995.
[29] R. Quercia, M. Stegman, & W. Davis, "An Assessment of the Impacts of North Carolina's Predatory Lending Law" (forthcoming Fannie Mae Foundation Housing Policy Debate), p.26. See "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

[30] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.responsiblelending.org).

declined by 28 percent. According to HMDA data, overall loans by primarily prime lenders increased by 40 percent in the state from 2000 to 2001. This finding suggests a reduction in "steering" of borrowers to loans with a higher price than that justified by their credit history.

C. Although research has not yet been conducted, we would expect foreclosure rates to fall in North Carolina in concert with the reduced incidence of predatory loan terms.

As I mentioned, a loan-level study from Kentucky found that particular combinations of predatory loan features appear to contribute to foreclosure rates. In particular, the Kentucky study looked at prepayment penalties (when coupled with high interest rates), balloon payments, and high loan-to-value ratios. In North Carolina, we have decreased the incidence of all three of these features. Although I do not believe that anyone has conducted a formal study of foreclosures in North Carolina, it is clear to me that our tremendous drop in loans containing these features will result in a substantial decrease in foreclosures than would have happened without the law.

D. North Carolina's law has allowed for the continued widespread availability of credit.

It is important to note that a finding of a reduced number of subprime refinance loans after a law has been passed is only the start of an honest inquiry, since part of the purpose of the law was to accomplish exactly that, by eliminating predatory lending. First, when the prevalence of equity-stripping loans that do not benefit the borrower is reduced, subprime lending volume falls but the state is better off. The loan to Mrs. V. that I described earlier, for example, never should have been made. The Associates settled a predatory lending case for $215 million dollars with the Federal Trade Commission, while Household Finance settled with state Attorneys General for $484 million. Had North Carolina's law been in place to keep these loans from

being made in the first place, we would have been much better off. In fact, UNC found that 90 percent of the reduction in refinance lending after the law was implemented was in loans with predatory, equity-stripping features. Second, when borrowers with prime-eligible credit receive a conventional loan instead of a subprime one, that also is a result to be celebrated. As mentioned, subprime loans to borrowers with credit scores over 660 fell by 28 percent after the law; since conventional lending increased by 40 percent, we can conclude that steering fell in the state, to its benefit.

The North Carolina successfully addressed practices that strip homeowners' equity, steer homeowners into unnecessarily expensive loans, and contribute to foreclosure rates, and simultaneously has allowed the subprime lending market to thrive. Our own analysis of home loans reported to federal regulators as originated under the Home Mortgage Disclosure Act (HMDA) shows that North Carolina was still the sixth most active state for subprime lending in 2000, with North Carolina borrowers 20 percent more likely to receive a subprime loan than borrowers in the rest of the nation. One in every three loans to low-income North Carolina families (annual incomes of $25,000 or less) was subprime, the highest such proportion in the country.[31]

Still, the UNC study found that home purchase loans to borrowers with credit scores below 580, those whose only option is subprime, more than doubled after the law was fully implemented, compared with an increase of 62 percent nationally. While refinance loans to borrowers to higher credit score borrowers fell, a consequence of reduced steering, such loans to borrowers with credit scores below 580 increased by 18.5 percent in NC after the law. While

[31] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.responsiblelending.org).

this increase was at a lower rate than the country as a whole -- since abusive loans were not made in the state -- it demonstrates that the market continues to be available to those who need it most.

In other words, as UNC Professor Michael Stegman reported, "[t]he North Carolina predatory lending law is doing what it was intended to do: purge the market of abusive loans without restricting the supply of subprime mortgage capital accessible to North Carolina borrowers with blemished credit records."[32]

While the most rigorous examination of North Carolina's subprime market, the UNC study does not stand alone. A leading industry trade journal, *Inside B & C Lending*, reported that top North Carolina subprime lenders "continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate" compared to other states.[33] A recent Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher state laws, including North Carolina's, have not reduced subprime residential lending volumes.[34] In fact, 84 percent of the managers thought changed practices are having neutral to positive impact on volume because they make customers feel more comfortable and "lower points and less onerous prepayment penalties make the economic terms more attractive."

What the academic studies show is simply what lenders like us who operate in this state every day experience -- there is no shortage of credit available to borrowers across the state. Joseph Smith, North Carolina's Commissioner of Banks, has commented that "[d]uring the last

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[32] Quercia at p.1. Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with suspicion. The CRC study contradicts other industry reports and the weight of available evidence. The CRC study relies upon a limited data set from nine anonymous lenders that has not been made available for independent verification. The CRC study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-end home loans from those lenders. Finally, the CRC study ignores the problem of "flipping" (refinancing loans with no benefit to the borrowers) and "steering" (providing subprime loans to prime-eligible borrowers) and consequently assumes that any reduction in subprime originations is evidence of harm. However, any successful anti-predatory lending law would curb both practices and thus would tend to reduce the number of subprime refinance originations.

[33] Inside B&C Lending. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5, 2001.

twelve months, over seventy-five percent of formal complaints to [his office] ... have involved mortgage lending activities [but] .... [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[35]

Conclusion

While the North Carolina anti-predatory lending law certainly has not eliminated predatory lending from our state, mounting evidence suggests that it and similar state laws are effective because they set clear and meaningful standards that drive out unscrupulous actors and allow responsible lenders to flourish. Carefully crafted reforms are needed to change the incentives for lending practices and to make market participants compete on the basis of what they can offer homeowners rather than how much they can strip away.

State anti-predatory lending laws have by in large been carefully designed to correct specific market failures identified in each state. North Carolina and a number of other states have taken the lead in addressing the inequities of the subprime market. We have limited the financing of fees, created disincentives for packing high fees into loans, and prohibited the flipping of loans when only the broker or lender benefits. We have taken steps to put unscrupulous brokers out of business and to create pressure on lenders to decrease side-payments to brokers for steering people into unnecessarily costly loans. We have limited prepayment penalties that strip equity from homeowners on the "back end" of their loans. These steps serve as important protections against rising rates of foreclosure and ensure that we continue to build wealth in all of our communities.

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[34] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.
[35] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available at http://www.banking.state.nc.us/reports/Hawke.pdf).

Testimony of

Geoff Smith
Project Director
Woodstock Institute

Before the
Subcommittee on Housing and Community Opportunity
And
Subcommittee on Financial Institutions and Consumer Credit

U.S. House of Representatives

Regarding
Subprime Lending: Defining the Market and its Customers

Tuesday, March 30, 2004

Thank you for the invitation to testify at this hearing. My name is Geoff Smith, and I am Project Director at the Woodstock Institute. Woodstock Institute is a 30-year old, Chicago-based non-profit organization that works locally and nationally to promote reinvestment and economic development in lower-income and minority communities. Woodstock has been extremely active in the area of predatory lending conducting research that illustrates the scope and impact of the predatory lending problem and working to develop local, state and federal policy that addresses this problem. My testimony today will focus on the findings of a research report recently released by Woodstock Institute, working with Dan Immergluck, that attempts to quantify the relationship between skyrocketing neighborhood foreclosures and increased levels of subprime lending in preceding years.[1] The results indicate that subprime lending was a dominant force in the increased and highly concentrated levels of neighborhood foreclosures of recent years.

Introduction

The policy debates about subprime and predatory mortgage lending have often focused on the abuses suffered by individual borrowers, on the one hand, and on the possible "unintended consequences" of increasing regulation of the subprime industry on the other. In considering policy in this area, participants in the policy process should be clear on the benefits and costs of different regulatory alternatives. The debate tends to hinge on protecting individual borrowers while not overly restricting the availability of credit. Often lost in this debate are the spillover costs presented by high-risk lending, what economists call "negative externalities." These are costs borne by neither the lender nor the borrower but by parties "external" to the mortgage transaction. While borrowers certainly bear a good deal of the costs of foreclosures, in modest-income communities entire neighborhoods are harmed by foreclosures. They easily lead to boarded-up homes, abandonment and blight. The spatially concentrated increase of foreclosures that arise due to higher levels of subprime lending has an important economic and social spillover cost that should be a more central concern of policy making in this area.

While individual community development practitioners can point to anecdotal evidence of the link between subprime lending and increased foreclosures in their neighborhoods, and a few studies have documented an apparent relationship between subprime lending and foreclosures, our study goes considerably further. We developed a multivariate estimation of neighborhood foreclosure levels that allows us to develop a precise quantitative measure that relates subprime lending at the neighborhood level to neighborhood foreclosures. Understanding the magnitude of this relationship should allow policy-makers to give it the appropriate level of attention in considering the impacts of regulation and legislation of high cost lending.

Policy Concerns About Subprime Lending

There are at least three somewhat interrelated reasons why community reinvestment advocates and policy-makers have expressed serious concerns about the explosion of subprime lending that has occurred since the early 1990s. First, because the market for home loans is extremely segmented by race, with minority neighborhoods served excessively by subprime lenders, homeowners in minority communities may be effectively steered toward higher-cost products. If minority communities are targets of higher-cost lenders and receive little attention from prime lenders, the odds of minority borrowers with good credit receiving higher-cost loans will be higher than that of white borrowers with good credit. A second concern – and a subject of a large part of recent policy debates – has to do with the rise of abusive or predatory practices that have been associated with the subprime industry. A third reason policy-makers

[1] The full text of the report, *Risky Business – An Econometric Analysis of the Relationship Between Subprime Lending and Neighbohrood Forelosures*, can be found at the Woodstock Institute web site www.woodstockinst.org.

are concerned about hypersegmented refinance markets is that the growth of subprime lending has been associated with a simultaneous rise in foreclosures. Moreover, the spatial concentration of subprime lending appears to have led to a concentration of subprime foreclosures in minority and modest-income neighborhoods, which in turn can have a devastating impact on their stability and development prospects.

The Pricing Issue

Various sources of data indicate that a substantial portion of subprime loans are priced in excess of what is merited by the risk involved. A study using an industry survey of mortgages with subprime pricing found that almost 29 percent of subprime-priced loans had credit scores above 640, generally considered the point at which prime lenders become quite comfortable with loans.[2] In examining 15,000 subprime mortgages originated by four financial institutions, Freddie Mac found that between 10 and 35 percent of borrowers who obtained mortgages in the subprime market could have qualified for a conventional loan.[3] Freddie Mac also estimated that subprime borrowers who would have qualified for conventional loans paid mortgage rates on the order of one to two-and-one-half percentage points higher than they would have paid in the prime market. However, this does not take into account the higher up-front fees on most subprime loans. It is often up front fees, even more than excessive interest rates, that tend to be the source of a good deal of overcharging.

A study of home purchase loans conducted by an affiliate of the Mortgage Bankers Association found that the probability of a home purchase borrower receiving a subprime loan, controlling for credit history, location and other variables, increased by approximately one-third, from 0.8 percent to 2.5 percent, if the borrower was black.[4] The loan sample in this study had relatively few subprime loans in it, but the increase was relatively substantial and statistically significant.

In an analysis of subprime lending in Chicago and Philadelphia, Calem, Gillen, and Wachter found that, after controlling for education, credit score, income, and housing stock characteristics, black neighborhoods still had much higher levels of subprime lending than white neighborhoods.[5] For refinance loans, an all-black neighborhood was expected to have a subprime share that was twenty-four percentage points higher than an otherwise equivalent white neighborhood, even after controlling for the credit history of neighborhood residents. A larger study of ten metropolitan areas found similar results.[6] Even after controlling for housing turnover, age of housing stock, median income, percent of residents aged 65 and older, and the percent of residents with high risk credit scores, the percentage of residents who were black was a consistently strong determinant of subprime lending activity.

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[2] Phillips-Patrick, Eric Hirschhorn, Jonathon Jones, and John LaRocca. 2000. What About Subprime Mortgages? *Mortgage Market Trends* 4, no. 1 (June). Washington, D.C.: Office of Thrift Supervision Research and Analysis.

[3] Freddie Mac. 1996. *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families.* Washington, D.C.: Freddie Mac. September.

[4] Pennington-Cross, Anthony, Anthony Yezer, and Joseph Nichols. *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Washington, D.C.: Research Institute for Housing America, Working Paper 00-03.

[5] Calem, Paul, Kevin Gillen, and Susan Wachter. 2002. "The Neighborhood Distribution of Subprime Mortgage Lending." Unpublished manuscript. October.

[6] National Community Reinvestment Coalition. 2003 *The Broken Credit System: Discrimination and Unequal Access to Affordable Loans by Race and Age.* Washington, D.C.: National Community Reinvestment Coalition.

This dual market, caused in part by the aversion of many prime lenders to marketing and making loans in minority communities, can create a sense of futility among minority homeowners in considering banks and other prime lenders as potential sources of mortgage credit. Moreover, even among borrowers who do have impaired credit, the subprime market does not appear to be functioning in a way that serves the interests of borrowers. In Fannie Mae's 2001 National Housing Survey, only 34 percent of credit-impaired respondents were confident that they got the lowest cost mortgage available, compared to 68 percent of all homeowners surveyed.[7] Thirty-two percent of credit-impaired homeowners, compared to ten percent of other all respondents, did not care whether they got the lowest cost mortgage. They were "just happy to be approved." Moreover, more subprime than prime respondents reported not knowing anything about their credit rating.

Predatory Practices beyond Excessive Pricing

Many major subprime lenders have been implicated in at least some instances of abusive lending. One former Chicago legal aid attorney recalled that, when looking at a list of the top 14 subprime refinance lenders in black Chicago neighborhoods, he noticed that his agency had identified specific cases of predatory lending involving each of them.[8] A variety of loan terms and lending practices have been described as predatory or abusive, especially when employed in high-cost or subprime loans. Some of these practices, particularly loan terms such as prepayment penalties, are used in the prime market often without any detriment to the borrower. However, the use of such terms and practices in the subprime market is largely inappropriate. For example, debt-to-income ratios above 40-45 percent may be appropriate in some cases in the prime market, especially for borrowers with high incomes. A 50 percent debt-to-income ratio leaves 50 percent of income available for nonmortgage expenses, which is generally sufficient for high-income households, although perhaps still not an optimal situation. For most households with credit history issues, however, stretching the debt capacity to this degree is not considered responsible lending. Another example is a short-term (e.g., five-year) balloon loan in which payments may be reduced in the near term but then a very large payment comes due at the five-year maturity. A balloon payment for someone who can be expected to obtain refinancing rather easily in the foreseeable future may be appropriate. But for most subprime borrowers, using a balloon payment to lower monthly payments to the point of "affordability" will leave a balloon or escalating principal that the borrower will have great difficulty repaying.

An instance of predatory lending could involve just one predatory practice. More commonly, though, a number of practices occur simultaneously. Moreover, high-pressure or "push" marketing may be most effectively employed when targeting homeowners in vulnerable situations, including those with high levels of health-related or credit card debt. Those not in immediate financial distress are less susceptible to pressure tactics and are more likely to "shop around" for better alternatives.

The proportion of loans made by subprime lenders that contains abusive practices is the subject of some debate, but it is rare to find a case of a predatory lending that does not involve a subprime lender. Some evidence suggests that the proportion of subprime loans with at least one problematic feature may be quite large.[9] For example, estimates of the number of subprime loans containing prepayment penalties range

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[7] Fannie Mae. 2001. *2001 National Housing Survey*. Washington, D.C.: Fannie Mae.

[8] Rheingold, Ira, Michael Fitzpatrick, and Al Hofeld, Jr.. 2001. "From Redlining to Reverse Redlining: A History of Obstacles for Minority Homeownership in America." *Clearinghouse Review*. 34 no. 9/10 (January/February): 642-654.

[9] Ernst, Keith, John Farris, and Eric Stein. 2002. "North Carolina's Subprime Home Loan Market and Predatory Lending Reform." Durham: Center for Responsible Lending. August.

from 43 percent to 80 percent, while estimates of the share of prime loans containing prepayment penalties are much lower—between 2 and 11 percent.[10]

A couple of recent studies have surveyed recipients of subprime loans to understand the incidence of various predatory lending practices. In a study of 255 very high-costs loans in Dayton, Ohio, 75 percent were found to have prepayment penalties and 24 percent had balloon payments.[11] The researchers also interviewed subprime borrowers who were in the process of foreclosure as well as those who were not. Thirty nine percent of respondents in foreclosure and thirty three percent of respondents not in foreclosure stated that the initial contact with the lender was initiated by the lender via phone or mail. Forty-five percent of foreclosure respondents and 24 percent of other respondents said that their loans' terms at closing were different than what had been discussed. Eighty-six percent of foreclosure respondents and 68 percent of nonforeclosure respondents who noted a difference in terms accepted the difference, perhaps due to pressure at the closing from the lender. And finally, 19 percent of nonforeclosure respondents and 42 percent of foreclosure respondents were encouraged to borrow more than they had intended. In California, researchers interviewed 125 subprime borrowers and found that 39 percent of subprime respondents said that the idea to take out a home-secured loan came from the lender-broker.[12] They also found that 64 percent of respondents had refinanced their homes six times. Forty percent of the refinances had taken place within two years of the prior loan, a strong indicator of the predatory practice known as flipping. The researchers found that 38 percent of the subprime borrowers fit a "worst case scenario" characterized by a combination of onerous loan terms, high costs, and aggressive sales tactics.

Subprime Loans and Foreclosure

One of the reasons that subprime lending has been the subject of a good deal of advocacy and policy-making in recent years has to do with the problem of increased foreclosures. Foreclosures, especially in low- and moderate-income neighborhoods turn what might be typically viewed as a consumer protection problem, in which an individual homeowner is overcharged or even loses her home, into a community development problem, in which increased foreclosures lead to property abandonment and blight. In Chicago, for example, some of the most effective organizing and advocacy for state regulatory action on the predatory lending issue came from groups like Neighborhood Housing Services and the Southwest Organizing Project, which saw that increased foreclosures were threatening more than two decades of work in revitalizing and stabilizing their communities.

Defaults and, especially foreclosures, can entail significant costs and hardships not just for the families most directly affected, but also for surrounding neighborhoods and even the larger communities. McCarthy, Van Zandt, and Rohe describe how foreclosures can involve losing not only accumulated home equity and the costs associated with acquiring the home, but access to stable, descent housing.[13] Moreover, foreclosures damage credit ratings, hurting the owners' prospects not only in credit markets but

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[10] Fannie Mae. 2001. *2001 National Housing Survey*. Washington, D.C.: Fannie Mae; U.S. Department of Housing and Urban Development. 2000. *Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending*. Washington, D.C.: U.S. Department of Housing and Urban Development

[11] Stock, Richard D. 2001. "Predation in the Subprime Lending Market: Montgomery County. Dayton, Ohio: Center for Business and Economic Research, University of Dayton. Project 1097. October.

[12] Stein, Kevin, and Margaret Libby. 2001. *Stolen Wealth: Inequities in California's Subprime Mortgage Market*. San Francisco: California Reinvestment Committee. November.

[13] McCarthy, George, Shannon Van Zandt, and William Rohe. 2001. The Economic Benefits and Costs of Homeownership: A Critical Assessment of the Research. Washington, D.C.: Research Institute for Housing America. Working Paper 01-02. May.

also in labor and insurance markets and in the market for rental housing. Moreno estimated average losses to the foreclosed family at $7,200.[14] Cities, counties and school districts lose tax revenue from abandoned homes. In addition to the direct costs in dealing with abandoned properties and the public safety costs associated with them, there are potential spillovers on the property values and tax receipts from nearby properties. These spillover effects can be significant. Simons, Quercia, and Maric estimated that average sales prices fell $788 for each 1 percent increase in tax delinquencies in a one- to two-block area of a residence.[15] For FHA foreclosures, Moreno (1995) estimated average city expenses of $27,000 and neighborhood expenses of $10,000. Moreover, these figures do not account for all of the social and psychic costs of foreclosures, either to the family or the community.

Subprime loans lead to delinquency and foreclosure at relatively high rates, especially among the higher-risk segment of the industry. A late 1990s industry survey of 27 larger subprime lenders indicated that 90 day delinquency rates for C- and D-grade refinance loans were 10 percent and 22 percent, respectively, compared to a rate of 0.25 percent for prime refinance.[16] Even FHA loans, which have been persistently tied to foreclosure and blight problems in minority communities, had 90-day delinquency rates of less than 2 percent for refinance loans over the same period. The foreclosure rate for all subprime loans in this sample (including the 55 percent that were A- grade) was more than four times the FHA rate. The foreclosure rate for C and D loans is expected to be much higher. In this voluntary survey, almost 20 percent of subprime loans were C and D grade. However, the source of these data appears to be biased towards substantially underepresenting higher-risk loans. Even more concerning is the fact that problems among subprime loans worsened considerably beginning in 2000.[17] Rates of serious delinquency for subprime loans (of all grades) increased from less than five percent in early 2000 to more than eight percent by late 2001. Prime loan delinquencies were almost constant over this period, at around 1 percent, and FHA delinquencies rose much more slowly from about 3.5 to about 4.5 percent.

Because subprime lending—especially the higher risk segments known as B, C or D lending—is highly concentrated in certain types of neighborhoods, these neighborhoods bear a disproportionate share of subprime foreclosures. Moreover, many of the subprime lenders exhibiting the highest foreclosure rates are concentrated in certain areas, so that these areas are hit especially hard. The nature of residential sorting and the experience of the FHA program suggest that a lender may have a substantial but not unreasonable foreclosure rate nationally and still have a foreclosure rate in certain neighborhoods that is exorbitant. Lenders may be able to tolerate foreclosure rates of two to five percent nationally and still be successful raising capital. These same lenders may have foreclosure rates of more than ten to fifteen percent in specific communities.

Foreclosures—particularly those leading to abandonment and blight—often have negative spillover effects, or externalities, that can be a key source of market failure. Because the negative social costs of these spatially concentrated foreclosures (abandonment, blight, crime, and lower neighborhood property values) are not captured in market transactions, the high foreclosure numbers can indicate that lending levels will be excessive even from an efficiency perspective. It is important to add that foreclosures in

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[14] Moreno, A. 1995. The Cost-Effectiveness of Mortgage Foreclosure Prevention. Minneapolis: Family Housing Fund.

[15] Simons, R. A., R. G. Quercia, and I. Maric. 1998. "The Value of Residential Construction and Neighborhood Disinvestment in Residential Sales Price." Journal of Real Estate Research 15(1-2):147-61.

[16] Phillips-Patrick, Eric Hirschhorn, Jonathon Jones, and John LaRocca. 2000. What About Subprime Mortgages? *Mortgage Market Trends* 4, no. 1 (June). Washington, D.C.: Office of Thrift Supervision Research and Analysis.

[17] Crews Cutts, Amy and Robert A. Van Order. 2003. "On the Economics of Subprime Lending." McLean, VA: Freddie Mac.

struggling, low- or moderate-income and minority neighborhoods may have greater negative impacts than those in middle- and upper-income areas. In the latter case, the foreclosures are less likely to lead to abandoned buildings, blight and crime.

At least five recent studies have identified some relationship between subprime lending and foreclosures at the neighborhood level.[18] In Baltimore, while the subprime share of mortgages in the city was 21 percent in 1998 (presumably higher than in previous years), 45 percent of foreclosure petitions in that year were tied to subprime loans. Subprime foreclosures accounted for 57 percent of all foreclosures in black Baltimore neighborhoods. In Atlanta, a study by Abt and Associates found that foreclosures attributed to subprime lenders accounted for 36 percent of all foreclosures in predominantly minority neighborhoods in 1999, while their share of loan originations was between 26 and 31 percent in the preceding three years. In Essex County, New Jersey, researchers found that the percent of foreclosures attributed to subprime lenders increased from 19 percent in 1995 to 30 percent in 2000, though they also admitted that these figures substantially underestimated the subprime share of foreclosures. By mapping foreclosures they were also able to identify that foreclosures were disproportionately concentrated in predominantly black neighborhoods

These studies generally tend to underestimate the proportion of foreclosures due to subprime originators and overestimate the proportion due to prime originators. Many subprime loans are sold to financial institutions identified by the U.S. Department of Housing and Urban Development as "prime" or are held in trusts at prime lending institutions (usually banks). The reverse does not tend to be the case; subprime lenders do not often buy loans from prime lenders and generally do not have trust capacity. Thus, foreclosures of subprime loans sold to prime lenders or trusts would list only the prime lender who currently holds the loan, not the originating subprime lender.

In the studies of Chicago, the authors were plagued by the same problem, but did obtain pricing data on a portion of the foreclosures. The National Training and Information Center (1999) found that foreclosures on loans with interest rates above comparable Treasury rates plus four percentage points (clearly subprime-priced loans) increased by 500 percent from 1993 to 1998. Many of these foreclosures were concentrated in minority neighborhoods. Collins (2003) found that loans by subprime lenders increased by 32 percent from 1996 to 2001, while foreclosures on loans priced 300 basis points or higher increased by 260 percent over the same period.

Establishing a Stronger Measure of the Relationship Between Subprime Lending and Foreclosures

Subprime loans are expected to entail at least marginally higher risks than prime loans, so somewhat higher foreclosure rates should be expected. The heart of many policy debates regarding subprime and predatory lending, however, is a question of how much additional risk should be tolerated. In order to inform this debate, we need better measures of the impact that subprime loans of various types (home purchase versus refinance, for example) have on neighborhood foreclosure levels. To do this we gathered

[18] Collins, Michael. 2003. "Chicago's Homeownership Preservation Challenge: Foreclosures," presentation. Washington: Neighborhood Reinvestment Corporation. February; Greunstein, Deborah and Christopher Herbert. 2000. *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area*, Abt Associates, February; National Community Reinvestment Coalition. 2003 *The Broken Credit System: Discrimination and Unequal Access to Affordable Loans by Race and Age*. Washington, D.C.: National Community Reinvestment Coalition; Zimmerman, Ken, Elvin Wyly, and Hilary Botein,. 2002. *Predatory Lending in New Jersey: The Rising Threat to Low-Income Homeowners*. Newark: New Jersey Institute for Social Justice, February.

computerized foreclosure data for the five-county metropolitan Chicago area, geocoded it to the census tract level, and compared it to lending data in the same area.

Before developing some relatively precise measures of the relationship between subprime lending and foreclosures, we first examine broader patterns of foreclosures. From 1995 to 2002, the Chicago area experienced tremendous growth in foreclosure starts. The total number of starts went from 7,433 in 1995 to 25,145 in 2002, an increase of 238 percent. What is particularly troubling about this trend is the disproportionate increase due to conventional, nongovernment-guaranteed loans. Historically, FHA loans, which account for the bulk of government-guaranteed loans, have had substantially higher foreclosure rates than conventional loans and have accounted for a very large and disproportionate share of foreclosures. Of course, as subprime loans (which comprise a portion of conventional loans) increased, more conventional loans foreclosure rates would be expected to increase to some degree. However, the nature of urban foreclosure problems has been fundamentally transformed during the middle-to-late 1990s and into the new century. It is now the conventional mortgage market that accounts for the bulk of foreclosures.

Figure 1 shows that while government guaranteed foreclosures rose significantly between 1995 and 2002, from 3,387 to 6,932, conventional foreclosures skyrocketed from 4,046 to 18,213. Foreclosures of conventional loans increased at a rate (350 percent) more than three times the government-guaranteed rate (105 percent). As Figure 2 shows, the result is that, while conventional loans accounted for only slightly more than half of foreclosures in 1995, they accounted for almost three out of four just seven years later. This rise in conventional loan foreclosures is cannot solely be attributed to increases in originations. In the intervening years, from 1996 to 2001, conventional lending grew by roughly 104 percent while government lending increased by about 55 percent, so relative to government foreclosures, conventional foreclosures increased at a far greater rate than conventional lending.

Foreclosures and Neighborhood Racial Composition

It is well established that subprime lending increased much more in minority than nonminority neighborhoods in the 1990s.[19] It is also well established that mortgage brokers have been implicated in many instances of abusive and irresponsible lending activity. Brokers act as a local intermediary between national lenders and borrowers. The nature of the broker market is such that there are many small brokers serving different geographic areas and many who focus on certain communities. The use of brokers, then, may segment the foreclosure patterns of a specific lender, with higher foreclosure rates resulting in areas served by less responsible or reputable brokers.

Thus, individual lenders may experience large spatial variations in loan performance within a metropolitan area. Moreover, broker-originated loans are twice as likely to be subprime than lender-originated loans.[20] Among older borrowers, brokers are also more likely to lend to nonwhite borrowers. Sixty-two percent of older nonwhite borrowers received loans via brokers, while only 38 percent of older white borrowers did. Brokers are heavily associated with aggressive "push marketing." In their study of older borrowers, Kim-Sung and Hermanson (2003) found that 56 percent of borrowers with brokered loans reported that contact was initiated by the broker, while other borrowers reported that lenders initiated contact only 24 percent of the time. More than twice as many borrowers using brokers received

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[19] Immergluck, Daniel and Marti Wiles. 1999. *Two Steps Back: Predatory Lending, the Dual Mortgage Market, and the Undoing of Community Development.* Chicago: Woodstock Institute.

[20] Kim-Sung, Kellie and Sharon Hermanson. 2003. "Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans." Washington, D.C.: AARP Public Policy Institute. January.

loans with prepayment penalties (26 percent versus 12 percent), and significantly more brokered loans involved refinancing two or more times over a three year period. Borrowers with brokered loans were generally less satisfied with their loans and were less likely to feel that they received honest information. Brokers are generally regulated only by state regulators, and the degree of such oversight tends to vary from minimal to nonexistent.

Figure 1. Increases in Foreclosure Starts by Conventional/Government-guaranteed Type in the Chicago Metropolitan Area 1995 –2002

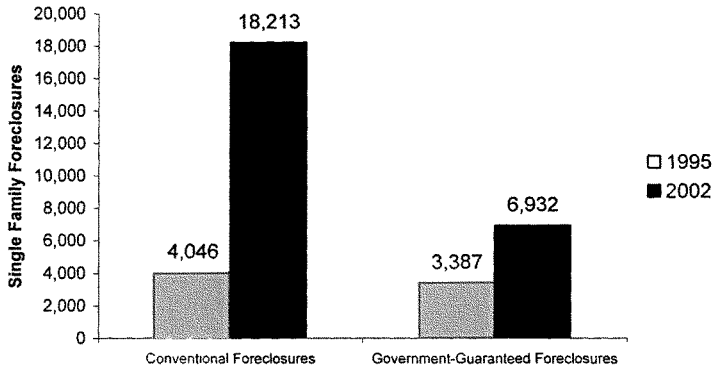
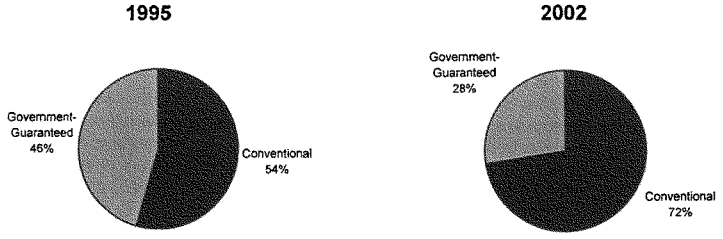


Figure 2. Share of Foreclosures by Government/Conventional Type



Even lenders not using brokers may experience differentials in loan performance across neighborhood space. In particular, if lending policies are not well designed for lower-income borrowers, a lender may see higher foreclosures in lower-income neighborhoods. In addition, if markets function more poorly in particular geographic areas, then borrowers may be paying higher rates than they would otherwise. They might also accept structured or abusive loans at higher rates than in places where markets function better. These patterns can intensify the geographic concentration of foreclosures.

Figure 3 illustrates the large differences in the growth of foreclosures by neighborhood racial and ethnic composition. While conventional foreclosures increased dramatically in all neighborhood types, they increased considerably faster in neighborhoods with higher minority populations. Neighborhoods with minority populations of less than 10 percent in 2000 saw an increase in foreclosures of 215 percent, while neighborhoods with 90 percent or greater minority populations experienced an increase of 544 percent.

Figure 3. 1995 – 2002 Increases in Conventional Foreclosures by Neighborhood Racial Composition in 2000

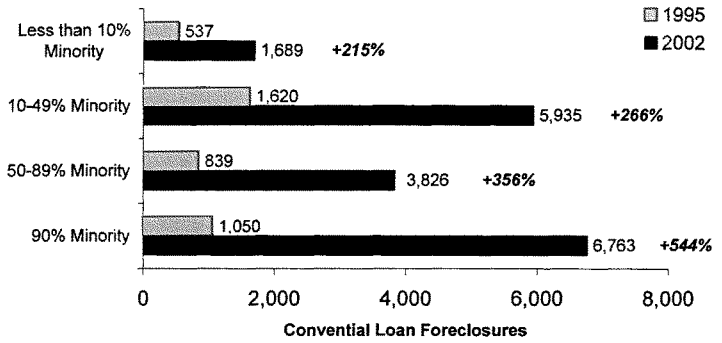


Figure 3 also indicates that neighborhoods with 90 percent or more minority residents in 2000 accounted for 40 percent of the 1995-2002 increase in conventional foreclosures.[21] These same tracts represented only 9.2 percent of the owner-occupied housing units in the region. Tracts with 50 percent or greater minority populations accounted for more than 61 percent of the increase in foreclosures.

Analyzing the Link between Subprime Lending and Foreclosures

To better understand the relationship between subprime lending and neighborhood foreclosures we developed two multivariate regression models to determine to what extent different variables affected foreclosure. The dependent variable in both models is 2002 foreclosures. The first model controls for loan level features including type of lender (prime or subprime) and owner-occupancy of property (owner occupied or non-owner occupied). The second model adds information on loan purpose (home purchase, home improvement, refinance). For both models we use total loans by tract from 1996 to 2001. Both models also control for change in neighborhood demographic and economic characteristics relating to population, race/ethnic make-up, median family income, unemployment rate, and median property value. The results show that:

[21] The HMDA data used in this study are reported according to 1990 census tract boundaries. Therefore, it was necessary to obtain 2000 census data recalculated to 1990 tract boundaries for the purposes of matching the data with the 1990 boundaries. This data was procured from PCI Services, Inc., which provides this product for its CRA Wiz software, a program commonly used by financial institutions and bank regulators to analyze HMDA data.

- **Subprime lending has a substantial impact on neighborhood foreclosure levels.** For every 100 additional subprime loans on owner-occupied properties made in a typical neighborhood from 1996 to 2001, there were an additional 9 foreclosure starts in the community in 2002 alone.[22] Nine foreclosure starts in a census tract in one year is a substantial increase. The average tract in the Chicago area had only about 11 foreclosures starts in 2002. Thus, this represents an increase of 76 percent in the foreclosure level.

- **Non-owner-occupied subprime loans, although far fewer in number than those to owner-occupied properties, have an even higher propensity to lead to increased foreclosures.** A tract with just 10 more such loans over the 1996 to 2001 period, other things being equal, would be expected to have more than 2.5 additional foreclosures in 2002.

- **Prime lending has a minimal impact on the neighborhood foreclosure level and, in the case of refinances, prime lending actually reduces the level of expected foreclosures.**

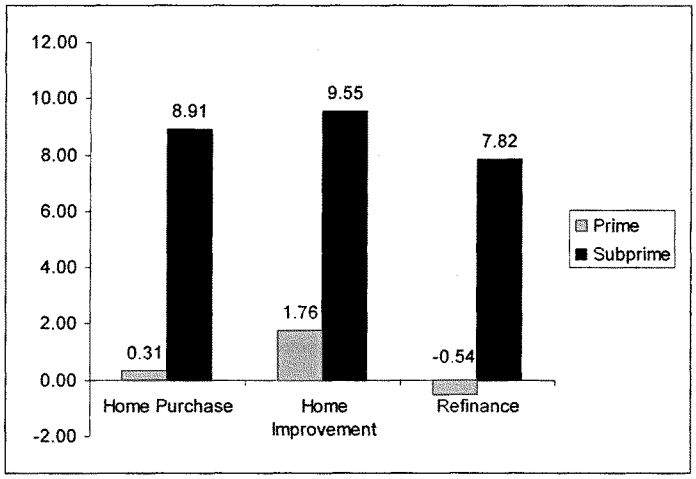
- **The contribution of subprime home purchase loans to neighborhood foreclosures is 28 times that of prime home purchase loans.** While a tract with 100 additional prime home purchase loans from 1996 to 2001 is expected to have only 0.3 additional foreclosures in 2002, a tract with 100 additional subprime home purchase loans is expected to have almost 9 additional foreclosures.

- **In the case of refinance loans, a higher number of owner-occupied prime loans actually leads to *reduced* foreclosure levels.** A tract with 200 more owner-occupied prime refinance loans during the 1996 to 2001 period is expected to have 1 fewer foreclosure in 2002. This finding argues strongly for a substantial substitution effect between prime and subprime refinance loans. That is, as prime loans increase, the potential market for subprime lenders may be diminished, thus crowding out such lenders.

- **Subprime home improvement loans have the largest impact on foreclosures on a per-loan basis.** A tract with 100 more subprime home improvement loans is expected to have an additional 9.5 foreclosures in 2002 while the corresponding effect for purchase loans is 8.9 and for refinance loans it is 7.8. However, because there are so many more subprime refinance loans, they account for a much larger share of foreclosures.

[22] The 100 loan figure is a reasonable one for discussion purposes. The average number of subprime loans per tract in the study was 114 over the 1996-2001 period, with a standard deviation of 105 loans.

Figure 1. Expected 2002 Foreclosures per 100 Loans from 1996 to 2001 by Type of Lender and Purpose of Loan[23]



Conclusions

The findings of this study clearly indicate that subprime lending is a dominant driver of the increased and highly concentrated neighborhood foreclosure levels of the late 1990s and through 2002. Responsible subprime lending may indeed bring important benefits to families that have difficulty obtaining credit elsewhere. However, this study shows that, after controlling for neighborhood demographics and economic conditions, subprime loans lead to foreclosures at twenty or more times the rate that prime loans do. This is a heavy social cost. For every 100 subprime loans made in a typical neighborhood from 1996 to 2001, there resulted an additional 9 foreclosures in the community in 2002 alone. Nine foreclosures in a census tract in one year is a substantial increase.

Prime lending, on the other hand, had minimal impact on the foreclosure level and, in the case of refinance lending, prime lending actually reduces the level of foreclosures expected. If anything, this analysis is likely to underestimate the impact of subprime lending on foreclosures in neighborhoods that are particularly vulnerable. Residents of lower income and minority communities are less likely to be able to avoid foreclosure via borrowing from friends and relatives; increasing earnings by having a spouse increase working hours; or tapping into other wealth reserves.

[23] Expected foreclosure values are derived from a regression model explained in detail in the full publication. The above individual values should be interpreted as holding all other variables in the model constant. The model controls for loan level features including type of lender (prime or subprime), purpose of loan (home purchase, home improvement, refinance), owner-occupancy of property (owner occupied or non-owner occupied). It also controls for neighborhood demographic and economic characteristics relating to population, race/ethnic make-up, median family income, unemployment rate, and median property value.

This study has a number of implications for regulatory policy in the arena of home lending. First, it makes a strong case that the magnitude of the effect of subprime lending on neighborhood foreclosures is very large. Given the impact of foreclosures on neighborhood vitality and stability, especially in modest-income neighborhoods where foreclosures more often lead to abandonment and blight, this cost of high-risk lending should be given more weight in policy discussions. This is especially true since much of this cost is borne by entire communities, not just by the lender or borrower.

Foes of increased regulation of the subprime mortgage market often argue that increased regulation will result in higher costs of borrowing for many borrowers and perhaps even reduce credit access for some. However, the social costs involved in substantially higher foreclosures in many struggling neighborhoods might not be easily outweighed by marginally lower borrowing costs spread thinly across a broad set of borrowers. Even if some worthy borrowers are prevented from obtaining credit due to increased regulation, the benefits of reduced foreclosures may justify such action. Moreover, foreclosures are hardly the entire costs of overly risky and irresponsible subprime lending. Financial and emotional stress, excessive charges and fees, and other harms to borrowers must be considered. Certainly, many borrowers benefit from responsible subprime lending. The findings of this study, however, suggest that the negative spillovers occurring in the existing marketplace are substantial and that such spillovers must be more clearly considered in policy-making.

STATEMENT

Of

THE COALITION FOR FAIR AND AFFORDABLE LENDING ("CFAL")

And

NEW CENTURY FINANCIAL CORPORATION

On

"Subprime Lending: Defining the Market and Its Customers"

At The Joint Hearing Of The

Subcommittee on Housing and Community Opportunity

And

Subcommittee on Financial Institutions and Consumer Credit

March 30, 2004

Introduction

The Coalition for Fair and Affordable Lending[1] ("CFAL") and New Century Financial Corporation appreciate the opportunity to testify at today's hearing. My name is Terry Theologides, and I am Executive Vice President of Corporate Affairs for New Century Financial Corporation, one of CFAL's founding members. Among other things, I run the compliance, legal and fair lending functions at New Century, which is the nation's second-largest non-prime lender.

At your Committees' joint hearing on November 6, 2003, CFAL's Chairman, Steve Nadon, testified about the need to pass enhanced federal statutory protections to prevent abusive lending practices.[2] He described inadequacies in the current federal

[1] The Coalition for Fair and Affordable Lending (CFAL), launched in January 2003, was formed to advocate uniform federal legislative standards for non-prime mortgage lending. CFAL's members make up one-third of all non-prime mortgage loans.

[2] On behalf of CFAL, Mr. Nadon said: *"Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. Many of these abuses are fraudulent, deceptive and illegal. Enhanced enforcement together with more consumer financial education and counseling opportunities are needed to help prevent them. However, significant new federal statutory requirements*

"HOEPA" law[3] and the negative effects of the confusing patchwork of state and local "anti-predatory lending" laws. Mr. Nadon offered thoughtful proposals on how to further enhance pending legislation, such as H.R. 833, the Ney-Lucas bill. In that regard, New Century and other CFAL members are continuing to work with Members to help craft an even better final measure that can be passed with very broad bipartisan support. We believe that it is in the best interest of both borrowers and industry to have clear uniform rules that apply equally to all types of mortgage lenders and that provide strong protections to all Americans while preserving access to affordable non-prime mortgage credit.

Members of the Subcommittees will be better able to craft such national standards if they have a good understanding of the non-prime[4] mortgage market and the Americans who rely on it. Therefore, we commend Chairmen Ney and Bachus for holding today's hearing focusing primarily on the nature of the non-prime market itself.

The Non-Prime Mortgage Market

The American mortgage market has greatly expanded over the last 30 years, and homeownership rates are at the highest levels in history. Indeed, our strong mortgage marketplace is the envy of the world. In the fourth quarter of 2003, there were an estimated 121.4 million housing units in the United States of which roughly 105.9 million housing units were occupied. This high occupancy rate was comprised of 72.7 million

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also are needed to remove gaps or weaknesses in current law. . .CFAL believes that it is imperative that Congress promptly pass such new federal requirements. H.R. 833, the Ney-Lucas bill, effectively addresses many of the current law's shortcomings. We urge Members to work together after the November 5th hearing to further refine H.R. 833 as may be needed to address any additional concerns and gain broader bipartisan support. We want to work constructively with you and other interested parties to help craft a fair and balanced refined legislative proposal that can be the basis for the new federal law and that the full Committee can act on early next year. . .The arbitrary and irrational growing patchwork of state and local laws intended to prevent mortgage lending abuses is proving to be unduly burdensome and costly. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, but also confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures, and the national housing finance market is being disrupted. . .Accordingly, CFAL thinks that the new federal fair lending rules should apply uniformly so that all mortgage lenders are governed by them and that every American borrower receives the same effective protections. And, we want to see both federal and state regulators actively enforce these nationwide standards. . .Congress clearly has the power to pass legislation providing for uniform national standards for nonprime lending. We believe that such uniform rules are badly needed and that it is sound public policy for Congress to establish them."

[3] The "Home Ownership and Equity Protection Act of 1994"

[4] This market segment is also sometimes called "sub-prime," "non-conforming," or "specialty" lending.

homeowners and 33.2 million renters.[5] These statistics set a new record homeownership rate of 68.3%.[6] This impressive rate could not have been realized without the development of a highly specialized non-prime mortgage market.

Non-Prime Market Size

Today, the non-prime market has grown significantly into a highly competitive market. In 1994, there were $34 billion in non-prime mortgage originations, representing about 5% of the overall mortgage origination market.[7] Last year, originations grew to roughly $325 billion, which represented 10.5% of all mortgage originations.[8]

Much of our industry's dramatic growth has been due to the securitization of non-prime mortgages. The industry depends on the liquidity generated by the secondary market in order to bring affordable mortgage credit from Wall Street to Main Street. In 1994, $11 billion of non-prime mortgage loans were securitized. By 2003, this had increased to around $215 billion, which represented 66% of the entire non-prime market. Securitization has greatly increased the availability of mortgage capital and has helped lower borrowers' cost.[9]

In particular, the growth of the non-prime mortgage market since the early 1990's has dramatically transformed the national mortgage market by providing access to credit for millions of Americans who historically have been unable to qualify for credit under so-called "prime" mortgage[10] underwriting standards.

Expanded Credit Opportunities for Minorities

The credit provided by the non-prime lending industry is especially important for many minorities. For example, overall the African-American and Hispanic populations differ in a number of important economic characteristics relative to the White population. As a group, their respective median incomes are lower, wealth is lower, unemployment rates are higher and credit scores lower. This unfortunate economic disparity has been clearly documented in data by the Census Bureau, the Federal Reserve, the Labor Department and a variety of other reports.[11]

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[5] U.S. Census Bureau
[6] Department of Housing and Urban Development ("HUD")
[7] HUD/Treasury Report
[8] SMR Research, "Subprime Mortgage Loans, 2004" ("SMR")
[9] Securitization is discussed further in Appendix "A"
[10] The term "prime" in the mortgage context does not refer to the "prime" interest rate that banks charge their best customers for loans; instead, it refers to the lower rate that mortgage lenders charge the lowest risk borrowers who qualify for mortgages that are bought by Fannie Mae and Freddie Mac, the two large housing government sponsored enterprises ("GSEs").
[11] CFAL will be soon releasing a report prepared by a major national consulting firm that explains these issues in detail and that highlights some of the basic economic data outlined in a number of these reports. For example, it will note that, in 2002, median income of African-Americans was 62% that of White median income and Hispanic median income was 71 % of White median income. In 2002, African-American adults age 25-54 experienced unemployment rates twice that of Whites, and Hispanic adult unemployment rates were about 50% higher than Whites. In 2001, 27% of African Americans had less

What this means is that African-Americans and Hispanics therefore are less likely to meet the more stringent economic risk evaluation criteria in the conforming or "prime" market that operates largely through Fannie Mae and Freddie Mac. However, with the emergence of a significant non-prime market, many of these higher risk minority borrowers, as well as similarly situated higher risk White borrowers, now are able to qualify for affordable mortgage credit at only moderately higher costs where heretofore most would have been unable to obtain it.

Market Participants

Today's non-prime lending industry is dominated by large, national companies who employ sophisticated risk-grading techniques to provide mortgages to millions of Americans who generally cannot qualify for "prime" mortgages. Most companies rely heavily on the capital generated in the secondary market from securitizations and whole loan sales to fund the mortgage loans they make to their higher risk customers.

This industry is comprised of mortgage companies, consumer finance companies, banks, thrifts, and other financial institutions. However, an analysis of the market share of these various financial institutions reveals that a substantial majority of non-prime mortgages are originated by state-licensed mortgage companies. Specifically, according to the GAO, "fifty-nine percent of these lenders were independent mortgage companies (mortgage bankers and finance companies), 20 percent were non-bank subsidiaries of financial or bank holding companies, and the remainder were other types of financial institutions. Only 10 percent were federally regulated banks and thrifts."[12] In addition, it is important to recognize that over half of the non-prime loans now are originated through mortgage brokers as opposed to lenders' retail loan offices.[13]

Borrower Profiles

Contrary to frequent allegations, non-prime borrower profiles typically are representative of the U.S. population as a whole. Often, charges have been made that most non-prime borrowers are elderly or minorities with low incomes. However, anyone who understands the industry knows this is not the case. This has been clearly documented publicly by using HMDA data and other information.

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than $1,000 in wealth (net worth) compared to only 8% of Whites. Around 36% of African-Americans had less than $5,000 in wealth compared to 13% of Whites. For Hispanics, median wealth is 20% to 35% of median White wealth. In fact, at every income level, wealth of African-Americans and Hispanics is significantly below that of Whites. Credit scores of these groups also have been found to be significantly lower. All of these economic factors help explain why it is more difficult for these minority populations to qualify for loans in the traditional prime segment of the market.

[12] GAO Report 04-280. It is also worth highlighting, especially given the current concerns many Members have raised over the OCC's recent preemption rule that the vast majority of non-prime loans are not made by federal banks or thrifts or by their operating subsidiaries. Therefore, most such loans are not affected by this preemption.

[13] Appendix "B" discusses how New Century manages its dealings with brokers to help ensure that no broker engages in improper lending practices that might harm our borrowers.

For example, SMR Research,[14] which is one of the leading national third-party firms that collects and reviews industry data, found after analyzing year 2002 HMDA data and 2000 Census data that the ethnic breakdown of non-prime lending was the following:

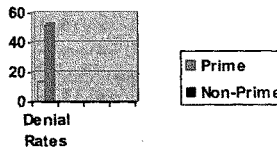
- Whites represented 68.2% of the population with 62.5% of non-prime loans;
- Hispanics represented 13.7% of the population with 14.6% of non-prime loans;
- African-Americans represented 11.9% of the population with 13.2% of non-prime loans;
- Asians comprised 3.7% of the population with 3.9% of non-prime mortgage loans; and
- Native Americans represented roughly .7% of the population with .6% of non-prime loans.

Additionally, regarding borrower income levels, SMR Research found that in 2002 non-prime borrowers had an average annual income of $71,509 compared to prime borrowers with $87,184 in average yearly income.

Lastly, regarding ages, Census Bureau data shows that 12.35% of the population is 65 years or older and 62.14% of the population is adults ages 20 to 65. However, SMR noted that "only 6.36% of all home purchase and refinancing loan borrowers in 2002 were 65 or older. . .This means that adults aged 65 or older were roughly three-fold less likely to have obtained mortgage loans in 2002 as were all adults." [15] And, after analyzing subprime lending in census tracts, SMR concluded: *"Rather than 'targeting' the elderly, these data seem to prove the reverse. It would appear subprime lenders focus attention on census tracts where the elderly do not get many loans, and make a lesser share of loans where the elderly borrowers are most plentiful."*

Repayment Ability

The perception that some people have that non-prime lenders typically engage in "asset-based lending" and will lend to anyone who has equity in their home irrespective of their repayment ability to make money by then foreclosing on the loan is false. Certainly, every reasonable effort is made to provide affordable credit, but lenders seriously evaluate a potential borrower before extending credit. We do a strict credit evaluation and apply a debt-to-income or residual income test to every loan to ensure the potential borrower can repay the loan without having to rely on the equity in their home. This reality is demonstrated by examining average approval versus denial rates. In 2002, 2.986 million loan applications were received by non-prime lenders of which 1.619 million were denied, yielding a 52% loan



[14] SMR Research Corporation, "Predatory Lending" A New Study of Unfair Lending Accusations" (2004)
[15] SMR

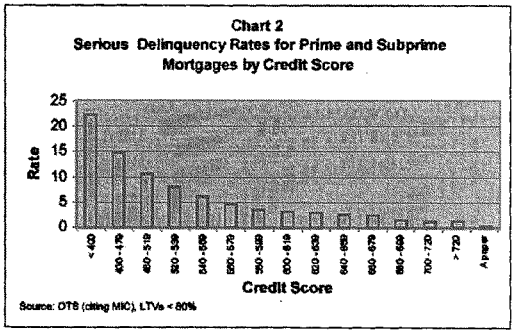
denial rate. In contrast, prime lenders denied 13.2%.[16]

In the non-prime mortgage business, it is important to balance the risk of making loans to borrowers who present more credit risk by rigorous credit evaluation and risk-based pricing. There are many examples of mortgage lenders that have failed in this regard, one notable example being the failure of Superior Bank. It is one reason why federal regulators impose higher capital requirements on depository lenders that make non-prime loans. Legitimate lenders make money by making loans to people who repay those loans, not by foreclosing and profiting from a borrower's remaining home equity. In fact, foreclosures are our worst nightmare, and we do everything possible to avoid them because lenders almost always lose money on foreclosures. New Century, for example, loses an average of around $40,000 whenever it is forced to foreclose on a loan.[17]

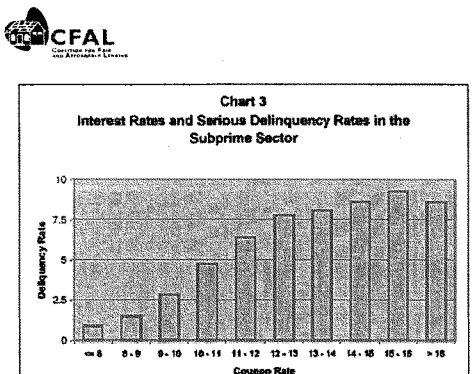
Non-Prime Rates and Risk-Based Pricing

As the non-prime mortgage market matures, the ability to quantify risk has become more manageable, and increased competition is working for the benefit of consumers by creating a more favorable interest rate environment. This occurrence is evidenced by a narrowing spread in interest rates between prime and non-prime mortgages. For example, in the 1990's the average rate spread between "A-" non-prime loans and prime loans was 2.5%, and by 2003 the average spread had fallen significantly to a range of 1.75 – 2.0%.[18] Likewise, as overall interest rates have fallen, the average non-prime rate has followed suit. In 2003 the average non-prime mortgage interest rate dropped over 1% to 7.91% compared to an average interest rate of 9.14% in 2002 and slightly over 11% in 2000.[19]

Lenders seek to price according to risk, and it is well documented that the industry does a relatively good job matching pricing to risk. A helpful illustration of this can be seen in Charts 2 and 3, reproduced from OCC's 2003 report on non-prime lending. These charts show how credit scores and interest rate track and indicate risk.



[16] SMR
[17] New Century's handling of delinquencies and foreclosures is discussed later in this testimony.
[18] "Economic Issues in Predatory Lending," OCC (July 30, 2003) at p. 8.
[19] SMR (based on average rate for 18 top lenders)



In order to better explain risk-based pricing and rates, as well as non-prime borrower characteristics in more detail, I will now provide you considerable summary data from my own company's records. Before doing so, however, I will first highlight some basic information about New Century.

New Century Information

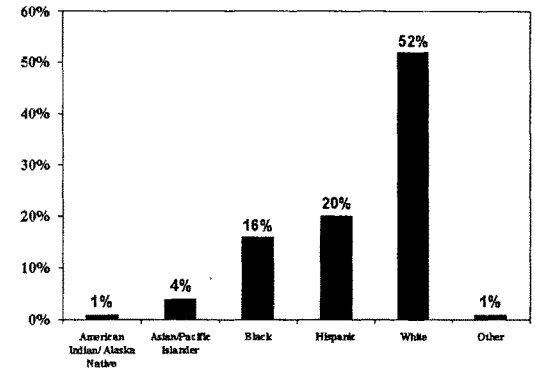
As I mentioned at the beginning of my testimony, New Century Financial Corporation[20] is the second largest provider of non-prime mortgages in the United States. We represent about 8% of the non-prime market. Together with our partners in CFAL, we represent a third of the non-prime market. In many ways New Century is representative not just of the CFAL membership, but of other major non-prime lenders that make up this marketplace today. By describing our products, processes, customers and pricing in this testimony, we hope to enhance the Committees' understanding of the non-prime lending industry in general.

Borrowers' Racial & Ethnic Characteristics

Like other major non-prime lenders, New Century's borrowers typically are not poor, nor are they primarily minority or elderly. Instead, they are middle-class, non-minority and in their 40s and 50s. The following charts, which show New Century 2003 data for funded loans by race or ethnic group,[21] demonstrate the diversity, age and income of our borrowers:

[20] New Century was founded in 1995 in California and has grown and expanded so that today we lend throughout the United States and have approximately 4,000 employees. We are a publicly traded company that, through our subsidiaries, made over 160,000 mortgages totaling over $27 billion last year. Our company originates first and second mortgage loans to customers who do not satisfy the stricter credit, documentation or other underwriting standards prescribed by Fannie Mae and Freddie Mac. Because these loans present a higher risk of default, we charge rates that are slightly higher than the rates offered by conforming lenders to borrowers with credit and loan characteristics that present the lowest risk. We originate 92% of our loans through a network of over 18,000 independent mortgage brokers located in 49 states and the District of Columbia. The other 8 percent are originated through our retail network of 72 branches in 26 states as well as a central retail operations center.

[21] Note: the information set forth in these charts is based on New Century's primary borrower only. "Primary borrower" is defined as the person whose name is first placed on an application for credit. Co-borrower information is not included herein, except as to average family income.

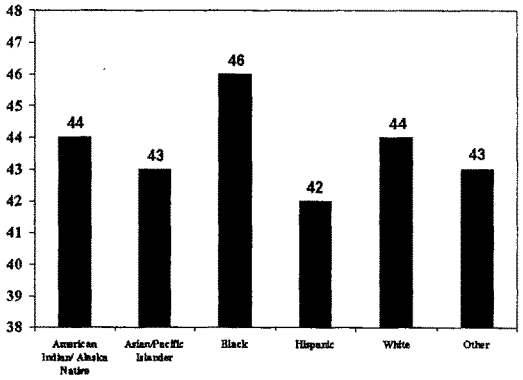


Source: HMDA data. 6% of applicants did not provide racial information.

As indicated previously, substantially more loans were made to Whites than to any other racial group.

Borrowers' Ages

This chart combines 2002 and 2003 data and depicts the average age of New Century borrowers in each racial group that received funded loans during that period.



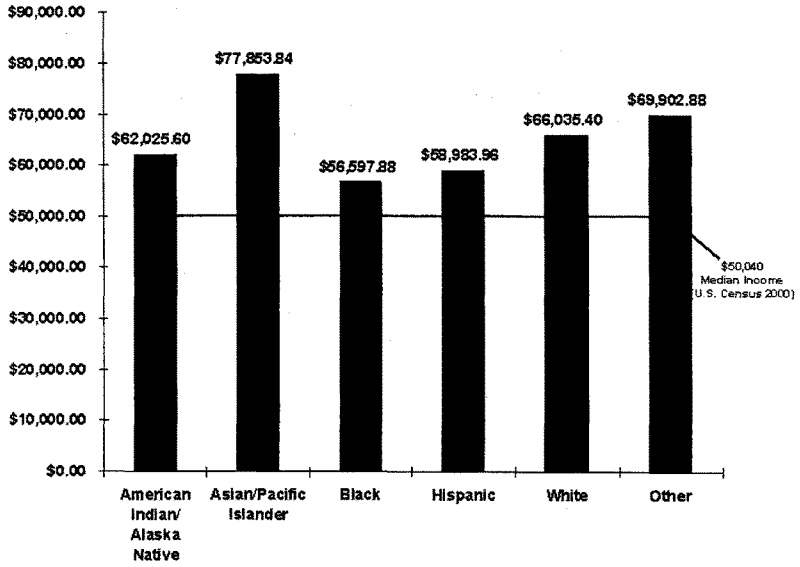
This data is further broken down in the following table:

Age Range	Company all	American Indian/ AK Native	Asian/ Pacific Islander	Black	Hispanic	White	Other	Information not provided
20-30	12.54%	12.18%	15.96%	8.98%	15.40%	12.33%	13.48%	12.08%
31-40	31.64%	30.21%	30.12%	28.18%	36.09%	31.23%	29.96%	31.39%
41-50	31.07%	32.44%	28.99%	31.57%	29.69%	31.42%	33.91%	32.11%
51-60	17.55%	16.51%	18.66%	19.90%	14.02%	18.11%	16.18%	17.58%
61-70+	7.20%	8.67%	6.27%	11.37%	4.87%	6.92%	6.47%	6.82%

As can be seen from the preceding data, the average age of all borrowers was well below 65, indicating that New Century is not targeting the older population in any racial group and that less than 7.5% of all of our borrowers are over the age of 60. We believe that other major non-prime lenders' data would be similar.

Borrowers' Incomes

The following chart shows New Century 2002 and 2003 combined data for funded loans by family income:



Summary Borrower Characteristics

As can be seen from the above information, New Century's non-prime borrowers are as racially diverse as the general population. Our average borrower has an annual family income that is approximately $72,000 per year and is under 50 years of age. Other 2003 statistics that define "who is New Century's borrower" include:

- ✓ 93.3% lived in the home that they pledged as security for their loans;
- ✓ 6.7% were non-owner occupied;
- ✓ 26.75% of the loans were for purchase of the home;
- ✓ 73.25% were refinances;
- ✓ Average first mortgage loan size was $170,857;

- ✓ Average second mortgage loan size was $46,165;
- ✓ Average FICO score was 606;
- ✓ Average Loan to Value ratio was 76.11%; and
- ✓ Average Debt to Income Ratio was 39.25%.

Current Production Data

In order to enhance the Committees' further understanding of today's non-prime mortgage lending industry, we thought it would be useful to provide more detail using our February 2004 loan production to better illustrate the characteristics of our loans. The table below shows the principal characteristics of those loans:

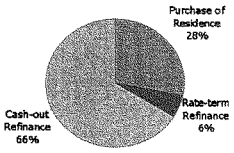
NEW CENTURY'S FEBRUARY 2004 LOAN PRODUCTION			
Loans Originated		Average Loan Size	
Number of loans	15,249	First Mortgage	$179,000
Dollar Value of Loans	$2.54 billion	Second Mortgage	$49,000
Product Types		Averages for First Mortgages	
Fixed Rate	28.0%		
2-Yr. Adjustable*	60.4%		
3-Yr. Adjustable**	2.4%	Debt-to-Income Ratio	40.28%
Interest only programs and other niche programs	9.6%	Loan-to-Value Ratio	78.88%
		FICO score	617

*fixed for 2 years then adjustable for the remaining 28

**fixed for 3 years then adjustable for the remaining 27

Loan Purpose

Borrowers in the non-prime market, just as those in the prime market, have a variety of reasons that serve as the catalyst for seeking a mortgage loan to purchase a home or to refinance an existing home loan. The accompanying table shows the stated loan purposes for our February 2004 loan production.



Fully two-thirds of our business in February involved our customers tapping into the equity in their homes to meet other financial needs. Those needs typically include:

- Refinancing higher interest rate mortgage loans or paying off higher interest consumer debt like credit cards and auto loans;
- Paying to remodel or repair the residence;

- Paying for higher education;
- Paying health care costs or debts;
- Purchasing a vehicle;
- Investing in a small business; and
- Lifestyle purchases like recreational equipment.

While some may take the position that borrowers should be restricted in using the equity in their home to better manage their financial lives, we believe that if a borrower is working within their income and budget and finds a loan that fits within their means, a home can be a financial asset that when used wisely can further a borrower's financial objectives. However, we believe that it is important that all borrowers be in a position to make informed choices. Therefore, New Century and other major lenders are strong supporters of consumer financial education and counseling programs. New Century's current educational and counseling initiatives, which are expanding, are highlighted in Appendix "H."

Also, in the lower interest rate climate we are currently experiencing, we afford first time homebuyers the opportunity to get a mortgage on reasonable terms to purchase a house. The recent increases in home ownership are in significant part due to the fact that non-prime mortgage lenders have made credit available to many first-time homebuyers. As noted in the above chart, 28% of our loans last month were for home purchase.

Prime vs. Non-Prime Underwriting Criteria

To help illustrate for you why our borrowers end up with a non-prime loan instead of a prime loan, we took some of our key underwriting guidelines and juxtaposed them to the Fannie Mae Guidelines. By doing so, the differences can be more easily understood. As can be seen in more detail in the Criteria Comparison Table in Appendix "C", there are a number of broad categories where borrowers could be precluded from qualifying for a prime loan under certain Fannie Mae criteria. These can be generally summarized as follows:

- Income documentation – Over 40% of New Century's loans are made on a "stated income" basis. Fannie and Freddie have more stringent income documentation guidelines. Borrowers who are self-employed or who have supplemental income from self-employment, as well as borrowers who have not been at their job very long and many recent immigrants, have difficulty satisfying the income verification requirements of conforming lenders. We are able to accommodate many of those borrowers. We use a variety of alternative means to evaluate their repayment ability including: (i) looking at their credit, (ii) looking at their history of meeting their other obligations such as their prior mortgage, their consumer debts, their rent and other debts, (iii) verifying the existence of their business if they are self employed, and (iv) obtaining a statement from them, under oath, regarding their income.

- Loan amount – The average loan size in states like California and New York is often in excess of the Fannie/Freddie maximums.
- Credit criteria – Non-prime criteria provide more tolerance and flexibility for late payments and even bankruptcy.
- Limited down payment and/or cash reserves – Again, conforming lenders typically require a down payment of 15% to 20% when making a mortgage loan for the purchase of a home. (They will go as low as 5% for some programs, but they may in all cases impose cash reserve requirements that will vary by borrower in order for a customer to qualify for the best rates.) We offer more flexible options as we will accommodate borrowers that may need some flexibility with regard to down payment while not requiring cash reserves.
- More cash-out – For refinance transactions, Fannie Mae and Freddie Mac do not generally permit a borrower to exceed a 90% loan to value ratio on a cash-out refinance loan. We and other nonprime lenders allow borrowers to take out more cash. Thus, in February, about 66% of our business consisted of such so-called "cash-out" mortgages in which our customers tap into their home equity to meet other financial needs such as paying off higher-interest consumer debt, purchasing a car, paying for educational or medical expenses and a host of other personal reasons.

Few Non-Prime Borrowers Qualify for Prime Loans

There is a widespread misperception that a large percentage of nonprime borrowers, especially those who are minorities, can in fact qualify for prime rate mortgages, but are being improperly steered into higher cost non-prime loans. This contention is wrong. One frequently repeated false statement in the debate over the predatory lending issue is that "30% to 50% of non-prime borrowers qualify for a prime loan." New Century's data, which we believe to be representative of other major players in the industry, shows that this is absolutely false.

In order to show why such claims are wrong, we took the Fannie Mae guidelines (per the above noted table) and ran our entire population of 2003 loans – 164,414 in all, through the above noted screening criteria. Recognizing that there are other factors that go into approving a loan under Fannie Mae criteria which we are not privy to, we found that a full 96.5% of our customers had credit, documentation or loan characteristics that would have precluded them from qualifying for a conforming mortgage based on the published Fannie Mae guidelines.

Of the 3.5% that could potentially have qualified for a conforming mortgage:

- The average interest rate was about 7.14% and the average APR was about 7.63%; and
- A majority (58.61%) of these borrowers were White, and, only 9.1% of this 3.5%, or .03% of all of our 2003 borrowers, were African-Americans who might possibly qualify for a prime loan.

Thus, it is seriously misleading to contend that 30% to 50% of our borrowers last year (or any year) could have potentially ended up with a conforming or "prime" mortgage.[22]

To further demonstrate how non-prime borrowers generally do not qualify for prime loans, by looking at credit scores alone one can see that only a small percentage might qualify. Of New Century's 2003 loans, 81% had credit scores below 660, which is the level below which the major federal banking regulatory agencies consider a borrower to be non-prime. [23] 88% of our African American borrowers, 87% of our Hispanic borrowers, and 81% of our White borrowers were below the 660 score level as illustrated in the following chart:

2003 New Century Originations by FICO Score

Fico Score Range	ALL	Am Indian/ AK Native	Asian/ Pacific Islander	Black	Hispanic	White	Other	Info not provided
	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
<500	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.01%
500-539	17.16%	18.74%	8.77%	23.42%	13.99%	17.03%	15.04%	17.79%
540-579	20.08%	22.95%	13.19%	24.39%	17.61%	20.28%	17.68%	19.79%
580-619	21.70%	23.19%	20.48%	22.22%	21.26%	21.83%	21.99%	21.31%
620-659	21.72%	19.44%	26.52%	17.96%	23.86%	21.75%	23.73%	21.14%
660-699	11.64%	10.42%	17.71%	7.97%	13.89%	11.42%	13.66%	11.63%
700+	7.69%	5.27%	13.33%	4.04%	9.39%	7.69%	7.91%	8.33%
Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

I believe that it also is worth pointing out that similar results have been noted for the broader non-prime industry. In that regard, let me quote from the earlier referenced OCC paper:

[22] We expect that number to be even lower this year as we continue a pilot project that we started last year to offer prime products through a private label arrangement with a large prime originator. Most of our brokers offer prime mortgages. Our software system for our brokers is set up so that they can run a borrower through Fannie Mae's Desktop Underwriter or Freddie Mac's Loan Prospector first. If the borrower does not satisfy those requirements, the broker can then in 2 clicks send the loan to New Century to see if it satisfies our guidelines.

[23] Interagency memo, *Expanded Guidance for Subprime Lending Programs*, January 31, 2001.

"As discussed earlier, risk plays a dominant role in determining whether or not a borrower ends up in the subprime market. Table 8, which was assembled by OTS, shows the percent of subprime mortgages in the MIC database within specific credit score categories. These data generally support the case that less creditworthy borrowers receive the great majority of subprime mortgage loans, as 81% of subprime loans have credit scores below 660. As discussed earlier, all of the major regulatory agencies use 660 as the cutoff point to denote borrowers that are at high risk of default. In addition, many prime lenders generally regard 680 as the point at which a borrower comes into consideration for a prime loan. Over 88% of the MIC subprime mortgages are associated with credit scores below 680. At the same time, 11.8% of borrowers with credit scores above 680 received subprime mortgage loans."

Table 8

Percentage Distribution of Subprime Mortgages by Credit Score

Credit Score	Percent
Under 400	0.02%
400 to 479	1.1
480-519	6.2
520-539	7.5
540-559	9.9
560-579	11.2
580-599	11.8
600-619	12.1
620-639	11.5
640-659	9.7
660-679	7.2
680-699	4.8
700-719	3.2
Over 720	3.8

Source: OTS (citing MIC); Percent figures based on $ volumes

Risk-Based Pricing

Our pricing is based on risk. Applicants are categorized into 6 separate risk grades based on a variety of factors including the following:

- Credit Score;
- Mortgage or Rental Payment History;
- History of paying consumer obligations;
- Income documentation;
- Loan-to-Value Ratio;
- Debt-to-Income Ratio; and
- History of bankruptcy, if any.

Our six risk grades are designated as AA, A+, A-, B, C and C-. Almost three-quarters of our production falls in our AA and A+ grades. As our underwriting guidelines[24] show, borrowers in our AA credit grade are typically those who have credit quality that is quite close to qualifying for a prime loan. However, they typically have debt ratios, loan-to-value ratios or income documentation limitations that would preclude them from qualifying in the prime market. In contrast, borrowers in our C and C- credit grades, representing only about 4% of our production, have more seriously impaired credit through some combination of late mortgage payments, late consumer debt payments, recent bankruptcies or other credit blemishes.

[24] Attached as Appendix "D" to this testimony, for example, is a table summarizing our underwriting guidelines as of March 17, 2004 for our California loans. Such state tables are available to our brokers in all states and anyone else at our website www.newcentury.com .

Once an applicant is categorized into a risk grade, his or her interest rate depends on a variety of factors including:

- Loan program;
- Loan size;
- Credit score band;
- Loan-to-value ratio;
- Income documentation;
- Property type (non-owner occupied; condominium, single family home, etc.);
- Points paid;
- Whether or not there is a prepayment penalty; and
- The state in which the property is located.

The assignment of risk grades to our applicants is done through an automated computer program and is not subject to employee discretion. It is also blind with respect to race and age. The following table shows how this system assigned risk grades last year.

2003 New Century Originations by Risk Grade

Risk Grade	Company All	Am Indian/ AK Native	Asian/ Pacific Islander	Black	Hispanic	White	Other	Info not provided
	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
AA	60.82%	57.03%	71.17%	55.89%	64.60%	60.24%	64.29%	59.25%
A+	19.02%	21.08%	16.05%	19.93%	18.34%	19.19%	18.99%	19.19%
A-	9.86%	10.54%	6.59%	11.79%	8.68%	10.03%	7.37%	9.76%
B	6.62%	7.38%	4.25%	8.11%	5.22%	6.82%	5.99%	7.15%
C	3.05%	3.51%	1.57%	3.65%	2.70%	3.07%	2.82%	3.42%
C-	0.64%	0.47%	0.39%	0.64%	0.46%	0.66%	0.54%	1.23%
Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

You can see from this table that 87.6% of African American borrowers, 91.6% of our Hispanic borrowers and 89.5% of our White borrowers have risk grades of "A-" or better. Only 3.7% of our borrowers (4.3% African American; 3.2% Hispanic; 3.7% White) are in our highest risk grades of "C" or lower.

Borrowers within a particular credit grade, as shown in the rate sheet in Appendix "D"[25] have variability in rate based on the screening factors noted earlier. The table below summarizes how various factors can affect the interest rate on our rate sheet:

[25] Appendix "D" contains a copy of our March 17, 2004 rate sheet effective for Southern California. Again, this information is available on our website.

Factor	Effect on Interest Rate
Loan Program	Our rate sheet displays the rate for our most common product, the 2-28 Adjustable Rate Mortgage. This product is fixed for 2 years and then adjusts every 6 months thereafter. As is typical, our rate for a 30-year fixed-rate loan is higher than for our adjustable product. Our rate for a 30-year fixed-rate loan is 1.00% higher than that for the 2-28 ARM. Our lowest rate for a 2-28 ARM is 4.50% while our lowest rate for a 30-year fixed-rate loan is 5.50%.
Credit Score	Even within our credit grades, we stratify pricing by FICO score. Therefore, for a borrower in our AA credit grade with a high credit score, the rate could be as low as 4.50%. A borrower with the lowest eligible credit score within our AA credit grade could receive a rate no higher than 6.85%.
Income Documentation	Our AA borrowers are eligible for rates as low as 4.50% if they are able and willing to provide full documentation of their income. Borrowers who apply under our Limited Documentation program pay rates that are 0.25% higher. Borrowers who apply under our Stated Documentation program, which has the most flexible requirements regarding income documentation, pay about 0.90% above the Full Documentation rates.
Loan Size	Because so many of the origination costs are fixed regardless of the size of the loan, we are able to adjust the rate depending on the loan size. Borrowers who apply for loans of between $250,000 and $500,000 are eligible for a rate typically 0.25% lower than the rate for a corresponding loan of $100,000 to $249,999. Likewise, we charge an extra 0.25% for loans under $100,000.
Loan-to-Value Ratio	All things being equal, a loan with a higher loan-to-value ratio presents a higher risk to a lender if the borrower were to default. Therefore, we offer our best rates within a credit grade to applicants with Loan-to-Value Ratios of 65% or less. Our rate sheet typically provides a rate increase of 0.15% to 0.35% as a borrower moves from a 65% LTV loan to one with an 80% LTV.
Property Type	Our rate sheet provides for rate increases of 0.25% to 0.75% if a property is non-owner occupied, a condominium, a rural property, or if it is a 3-4 unit property.
Prepayment Penalty	If a borrower agrees to a prepayment penalty on his or her loan, our rate sheet provides for a rate reduction of up to 1.00%, depending on the loan program and the duration of the prepayment penalty, which can be no longer than 3 years. In some states where prepayment penalties are not permitted, we cannot offer the benefit of such a rate

	reduction option to our borrowers.
Points	In our retail originations, if a borrower wishes to pay lower points than a particular loan program would typically require, the borrower may be eligible to do so in exchange for a slightly higher interest rate. Likewise, through our wholesale channel we offer our brokers the opportunity to provide the same tradeoff choice to their applicants. If a wholesale applicant either cannot afford to or prefers not to pay the up-front compensation that the broker would typically require for a particular loan program, the broker can offer a higher rate to the borrower and receive a so-called "yield spread premium" from us.
State	Our rates vary depending on the state in which the property is located. In some states, such as Georgia and New Jersey, state laws constrain our ability to offer loans with prepayment penalties or for us or our brokers to collect as much in points and fees as we would typically collect in another state. In order to make certain that we stay within acceptable risk parameters, we are forced to make fewer loans in those states and, to the extent we are able to make a loan, more of our pricing is driven into the interest rate. All things being equal, our rates in Georgia and New Jersey are 0.50% to 1.15% higher in our AA risk grade than our Southern California rates. We believe that the state laws in Georgia and New Jersey contribute significantly to this pricing differential.

Our rate sheet and pricing then correspond to the risk grades and loan characteristics. Below is a table showing high-level data regarding our February 2004 loans:

Risk Grade	Weighted Avg Interest Rate	Weighted Avg APR	Weighted Avg Points & Fees*	Weighted Avg FICO Score
AA	6.83	7.26	2.47	633
A+	7.06	7.51	2.83	592
A-	7.28	7.74	3.14	575
B	7.80	8.26	3.40	561
C	8.13	8.64	3.32	551
C-	9.58	10.03	3.67	547

*Includes both New Century and broker points and fees paid by the borrower, but excludes third-party pass-through fees such as appraisal, title insurance and public official fees.

Set forth in Appendix "E" is a breakdown of the average compensation that is paid to the broker and to New Century in a typical loan transaction. <u>On average the borrower in our broker transactions will pay less than 2.5% in points and fees.</u> The brokers' average compensation, including amounts paid by the borrower and New Century was only 2.72% of the loan amount.

Prepayment Penalties

Prepayment penalties have been one of the most heated and misunderstood issues in debates at the state and local level over how best to eliminate abusive lending practices. Clearly, any bipartisan federal legislation will need to grapple with how to address potential abuses and benefits stemming from prepayment penalties.

There is no doubt that prepayment penalties can be abusive and harmful to borrowers, especially when they are unduly long, unusually large, poorly disclosed or simply forced on an unwitting borrower. They pose particular risks in the non-prime market. When a borrower is striving to migrate up the credit spectrum in order to be able to refinance into a lower rate mortgage, a long prepayment penalty can thwart that effort or make it more expensive.[26]

It is fair, then, to ask what legitimate purpose is served by prepayment penalties and why are they so prevalent in the non-prime market. The value and opportunity in prepayment penalties stem from the fact that borrowers can obtain a substantially lower rate if they accept a loan with such a penalty. The secondary mortgage market will pay significantly more for a loan that is less likely to prepay within the first 2 or 3 years after origination. What the investor pays is a function of their expectation of the return on their investment taking into account that the loan may prepay earlier than expected.

The higher secondary market value enables lenders to offer a lower rate if a loan has a prepayment penalty as part of its terms. For example, on our March 17, 2003 rate sheet attached in Appendix "D", a borrower in our AA credit grade applying for a 30-year fixed-rate $180,000 loan with us with a 595 FICO score and an 85% loan-to-value ratio would get a 6.50% rate. If that borrower were comfortable that she was not planning to move or refinance in the next 3 years,[27] she could lower her rate by a full 1.00%, to 5.50% with the addition of a prepayment penalty. In practical terms, that would amount to lowering the monthly payment by $115.70, from $1,137.72 to $1,022.70. In the first 3 years the borrower would save $4,165.20 in interest.[28]

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[26] One misperception is that prepayment penalties exist only in the non-prime world. While they are certainly more prevalent in the non-prime market, tens of thousands of prime loans are originated each year with prepayment penalties. Fannie Mae and Freddie Mac buy both prime and non-prime loans with prepayment penalties.

[27] Although borrowers do not enter into a loan transaction thinking they will pay a prepayment penalty, inevitably some do for reasons including the following: (1) an unexpected job relocation; (2) a declining rate environment in which the borrower may conclude that it is economically in his or her best interest to refinance into a lower rate and pay the prepayment penalty than it is to wait until it lapses and risk a change in the interest rate environment---for example, a declining rate environment, combined with improvement in the borrower's credit profile so that the borrower would qualify in a higher non-prime grade or even a prime grade, may tilt the scale in favor of refinancing even with the additional cost of a prepayment penalty; or (3) a need to refinance to tap into additional equity in the home to meet unanticipated financial needs.

[28] After 5 years the borrower would have saved $6,942.00. If the borrower were to hold the loan for 30 years, the total savings would be $41,652.

But, what would happen if the borrower were to need to refinance within the 3-year penalty period? In the above example, the borrower would have to pay a prepayment penalty of $3,949.09.[29] The true cost of the prepayment penalty is in fact less since the borrower received a $115.70 payment reduction for each month of the mortgage until she refinanced. Thus, for example, if the borrower prepaid after 2 years, the actual cost to the borrower after factoring in the interest savings is only $1172.29.

This example, based on our average loan size and using our most common credit grade, including a typical FICO score and loan-to-value ratio, comes straight off of our rate sheet. It illustrates how, in the hands of a well-informed borrower, a prepayment penalty can be a very powerful payment reduction tool.

Another very important consideration in accepting a prepayment penalty is the fact that it enables many borrowers to qualify for the loan. For many borrowers, lowering the rate by agreeing to a prepayment penalty and obtaining a significantly lower monthly payment enables them to qualify for a loan because it helps them to meet our debt-to-income ratio guidelines.

Length of Prepayment Penalties - Like most of the leading non-prime lenders, the longest prepayment penalty we offer is 3 years. On our adjustable rate loans, we do not permit the prepayment penalty term to extend beyond the first adjustment date. For example, our most common product is a so-called 2-28 ARM. This loan bears a fixed rate for the first 2 years and then converts to an adjustable rate loan for the remaining 28 years. On these loans, our prepayment penalty does not extend beyond 2 years. This, too, is typical for the industry today.

Frequency of Prepayment Penalty Election - The example above illustrates the potential benefits of prepayment penalties. Thus, it should not be surprising that so many non-prime borrowers choose to obtain a lower rate by accepting such a penalty. About 75% of our borrowers agree to take loans with prepayment penalties. Those who charge that "prepayment penalties lock borrowers into higher cost loans" usually fail to note that the borrower receives a significant benefit through a lower rate and lower monthly payment, that this helps many qualify for the loan, and that even if the penalty is triggered a year or two later, the real cost has been substantially offset by the savings in monthly payments due to the lower rate.

While the mortgage process is admittedly complex and there is always room for improved disclosure, we in industry find it to be inconceivable that critics' charges are correct that hundreds of thousands of non-prime loans were made last year without most borrowers realizing they have a prepayment penalty. We know that the primary reason so many of our borrowers elect to take the loan with the prepayment penalty is that one of

[29] In California, as in most states, the formula we use for a prepayment penalty is 6-months' interest on 80% of the original balance.

their main considerations is cash flow. They want to be able to keep their monthly payment as low as possible.[30]

Informing Borrowers About Prepayment Penalties

Nevertheless, as noted earlier, prepayment penalties, like many other loan terms, have the potential of being abusive when they are unusually long, unusually large and/or not properly explained to the borrower. We are required by law in our initial disclosures to a borrower to indicate whether or not the loan may bear a prepayment penalty. Likewise, we include a color brochure with our initial borrower disclosure package that contains an explanation of how prepayment penalties work. [31]

Our sales associates are trained to explain how the prepayment penalties work. And, as we continue to strive to improve our practices, we are engaging a nationally respected fair lending firm to, among other things, to test our branches and loan officers on the quality of their explanation of prepayment penalties. Finally, in our loan documents themselves, we do not bury the prepayment clause in the middle of the promissory note. Rather, we have a separate, prominently labeled form that covers the prepayment penalty. We have the borrower review and sign that form separately. [32]

Despite my confidence that New Century and other responsible lenders are handling prepayment penalties properly, we and our CFAL partners recognize that not all lenders or brokers do so. Therefore, we have called for additional federal legislative protections to ensure that borrowers are always given the choice of a loan with or without such a penalty and that the length and amount of the penalty be limited.

Making Loans That Benefit Borrowers

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[30] A typical borrower has two principal means of reducing his or her monthly payment. One is to pay more points up front to "buy down" the interest rate. This is in effect an upfront prepayment penalty. The borrower must either bring additional cash to the table or borrow additional sums to finance the additional up-front points. The alternative, and often more attractive choice, is to agree to accept a prepayment penalty. If a borrower believes he or she is likely to remain in the home and not refinance for 2 or 3 years, then for no cost the borrower can reduce his or her payment significantly by agreeing to a limited prepayment penalty.

[31] This disclosure explanation states: *Determine what prepayment option makes the most sense for you. Many borrowers elect to have a prepayment clause included in their loan agreement to obtain a lower interest rate. If you choose to have a prepayment clause in your loan, be sure you understand the length of time it will be in effect and how much it will cost to pay your loan off early. New Century Mortgage offers loans with and without prepayment options.*

[32] While we are always searching for ways to improve how we explain and disclose these potentially confusing concepts, on the whole we think we are doing a good job. Last year we originated over 128,000 loans with prepayment penalties. Our central complaint log shows that we currently have only 29 complaints related to prepayment penalty issues. Now, in my view, even one legitimate complaint is one too many, and you can be sure that we follow through on each one of those complaints to understand the potential causes. However, with such a low complaint rate I am comfortable concluding that there is nothing inherently or systemically wrong with the way we offer prepayment penalties.

Our policy is that each loan must benefit the borrower so we subject each loan to a reasonable benefit test prior to closing. In the case of cash-out refinance loans, we measure the cost of the loan, i.e., the points and fees being paid by the borrower, against the cash that the borrower is receiving back from the loan. The loan is not made unless the borrower is getting more cash out than they are paying in points and fees. With respect to rate and term refinances, we look at the monthly reduction in mortgage payment as a result of the refinance versus the points and fees paid on the loan. If the borrower cannot recoup the points and fees paid from the reduced mortgage payments within 48 months, then there is deemed to be no benefit to the borrower. In these situations, the underwriter is responsible for running the test and if it is determined that there is no such benefit, the file is escalated to an operations manager. The operations manager can look for ways to lower the costs to the borrower, which may involve reducing the interest rate or lowering the points and fees charged. If no reasonable benefit can be achieved, then the loan will be declined. In addition, there are situations where after the loan is closed, a borrower may complain, an investor may raise a question, or we may discover by our own audit of the file as part of a quality assurance review that some aspect of the loan needs to be revisited. In these situations, we often will pro-actively rewrite the loan to correct the problem or refund points and fees as appropriate.

Although New Century and other responsible lenders now apply borrower benefit tests before we make a loan, and document our determination, we do have a real concern over the fact that statutory or regulatory benefit tests vary and are in some cases quite unclear, making compliance uncertain. Such tests include wording such as "identifiable" benefit, "tangible net" benefit, or "borrower's interest" with little or no definition or limitation in most cases. CFAL believes that a uniform national benefit test should be enacted when Congress amends HOEPA, but we feel that it should be clearly defined and contain reasonable qualifications (such as requiring that any violation be "knowing or intentional") and that safe harbor examples be provided in the statute and implementing regulations.

Lending "Best Practices"

I also want to point out that, like other major non-prime lenders, we have a strong commitment to fair and ethical lending. Therefore, not only do we seek to comply fully with applicable and regulations, but we also frequently go beyond what the law requires with additional voluntary "best practices." Here are some of New Century's best practices that we adhere to in originating mortgage loans:

- We will not underwrite or purchase "high cost" loans as defined by the federal Home Ownership and Equity Protection Act (HOEPA"), or any loans defined as "high cost" under State or local law. [33]

[33] New Century Mortgage does not originate "high cost" loans due to the reputation risk and legal risk associated with initiating high cost loans. We, like most other companies, do not wish to have our reputation tarnished by being associated with loans that are perceived as being "high cost," which in turn

- We do not purchase or offer loans with balloon payments, negative amortization or mandatory arbitration clauses, abusive reverse mortgages, or with loan terms that trigger interest rate increases by borrower default.
- We do not make or purchase loans containing single premium credit insurance or debt cancellation products.
- We offer loans with and without prepayment penalty clauses.
- We do not originate loans that pay off zero interest rate mortgages provided by charities or government without 3rd party counseling for the borrower.
- We only approve loan applications where we have verified the borrower's ability to repay the loan.
- In evaluating applications, we confirm that our loan represents a reasonable benefit to the borrower.
- We do not solicit our loan portfolio within twelve months of loan origination.

Most CFAL members have similar practices and procedures, as do other leading companies.

Delinquency, Loss Mitigation and Foreclosure

New Century's overriding objective is to keep our customers in their homes should they encounter financial hardship. Two New Century employees specially trained to help customers in financial difficulty review every potential foreclosure. New Century makes every effort possible to provide payment alternatives, and we routinely refer borrowers to HUD-approved credit counselors. New Century also is currently establishing relationships with nationally recognized credit counseling organizations to help borrowers who want or need assistance. Equally as important, New Century does not offer financial incentives to employees based upon their foreclosure results. Our objective is to avoid foreclosure by exploring every option to keep customers in their homes.

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has for many become synonymous with "predatory." Additionally, the legal risk of originating high cost loans is enormous.

Under the federal HOEPA, penalties for even an unintentional violation include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Moreover, under this law, assignees and secondary market purchasers would likewise be liable for this unintentional violation of which they neither knew nor could have known. State and local laws, such as the original version of the Georgia Fair Lending Act and ordinances enacted in Oakland, California and elsewhere, contain even more draconian penalties.

The laws that have been enacted contain requirements for making so-called "high cost" loans are generally unclear and contain overly broad requirements. They lack any meaningful right to cure unintentional errors, provide severe penalties for violation of the law, and in many cases mandate unlimited assignee liability. For these reasons, most non-prime lenders have stopped making "high cost" loans and the secondary market for purchasing or securitizing them has virtually evaporated.

Contrary to the claims of some consumer advocates, our delinquency and foreclosure rates on our securitized pools of loans, like those of other leading companies, are quite respectable. Our average 13-month rolling 60-day delinquency rate is 9.82% for all loans and 13.31% for our seasoned loans (at least 6 months old). Most delinquent borrowers are able to become current in their payments and their delinquencies do not become foreclosures.

Our average foreclosure rate is around 5% - nowhere near the rates claimed by some consumer advocates.[34] The table attached as Appendix "F" shows the delinquency and foreclosure rates for loans originated in 2001, 2002, and 2003 broken out by FICO score bands. It clearly shows how delinquencies and foreclosures track by the credit standing of the borrower. This information is further evidence that responsible non-prime lenders can make reasonable loans that consumers are able to repay and thereby avoid foreclosure.[35] When a foreclosure occurs, we find that it most frequently is not due to some improper lending practice, but is due to an unexpected and adverse change in the borrower's personal circumstances. This scenario typically includes things such as the loss of employment or a serious illness. We try whenever possible to help borrowers weather such personal crises, but this is not always possible.

New Century has a Loss Mitigation Department whose job it is to turn delinquent loans into performing ones by pursuing available workout alternatives. This Department has the ability to work out mutually acceptable forbearance plans to help the borrower reinstate their loan. Candidates for workout proposals from the Loss Mitigation Department include delinquent loans, damaged properties, loans involving fraud or title issues, loans in foreclosure, delinquent Chapter 7 Bankruptcy discharges, and loans where the property is located in an area where a natural disaster has occurred. Acceptable reasons for default assistance include the following:

- Involuntary reduction of income;
- Unemployment of one or both spouses;
- Loss of overtime income;
- Decline of income for the self employed borrower;
- Incarceration of a spouse or co-borrower;

[34]This percentage represents those borrowers that enter the foreclosure process. The percentage of borrowers that actually have their properties foreclosed is much less. With the recent restart of our Loan Servicing Division, we have seen a definite trend in the improvement of roll rates as well as in cure rates. Foreclosures are also at a 13-month low on a dollar basis and are flat on a percentage basis. The percentage of 90+ day delinquencies that went bankrupt declined by almost 10% in 2003, as did the percentage of 90+ day delinquencies that went into foreclosure for the same period. As a result, the percentage of 90+ day delinquencies that became foreclosed mortgages (REO – "real estate owned") also declined. Additional information regarding our servicing practices is contained in Appendix "G."

[35] While responsible lenders like New Century are not engaging in lending practices that result in inappropriately high foreclosure rates, it should be pointed out that we understand that in some areas of the country there have been a number of cases of so-called "property flipping" where borrowers have been grossly overcharged for homes due to fraud by unethical appraisers, brokers, lenders and others. Congress should consider whether additional statutory protections are needed to address such property flipping fraud which often results in borrowers losing their homes in foreclosures.

- Permanent or temporary disability;
- Serious illness;
- Divorce or separation;
- Natural or man-made disasters;
- Non-paying renters in a multi-family situation;
- Increases in expenses;
- Unexpected expenditures for property maintenance; and
- Funeral expenses of a family member.

New Century's goal is to do everything possible to work with borrowers to make their loans current and keep them in their homes. We have no interest in foreclosing on properties since foreclosure results in significant losses to the Company, typically more than $40,000 on an average loan.[36]

CONCLUSION

As our testimony has documented, New Century and other major reputable lenders like its CFAL partners are meeting the mortgage credit needs of millions of Americans whose risk profiles prevent them from qualifying under the stricter

[36] In the event that foreclosure becomes necessary, there are a number of steps that must be taken before a loan can be submitted for foreclosure action. Although every state has its own foreclosure procedures that we follow, at a minimum, no foreclosure can be initiated without issuing a Notice of Intent to Foreclose ("NOI") and giving the borrower at least 30 days notice prior to commencing a foreclosure. Loss mitigation efforts as described above take place during this notification period. Loans are submitted for foreclosure review after the 30-day notice period expires, upon breach of a formal payment arrangement and the delivery of the NOI, or upon recommendation of the Collection Department and the delivery of the NOI letter. The Foreclosure Committee reviews loans that are submitted for foreclosure review. This Committee meets weekly and consists of managers from the Collection Department, Foreclosure Department, and the Loss Mitigation Department. The Foreclosure Committee reviews foreclosure referrals that fall into the following categories: (1) unpaid principal balance over $300,000; (2) random 2% of all referrals; (3) potential risk management referrals; and (4) first payment default referrals.

Foreclosure files are referred to our Risk Management Department for investigation and potential resolution when one or more of the following events occur:

- If the loan was originated through our Retail Division and the difference between the original value of the property and the foreclosure evaluation is greater than 20%;
- If the loan was originated through a mortgage broker and the difference between the original value of the property and the foreclosure evaluation is greater than 30%;
- The loss is over $60,000 (regardless of the percentage difference in the property value);
- The loan is originated by a broker whose loans repeatedly result in foreclosure/loss;
- The loan is the product of an apparent "flip scheme";
- The loan may not represent an "arm's-length transaction";
- The loan was originated to a borrower who has multiple loans in default; and
- First payment default loans.

Thus, every effort is made to address potential abuses before a foreclosure is initiated on a defaulted loan.

underwriting standards of the "prime" mortgage market.[37] We are carefully evaluating risks and seeking to make loans only to those who can repay them. We always try to ensure that the borrower receives a reasonable benefit from the loan, which we price as fairly as we can based on our evaluation of each applicant's risk profile. Only a very small percentage of our borrowers actually might qualify for "prime" rates. We never intentionally engage in or condone improper practices, but we make mistakes, we seek to correct them and make the borrower whole. Borrowers are not intentionally "targeted" on the basis of race, age or other improper discriminatory factors. The vast majority of all our borrowers receive loans that are only modestly more expensive than "prime" loan costs, and this is due in substantial part to the flow of reasonably priced capital from the secondary market and competition in the non-prime marketplace.

At the same time, we recognize that there are some bad lenders and brokers who take unfair advantage of borrowers. We accordingly support strengthening current federal law, as well as enhancing enforcement and consumer financial education opportunities. We also understand that the many state and local legislators who have stepped in to try to fill the gaps in the federal HOEPA law have been well intended. However, the irrational patchwork of state and local "anti-predatory lending" laws that is developing is not workable.

Uniform National Non-Prime Lending Standards Are Needed –

None of these laws is the same, and requirements vary greatly. Provisions are often arbitrary, unclear and totally impractical for lenders to implement.[38] Well intended, but poorly crafted state and local requirements are having unintended negative consequences for borrowers. As noted in OCC's 2003 paper:

"There is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans."[39]

Our earlier experience in Georgia is a good illustration of the problems lenders and borrowers experience due to well intended, but poorly drafted state or local laws. The

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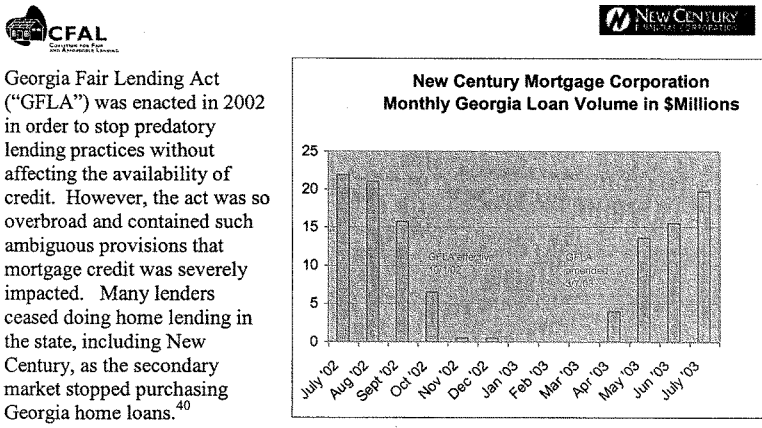
[37] We receive many communications from our borrowers expressing their appreciation for the services we provide to them. Appendix "I" contains several customer testimonials to illustrate this fact.

[38] All current and prospective homeowners, regardless of being prime or non-prime borrowers, should be given the opportunity to receive the best possible rate a lender offers based on their financial histories. As various states and cities enact predatory lending legislation, the legislation is impacting the rate and terms that borrowers receive. For example, the State of California has legislation that sets a standard for rates, points and fees throughout the state. Yet, the City of Oakland and the City of Los Angeles have proposed ordinances that will be more restrictive in terms of the interest rates, points and fees that can be charged in those municipalities. Thus, a resident of the City of Los Angeles may be denied access to credit under its proposed legislation but that same borrower who lives in a suburb outside of the Los Angeles city limits may be able to qualify for a loan because they will fall under the less restrictive state legislation. It seems inherently unfair that borrowers should have to deal with these inconsistencies and it makes it extremely difficult for lenders to operate in that patchwork of inconsistent laws and regulations.

[39] OCC report at p. 8.



Georgia Fair Lending Act ("GFLA") was enacted in 2002 in order to stop predatory lending practices without affecting the availability of credit. However, the act was so overbroad and contained such ambiguous provisions that mortgage credit was severely impacted. Many lenders ceased doing home lending in the state, including New Century, as the secondary market stopped purchasing Georgia home loans.[40]

This chart shows the impact on New Century's loan business in Georgia from shortly before the GFLA went into effect until shortly after the law was amended to correct its major deficiencies. We believe New Century's experience to be representative of the industry as a whole.

Although our Georgia business has rebounded somewhat, the sad fact is that there are still many higher risk Georgians who we cannot lend to because of the law even as it has been amended. Restrictions that still exist under Georgia law with regard to points, fees, prepayment penalties and other issues mean that many borrowers that can no longer qualify for a loan.

I also want to note that currently my company and most others are having to significantly limit the types of mortgage produces we offer in New Jersey due to that state's overly restrictive law. The "balkanization" of credit occasioned by such state and local laws simply leads to higher costs that are passed on to consumers, or to the reduction of products, and ultimately credit, to the detriment of those very consumers these "well intentioned" laws are designed to help.

When legitimate major lenders such as New Century are unable to operate under reasonable, consistent and predictable standards, business suffers. So, too, do consumers.

Today, nonprime lending is clearly a nationwide, interstate business that is highly dependent on the national capital markets in order to make affordable mortgages

[40] *Lawmakers Promise to Fix Predatory Lending Law* – Augusta Chronicle, January 23, 2003.

available to the millions of Americans who cannot qualify for conventional financing.[41] We need consistent, nationwide requirements to be able to continue providing access to credit effectively and efficiently. Most states also still have no effective borrower safeguards in place. Borrowers need protections not only from abusive lending practices, but also from differing, poorly crafted state and local laws that limit their access to affordable credit and force them to pay more.

New Century and CFAL therefore strongly support prompt Congressional action to provide clear, effective and workable uniform national fair lending standards for nonprime mortgage loans. These standards should provide equal protections for all Americans and apply to all mortgage originators, regardless of how they may be structured or chartered.

We also believe that state officials should have an active role along with federal authorities in enforcing these national standards.

Thank you for this opportunity to appear before your Subcommittees. New Century and its CFAL partners look forward to continuing to work with you and your colleagues, consumer and community groups, and all other interested parties to help craft a fair, effective and workable legislative measure that sets such national standards and that can be passed with broad bipartisan support.

[41] Since the advent of the secondary mortgage market, borrowers have been able to take advantage of longer terms and lower rates that are made possible by the free flow of capital. No longer are borrowers dependent on local financiers. No longer is the condition of the local economy a detriment to securing funding. Today, national and international funds from Wall Street are used to make the dream of homeownership a reality for millions of American families.

APPENDIX "A"

The Importance of the Secondary Market

The ability to secure access to capital is vital to the growth and prosperity of communities and families in our country. With access to capital, families are able to invest in a home, a college education or meet other financial goals. Additionally, a healthy stream of capital flowing through a community can contribute to the local economy in the form of jobs and services.

Since the 1930s, the federal government has been actively working to increase the amount of capital available in the marketplace through the creation of the secondary market. One of the primary objectives of the secondary mortgage market was to integrate local mortgage markets with national capital markets. Today, globalization has brought international capital into the secondary market, which translates into more financial resources for Americans. The secondary market allows banks, thrifts, mortgage companies and other lenders to sell their mortgage originations to investors through a process called mortgage securitization. The development of the secondary market has provided a free flow of capital for primary lenders. This has been recognized by Freddie Mac as having a significant impact on the pricing of loans as evidenced by the following quote:

***The supply of cash the secondary mortgage market makes available to lenders through the process drives down mortgage rates by as much as one-half percent – saving the homeowner with a $100,000 mortgage around $12,000 in interest over the life of a 30-year loan.** "Our Role Within the Secondary Market"* Freddie Mac 2004.

When New Century initially makes a mortgage loan, it draws the funds that it needs from a warehouse line of credit, which is a revolving credit facility designed for that purpose. New Century maintains the ownership of the mortgage loans that it makes for approximately 30-60 days during which time the mortgage loans are aggregated into pools which are sold into the secondary market. New Century sells all of its mortgage loan production into the secondary market in one of two ways: either by securitizing the mortgage loans; or by selling them in pools of whole loans to investors who, in turn, ultimately securitize them. So, eventually, virtually all of our mortgage loans are included in a securitization. New Century uses the proceeds of the sales of mortgage loans to repay the warehouse line of credit which it can then draw down on again to make more mortgage loans.

New Century makes "representations and warranties" to the banks who provide warehouse lines of credit, to the investors who purchase whole loans and to the investors in securitizations. Among the representations and warranties are those that are "loan-level". Loan-level representations and warranties are specific promises that New Century makes to its investors and bank lenders that mortgage loans being financed on warehouse lines of credit and sold to investors meet certain specifications. Included in typical loan-

level representations are requirements that each mortgage loan is valid, enforceable and was made in compliance with applicable laws and regulations. If any of the mortgage loans fails to meet these specifications, New Century is obligated to repay the bank or investor. Today, these representations and warranties also encompass whether or not the loans being securitized or sold are "high-cost"loans which New Century does not intentionally make and in some cases whether they are "covered" loans which may not be subject to being securitized or sold when made in certain states like New Jersey that have enacted overly restrictive predatory lending legislation.

As mentioned previously, New Century originates loans from one of two basic channels: wholesale and retail. Wholesale refers to mortgage loans, which were originated through a loan broker, and retail refers to mortgage loans funded directly by New Century through one of its own retail branches. Over 90% of New Century's mortgage loan production comes through the wholesale channel. That means that the consumer relationship is managed in large part by the mortgage loan broker whose job it is to find the best mortgage loan for their clients subject to our own standards for broker conduct.

In order to insure that we can comply with loan-level representations and warranties, New Century employs a number of systems and procedures. First, we monitor loan brokers for compliance with their broker agreement and we remove brokers from our approved list if we detect inappropriate behavior. Then, we have a quality control department that reviews samples of the mortgage loans that we produce both through the wholesale and retail channels. Our banks and our investors also conduct due diligence on our mortgage loans. Investors typically review a sample of loans before purchasing a whole loan pool. Finally, we have a quality assurance program which reviews mortgage loans which have been funded for problems and insures that our systems are appropriate.

In addition to these procedures, we have systems to detect potentially fraudulent mortgage loans. We are also subject to audits by state regulators who visit us and review loan files. All of our mortgage loans are produced by a loan origination computer system that generates loan documents and has logic built-in to prevent loans from being made which are not in compliance with applicable and our underwriting guidelines or which are not saleable.

All of these systems and procedures are designed to obtain a rating without onerous and uneconomical credit enhancement requirements from the rating agencies (Standard & Poors, Moody's and Fitch) so that our loans can be sold or securitized in the secondary market as investment grade securities. Consequently, when states impose overly restrictive requirements on the purchasers of these securities and seek to make them liable for any issues that may arise with respect to these loans, the rating agencies are unwilling to rate the securities, or rate them so poorly, making it impossible for lenders like New Century to access the secondary market in order to obtain the capital needed to continue to make mortgage loans. This type of broad or even unlimited "assignee liability" is detrimental to both non-prime lenders and consumers alike because

it defeats the overall goal of making credit available at lower rates for consumers. Georgia and New Jersey are real life examples of what can happen when access to capital dries up. In Georgia, many non-prime lenders stopped making all loans until their legislation was amended, and, in New Jersey, we have seen loan volume reduced by as much as 60% for important types of loans, particularly "cash-out refinance" loans.

As the Subcommittees consider legislation that will set a national standard for predatory lending, we urge you to not disrupt the flow of capital in the secondary market to responsible non-prime lenders like New Century by making standards with regard to assignee liability overly broad and restrictive.

APPENDIX "B"

Monitoring Broker Conduct

New Century is committed to setting the industry's highest code of conduct among the brokers with whom it does business. To work with New Century, brokers are required to consistently make loans that are fair and reasonable, and enable borrowers to equitably pursue their financial objectives. New Century's brokers must also conduct business in an ethical manner reflecting the company's values of professionalism, integrity, and outstanding service to all customers. New Century does not condone any broker practice that is predatory in nature and will terminate any broker who engages in such practices.

Brokers working with New Century must make a good faith effort to fully understand a borrower's needs and financial situation. Brokers must demonstrate that a loan has a reasonable benefit to borrowers, that borrowers clearly have the ability to repay the loan, and that the loan is not considered a "high cost" loan under federal, state and local laws. New Century will not purchase or fund any loan that includes potentially abusive loan terms such as single premium credit insurance premiums, balloon payments, negative amortization, unilateral loan call provisions absent default, mandatory arbitration clauses, or interest rate increases triggered by default. New Century also does not engage in equity stripping, flipping or packing, and expects the same of brokers.[42]

All New Century brokers must complete a qualification and certification process that includes background checks conducted by New Century's Broker Services Department and confirmed through a variety of independent sources. Our brokers are encouraged to take continuing broker education and training offered by New Century or other reputable education providers.

New Century also monitors brokers' loan production, complaints and lending data in order to confirm adherence to the Broker Code of Conduct. New Century will appropriately discipline brokers, including terminating our relationship, if they fail to comply with the company's Broker Code of Conduct. Terminated brokers may face a variety of civil and criminal penalties, and we may require brokers to repay the loan, forfeit fees, or take other action as deemed appropriate. New Century works closely with regulators to ensure the highest code of conduct among brokers.

We have cultivated a corporate environment that encourages fair and equitable treatment of all customers with regard to loan pricing, underwriting and servicing regardless of race, color, age, gender, marital status, disability, national origin or other prohibited basis. When negotiating the price or terms of a loan, brokers must treat all

[42] "Equity stripping" is typically considered to be the making of a series of loans with unjustifiably high costs to a borrower that results in the loss of equity and potentially the loss of the property. "Flipping" is the practice of refinancing existing loans within a short period of time when the borrower receives little or no benefit, and the lender charges unnecessary fees. "Packing" generally refers to the practice of including single premium credit insurance fees in a loan.

customers in a consistent manner. Brokers must be able to explain disclosure notices to each customer, be able to answer questions in a timely manner and respond quickly to customer concerns and issues by taking appropriate action to resolve them.

New Century brokers must make consumers aware of all applicable loan products to ensure that they understand their full range of options. Brokers may not engage in predatory marketing practices with any demographic group, including minority and elderly loan applicants. Broker advertising and marketing materials also must comply with federal, state and local laws.

APPENDIX "C"

CRITERIA COMPARISON TABLE

New Century Guidelines	Fannie Mae Guidelines	Source Verified By
1.Stated income, full documentation and limited documentation allowed	1. Full income documentation required.	Fannie Mae's Single Family Selling Guide/Underwriting Guidelines (www.fanniemae.com)
2. Maximum Loan Amount: $500,000 standard $750,000 jumbo	2. Maximum Loan Amount: $333,700 / Hawaii $500,550	Fannie Mae's Reference Tools & Information/ Loan Limits
3. Maximum Debt to Income Ratio: 50%	3. Maximum Debt to Income Ratio: 36% - but a higher ratio is sometimes allowed if certain factors are used to justify the higher ratio and this is documented. Maximum Debt to Income Ratio for Community Lending Mortgages: 38%.	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter X, Section 703: Benchmark Qualifying Ratio & Section 304: Underwriting Community Lending Mortgages
4. Minimum FICO Score: 500	4. Minimum FICO Score: 600	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter X, Section 301: Primary Risk Factors
5. Minimum FICO Score for loans with LTV over 90% is 580 and there are various programs available for borrowers with FICO scores between 580 and 640.	5. Minimum FICO Score for loans with LTV over 90%: 680	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter VII, Ch1, Exhibit 2: Enhanced Eligibility Criteria: Maximum Allowable Loan-to-Value Ratios for Fixed-Rate and Adjustable-Rate Mortgages (excluding special mortgage products)
6. Minimum FICO Score for self employed borrowers: 500	6. Minimum FICO Score for self employed borrowers: 740	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter VII, Ch1, Exhibit 2: Enhanced Eligibility Criteria: Maximum Allowable Loan-to-Value Ratios for Fixed-Rate and Adjustable-Rate Mortgages (excluding special mortgage products)
7. Minimum FICO score for investment properties: 500	7. Minimum FICO score for investment properties: 720	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter VII, Ch1, Exhibit 2: Enhanced Eligibility Criteria: Maximum Allowable Loan-to-Value

		Ratios for Fixed-Rate and Adjustable-Rate Mortgages (excluding special mortgage products)
8. Maximum LTV for investment properties: 90% LTV including cash out refinance	**8.** Maximum LTV for investment properties: 90% for Purchase Money and Limited Cash-Out Refinance; 85% for Cash-Out Refinance	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter VII, Ch1, Exhibit 2: Enhanced Eligibility Criteria: Maximum Allowable Loan-to-Value Ratios for Fixed-Rate and Adjustable-Rate Mortgages
9. Maximum Mortgage delinquencies 2x90 or 1x120 days late in the last 24 months	**9.** Maximum Mortgage delinquencies: 1x30 days late in the last 13 to 24 months preceding the date of the borrower's application	Fannie Mae's Single Family Selling Guide/Underwriting Guidelines Chapter X, Section 304.01: Credit History Based on Traditional Credit
10. Maximum Consumer credit delinquencies: open, with minimum FICO score of 500	**10.** Maximum Consumer credit delinquencies: 1x30 days late in the last 13 to 24 months preceding the date of the borrower's application	Fannie Mae's Underwriting Guide Chapter X, Section 304.01: Credit History Based on Traditional Credit
11. Chapter 7 Bankruptcy: Discharge - can be discharged at funding.	**11.** Chapter 7 Bankruptcy: Discharge must be at least 4 years from application date	Fannie Mae's Single Family Selling Guide/ Underwriting Guidelines/ Chapter X, Section 803.02: Payment History
12. Chapter 13 Bankruptcy: Discharge – can be discharged at funding.	**12.** Chapter 13 Bankruptcy: Discharge must be at least 2 years from application date	Fannie Mae's Single Family Selling Guide/Underwriting Guidelines, Chapter X, Section 803.02: Payment History

APPENDIX "D"
NEW CENTURY UNDERWRITING MATRIX AND RATE SHEET
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TRADITIONAL MATRIX

PARAMETERS	AA	A+	A	B	C	C-
Full Doc	95% LTV - $500,000 - FICO 697 90% LTV - $400,000 - FICO 697 90% LTV - $500,000 - FICO 720 85% LTV - $400,000 - FICO 645 80% LTV - $700,000	95% LTV - $500,000 - FICO 647 90% LTV - $400,000 - FICO 647 90% LTV - $500,000 - FICO 720 85% LTV - $400,000 - FICO 645 80% LTV - $700,000	90% LTV - $400,000 - FICO 640 85% LTV - $500,000 - FICO 720 80% LTV - $700,000	85% LTV - $300,000 - FICO 620 80% LTV - $400,000 75% LTV - $500,000 70% LTV - $600,000	80% LTV - $300,000 - FICO 550 70% LTV - $500,000 70% LTV - $400,000 65% LTV - $400,000 60% LTV - $500,000	60% LTV - $300,000 55% LTV - $400,000 50% LTV - $400,000 45% LTV - $400,000 40% LTV - $400,000
Limited Doc (12 Mo Personal Bank Statements)	95% LTV - $400,000 - FICO 637 90% LTV - $400,000 - FICO 649 85% LTV - $400,000 - FICO 646 80% LTV - $500,000	90% LTV - $400,000 - FICO 690 85% LTV - $400,000 - FICO 649 80% LTV - $500,000	85% LTV - $400,000 - FICO 628 80% LTV - $400,000 75% LTV - $500,000	80% LTV - $300,000 70% LTV - $400,000 70% LTV - $500,000	70% LTV - $300,000 70% LTV - $400,000 65% LTV - $400,000 60% LTV - $400,000	70% LTV - $300,000 65% LTV - $300,000 60% LTV - $400,000 55% LTV - $400,000
Stated Doc	95% LTV - $400,000 - FICO 697 90% LTV - $400,000 - FICO 680 85% LTV - $400,000 - FICO 695 80% LTV - $400,000 75% LTV - $400,000 70% LTV - $500,000	90% LTV - $400,000 - FICO 680 85% LTV - $400,000 - FICO 680 80% LTV - $400,000 - FICO 675 75% LTV - $400,000 70% LTV - $500,000	80% LTV - $400,000 - FICO 680 75% LTV - $400,000 70% LTV - $400,000 65% LTV - $500,000	75% LTV - $300,000 70% LTV - $300,000 65% LTV - $400,000 60% LTV - $400,000	70% LTV - $400,000 65% LTV - $300,000 60% LTV - $300,000 60% LTV - $400,000	55% LTV $300,000
LTV-CLTV Adjustments	Condo/Attached PUD -5% 2-4 units -5% Non Owner - 5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680	Condo/Attached PUD -5% 2-4 units -5% Non Owner -5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680	Condo/Attached PUD -5% 2-4 units -5% Non Owner - 5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680	Condo/Attached PUD -5% 2-4 units -5% Non Owner - 5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680	Condo/Attached PUD -5% 2-4 units -5% Non Owner - 5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680 (Non Owner - Refi Only)	Condo/Attached PUD -5% 2-4 units -5% Non Owner -5% FICO 680+ (Max Loan Amt $400K when LTV >80%) Non Owner - 10% FICO 680 (Non Owner - Refi Only)
Mortgage / Rental 12 month history	AA = 0 x 30	A+ = 1 x 30	3 x 30, no 60-days	Maximum 1 x 60	Maximum 1 x 90	Maximum 1 x 90 0 x 120
Consumer Credit	Credit score ≥ 620 (In AA Transitions are allowed down for the 680)	Credit score ≥ 580 (In A+ transitions are allowed down for the 680)	Credit score ≥ 500	Credit score ≥ 500	Credit score ≥ 500	Credit score ≥ 500
Rural/Unique	80% LTV Maximum 10% Reduced	80% LTV Maximum 10% Reduced	80% LTV Maximum 10% Reduced	70% LTV Maximum 10% Reduced	60% LTV Maximum 10% Reduced	Not Available
Max CLTV	100% CLTV-Max 80% LTV on 1st 95% CLTV-no restriction on 1st LTV Purchase or refinance	100% CLTV-Max 80% LTV on 1st 95% CLTV-no restriction on 1st LTV Purchase or refinance	100% CLTV-Max 80% LTV on 1st 95% CLTV-no restriction on 1st LTV Purchase or refinance	100% CLTV-Max 80% LTV on 1st 80% CLTV - No restriction on 1st LTV Purchase or refinance	95% Purchase 85% Refinance	85% Purchase 80% Refinance
Debt to Income Ratio at LTV	55% LTV 55% - 70% LTV	55% LTV 50% - 70% LTV	50% 50% - 70% LTV	50% 50% - 70% LTV	55%	55%
Bankruptcy	Ch 7 - 2 Yrs from Discharge Ch 13 - 2 Yrs from Discharge	Ch 7 - 2 Yrs from Discharge Ch 13 - 2 Yrs from Discharge	Ch 7 - 3 Yrs from Discharge Ch 13 - 2 Yrs from Filing & Discharged Prior to Funding	Ch 7 - 3 Yrs from Discharge Ch 13 - 18 Months from Filing & Prior to Discharge or Funding	Ch 7 - 3 Yrs from Discharge Ch 13 - 1 Yr from Filing & Prior to Discharge or Funding	Ch 7 - Discharged Ch 13 - Paid or Discharge or Funding
N.O.D. or Foreclosure	Minimum 3 years	Minimum 3 years	Minimum 5 years	Minimum 5 years	Minimum 10 months	No Current NOD
Liens	All liens affecting title must be satisfied subordinated per guidelines	All liens affecting title must be satisfied subordinated per guidelines	All liens affecting title must be satisfied subordinated per guidelines	All liens affecting title must be satisfied subordinated per guidelines	All liens affecting title must be satisfied subordinated per guidelines	All liens affecting title must be satisfied subordinated per guidelines

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TRADITIONAL MATRIX

GENERAL NOTES

Limited Doc

12 months, current consecutive, personal, one account bank statements including DBA to name address considered Limited Doc. No business bank statements allowed. The applicant(s) should be the only person on the account.

Stated Doc

Borrowers with additional 1099 income (realtors, consultants, etc.) or wage earners, are allowed on the stated income product.

Stated wage earners with LTVs greater than 90 or CLTVs over 95 require 2 months PITI S/S 90 days

Mortgage/Rental History

- 18-month mortgage history must be documented by credit report, VOM, VOR or 12 months cancelled checks. Rental history cannot be verified on credit report.
- Borrowers without previous mortgage or rental history are defined as:

1) 1st time homebuyers with no rental history (lived w/ relatives, etc)
2) Borrowers with free and clear homes that were last active over 12 months ago

These borrowers may be considered with the following restrictions:

1) 2+ AA trade lines and tops grade of A-
2) Absent of trade line requirement, max grade is C

Special programs may have different restrictions.

Consumer Credit

Trade line requirements, as noted on matrix, allow consumer credit only. Mortgage/VOR rating can not be counted toward required tradelines. One of the needed accounts must have at least 24 months history. Each of the accounts must be open/active and paid as agreed (date of last activity is used, not date last reported). A closed or zero balance account will be considered open/active if it was closed, or went zero balance within the last 24 months.

Rural/Unique Property

Maximum allowable acreage, 20 acres

MAX CLTV

Seller contributions toward closing costs are limited to 6% of the purchase price. Seller carry backs are allowed, 100% CLTV limits seller contributions to 3% and requires $1,000 minimum borrower funds for closing costs (when secondary financing is not in carry). 100% CLTV requires additional supporting value documentation. No Texas Home Equity on LTV/CLTV > 80%.

Second Homes

Second homes are treated as Owner Occupied up to a maximum LTV of 90%.

Bankruptcy

- Bankruptcies, Chapters 7 & 13, are seasoned from date of discharge, unless otherwise noted.
- A Bankruptcy Rating from the Trustee is required for any Chapter 13 Bankruptcy to be paid through close, or any Chapter 13 Bankruptcy discharged in the last 12 months. Rating is treated like a mortgage rating and the loan is graded accordingly

NOD or Foreclosure

Foreclosure seasoning is based on sale date or payoff date, and NOD seasoning date is based on the filing date

LTVs >90% generally do not allow any exceptions

Restrictions

NO MOBILE OR MANUFACTURED HOMES
NO FICO SCORES BELOW 500
Minimum loan amount for general products is $50,000. See special products for other minimums.
Not currently available to Correspondent.

Other

1 All Grades require 580 minimum FICO for loan amounts >$400,000

2 LTV's > 90% are subject to 1 MOR/Rental requirements as defined under Special Products notes section and 3 stated wage earners require 2 months PITI S&S 90 days (must be liquid)

3 Interest only option available on 2 and 3 year ARM. See rate sheet. Minimum FICO is 580 or minimum for program, whichever is greater. Interest only payment used for qualification. Interest Only not available for non-owner occupied properties. Not available on loans where only source of income is "fixed" income. Not available in AK, FL, LA, ME, NH, PA, TX, VA, VT, WI, WV. Not currently available to Correspondent.

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page 2

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2 YR. ARM @ PAR — FULL DOC

Mortgage Lates (last 12 months)	Credit Score*	65%	70%	75%	80%	85%	90%	95%
AA	680 +	4.500	4.625	4.700	4.750	5.000	5.200	5.750
0x30	660-679	4.700	4.750	4.850	4.900	5.100	5.300	5.900
No BK Last 24 months	640-659	4.850	4.850	4.900	5.000	5.200	5.400	6.000
	620-639	4.950	4.950	5.000	5.100	5.300	5.500	6.100
	600-619	5.050	5.050	5.100	5.200	5.400	5.600	6.350
No NOD Last 36 months	580-599	5.150	5.150	5.300	5.400	5.500	5.750	6.850
	550-579	5.500	5.600	5.700	5.800	6.000	6.650	
	525-549	6.100	6.100	6.300	6.400	6.600		
Margin: 6.30	500-524	6.650	6.650	6.850	6.950			
A+	680 +	4.600	4.725	4.800	4.850	5.100	5.300	5.850
1x30	660-679	4.800	4.850	4.900	5.000	5.200	5.400	6.000
No BK Last 24 months	640-659	4.900	4.900	4.950	5.050	5.250	5.450	6.050
	620-639	5.000	5.000	5.050	5.150	5.350	5.550	6.150
	600-619	5.100	5.100	5.150	5.250	5.450	5.750	6.400
No NOD Last 36 months	580-599	5.200	5.200	5.300	5.400	5.600	6.250	
	550-579	5.700	5.700	5.800	5.900	6.100	6.750	
	525-549	6.350	6.350	6.550	6.550	6.750		
Margin: 5.80	500-524	6.850	6.850	6.950	7.050			
A-	680 +	4.700	4.825	4.900	4.950	5.200	5.400	
2x30	660-679	4.850	4.900	4.950	5.050	5.250	5.450	
No BK Last 24 months	640-659	4.900	4.950	5.000	5.100	5.300	5.500	
	620-639	5.000	5.050	5.100	5.200	5.400	5.800	
	600-619	5.100	5.150	5.200	5.300	5.500	5.900	
No NOD Last 36 months	580-599	5.300	5.350	5.650	5.650	5.850	6.400	
	550-579	5.900	5.850	6.050	6.150	6.350	6.900	
	525-549	6.350	6.400	6.600	6.700	6.900		
Margin: 5.70	500-524	6.850	6.900	7.150	7.200			
B	680 +	5.100	5.275	5.400	5.450	6.200		
1x60	660-679	5.300	5.400	5.500	5.800	6.350		
No BK Last 18 months	640-659	5.400	5.500	5.600	5.700	6.400		
	620-639	5.550	5.600	5.700	5.800	6.500		
	600-619	5.700	5.800	5.900	6.000	6.600		
No NOD Last 24 months	580-599	6.150	6.250	6.350	6.450	6.850		
	550-579	6.850	6.750	6.850	6.950	7.150		
	525-549	6.800	6.900	7.000	7.100	7.500		
Margin: 6.95	500-524	7.300	7.400	7.500	7.600			
C	680 +	5.800	6.000	6.200	6.700			
1x90	660-679	5.900	6.100	6.300	6.800			
No BK/NOD Last 12 months	640-659	6.000	6.200	6.400	6.900			
	620-639	6.150	6.350	6.500	7.050			
	600-619	6.300	6.500	6.700	7.200			
	580-599	6.500	6.700	6.900	7.400			
	550-579	6.750	6.950	7.150	7.850			
	525-549	7.000	7.200	7.400				
Margin: 6.70	500-524	7.350	7.550	7.750				
C-	680 +	8.300	8.500					
2x90	660-679	8.400	8.600					
1x120	640-659	8.500	8.700					
	620-639	8.600	8.800					
	600-619	8.700	8.900					
	580-599	8.800	9.000					
	550-579	9.050	9.250					
	525-549	9.300	9.500					
Margin: 7.00	500-524	9.550	9.750					
	Max DTI:	55%	55%	50%	50%	50%	50%	50%

2 YR. ARM @ PAR — STATED DOC

Mortgage Lates (last 12 months)	Credit Score*	65%	70%	75%	80%	85%	90%	95%
AA	680 +	5.400	5.525	5.600	5.650	5.900	6.100	6.550
0x30	660-679	5.600	5.650	5.700	5.800	6.000	6.200	6.800
No BK Last 24 months	640-659	5.750	5.750	5.800	5.900	6.100	6.300	6.900
	620-639	5.850	5.850	5.900	6.000	6.200	6.400	7.000
	600-619	5.950	5.950	6.000	6.100	6.300	7.000	
No NOD Last 36 months	580-599	6.050	6.050	6.200	6.300	6.400	7.650	
	550-579	6.450	6.400	6.600	6.700	6.900		
	525-549	7.000	7.000	7.200	7.300	8.000		
Margin: 6.55	500-524	7.550	7.550	7.750	7.850			
A+	680 +	5.500	5.625	5.700	5.750	6.000	6.200	
1x30	660-679	5.700	5.750	5.800	5.900	6.100	6.300	
No BK Last 24 months	640-659	5.800	5.800	5.850	5.950	6.150	6.350	
	620-639	5.900	5.900	5.950	6.050	6.250	6.450	
	600-619	6.000	6.000	6.050	6.150	6.350		
No NOD Last 36 months	580-599	6.100	6.100	6.200	6.300	7.000		
	550-579	6.600	6.600	6.700	6.800	7.500		
	525-549	7.450	7.450	7.650	7.650			
Margin: 5.80	500-524	8.150	8.150	8.250	8.250			
A-	680 +	5.600	5.725	5.800	5.850			
2x30	660-679	5.750	5.800	5.850	5.950			
No BK Last 24 months	640-659	5.850	5.850	5.900	6.000			
	620-639	5.900	5.950	6.000	6.100			
	600-619	6.000	6.050	6.100	6.200			
No NOD Last 36 months	580-599	6.200	6.250	6.450	6.550			
	550-579	6.700	6.750	6.950	7.050			
	525-549	7.450	7.500	7.700	7.800			
Margin: 6.00	500-524	8.150	8.200	8.400				
B	680 +	6.000	6.175	6.300				
1x60	660-679	6.200	6.300	6.400				
No BK Last 18 months	640-659	6.200	6.400	6.500				
	620-639	6.400	6.500	6.600				
	600-619	6.600	6.700	6.800				
No NOD Last 24 months	580-599	7.050	7.150	7.250				
	550-579	7.550	7.650	7.750				
	525-549	7.700	7.800	7.900				
Margin: 6.45	500-524	8.200	8.300	8.400				
C	680 +	6.700	6.900					
1x90	660-679	6.800	7.000					
No BK/NOD Last 12 months	640-659	6.900	7.100					
	620-639	7.050	7.250					
	600-619	7.200	7.400					
	580-599	7.400	7.600					
	550-579	7.650	7.850					
	525-549	7.900	8.100					
Margin: 6.70	500-524	8.250	8.450					
	Max DTI:	55%	55%	50%	50%	50%	50%	50%

Adjustments To Rate	+/- Rate
LOAN SIZE	
Loan Amounts	
$250,000 - $500,000	-0.25
$50,000 - $99,999	+0.25
INCOME TYPES	
Limited Doc (Bank Statements)	+0.25
PROPERTY TYPES	
NOO	+0.75
2nd Home	+0.50
Rural	+0.50
3-4 Units	+0.50
Condo	+0.25
YSP (flat mortgages only)	
0.50 point YSP	+0.25
1 point YSP	+0.50
1.50 point YSP	+0.875
2 point YSP	+1.25
1 point Buydown	-0.50
PREPAYMENT PENALTY*	
3-yr prop term (excludes w/3 yrs Prepay)	+0.25
1-yr prop term (all products)	+0.25
Waive Pre-pay Penalty	+1.00
PROGRAM	
3 Year ARM	+0.25
30 Year Fixed	+1.00
20 Year Fixed	+1.00
15 Year Fixed	+0.75
Interest Only Adjustment	+0.25
MINIMUM PRODUCT RATES	
ARMs	4.50%
Fixed	5.50%
Note: The minimum product start rate = the floor rate	
TERMS AND CONDITIONS	
Max deductions are subject to program maximum product rates	
Max YSP = 1 pt. if no pre-pay	

*Prepay allowed by law
*Based on Ability of Borrowers (Fitch level 2)

FOR WHOLESALE USE ONLY. NOT FOR DISTRIBUTION TO THE GENERAL PUBLIC. NEW CENTURY DOES NOT MAKE "FRESH CREDIT HOME LOANS" AS DEFINED IN NOTE AND SECTION 32 OF REGULATION Z. TERMS AND PRICING SUBJECT TO CHANGE WITHOUT NOTICE. ADMINISTRATIVE FEES, PROGRAMS, TIGHT RATE PROGRAMS, NO-PAYMENT PENALTIES AND APPLICABLE FEES APPLY ACCORDING TO INDIVIDUAL STATE SPECIFIC RULES AND REGULATIONS

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APPENDIX "E"

BROKER COMPENSATION

Set forth below is a table showing average broker compensation, along with points and fees charged[43], on loans made through our Wholesale Division in the year 2003. Since the Retail Division does not utilize the services of mortgage loan brokers, its loans are not included in this table.

These are the average points and fees paid to New Century:

Average Loan	Average Points	Average Fees	Total	Percent
$166,590	$660	$518	$1,177	0.71%

These are the average points and fees paid to the broker:

Average Loan	Average Points	Average Fees	Average YSP	Total	Percent
$166,590	$2,389	$576	$1,558	$4,523	2.72%

On average, then, our wholesale borrower will pay $4,143, or 2.49% in total points and fees. This is substantially lower than the 10% to 4%, or higher, amounts that some often cite as the amount of points and fees paid in non-prime loan transactions.

Under the Home Ownership and Equity Protection Act (HOEPA), yield spread premiums (YSP) are not included in the definition of points and fees for calculating the maximum amount of points and fees that may be charged before triggering coverage under the law. See FRB Commentary to Paragraph 32(b)(1)(ii). Under the New Jersey Home Security Act, NJSA 46:10B-101, they are included. In Colorado, by comparison, they are not. See CRS 5-3.5-101. And to further confuse matters, in California, it is not clear whether they are included. See CA Financial Code Section 4970.

These inconsistencies between the state and federal law need to be resolved through the adoption of a uniform standard.

[43] Excludes third party fees, such as appraisal, title and public official fees.

CFAL

NEW CENTURY

APPENDIX "F"

NEW CENTURY DELINQUENCY AND FORECLOSURE RATES FOR 2001, 2002 AND 2003

	2001		2002		2003		Grand Total	
30	$	%	$	%	$	%	$	%
<500	$171,498	33.08%	$0	0.00%	$0	0.00%	$171,498	25.40%
500-539	$5,853,007	6.17%	$5,146,579	3.60%	$9,479,464	1.61%	$20,479,051	2.48%
540-579	$4,602,932	5.47%	$4,186,855	2.87%	$4,543,509	0.70%	$13,333,296	1.52%
580-619	$2,535,809	3.53%	$2,194,651	1.58%	$2,982,799	0.39%	$7,713,258	0.79%
620-659	$1,622,543	3.20%	$2,414,828	1.93%	$3,791,354	0.40%	$7,828,724	0.70%
660-699	$387,892	1.84%	$1,354,218	2.36%	$832,102	0.13%	$2,574,212	0.35%
700+	$0	0.00%	$197,465	0.46%	$0	0.00%	$197,465	0.03%
Grand Total	$15,173,681	4.50%	$15,494,596	2.37%	$21,629,227	0.50%	$52,297,504	0.99%

	2001		2002		2003		Grand Total	
60	$	%	$	%	$	%	$	%
<500	$0	0.00%	$0	0.00%	$0	0.00%	$0	0.00%
500-539	$3,899,631	4.11%	$2,989,337	2.09%	$5,219,880	0.89%	$12,108,848	1.47%
540-579	$2,514,837	2.99%	$2,697,430	1.85%	$1,924,885	0.30%	$7,137,152	0.82%
580-619	$2,151,257	2.99%	$842,401	0.61%	$1,979,402	0.26%	$4,973,060	0.51%
620-659	$978,694	1.93%	$1,124,918	0.90%	$2,253,919	0.24%	$4,357,532	0.39%
660-699	$125,819	0.60%	$349,303	0.61%	$313,911	0.05%	$789,033	0.11%
700+	$0	0.00%	$121,214	0.29%	$541,762	0.08%	$662,976	0.09%
Grand Total	$9,670,239	2.87%	$8,124,602	1.25%	$12,233,760	0.29%	$30,028,600	0.57%

	2001		2002		2003		Grand Total	
90	$	%	$	%	$	%	$	%
<500	$178,136	34.36%	$0	0.00%	$0	0.00%	$178,136	26.38%
500-539	$25,457,216	26.82%	$17,747,439	12.42%	$4,342,064	0.74%	$47,546,720	5.76%
540-579	$18,543,762	22.02%	$13,353,321	9.15%	$3,062,791	0.47%	$34,959,874	3.99%
580-619	$13,892,179	19.32%	$8,251,161	5.96%	$1,555,045	0.20%	$23,698,386	2.43%
620-659	$5,160,404	10.19%	$4,435,112	3.55%	$830,157	0.09%	$10,425,673	0.94%
660-699	$905,715	4.31%	$548,635	0.96%	$1,160,685	0.18%	$2,615,035	0.35%
700+	$718,042	5.26%	$441,943	1.04%	$407,082	0.06%	$1,567,066	0.21%
Grand Total	$64,855,454	19.25%	$44,777,611	6.86%	$11,357,825	0.27%	$120,990,890	2.29%

	2001		2002		2003		Grand Total	
FC	$	%	$	%	$	%	$	%
<500	$0	0.00%	$0	0.00%	$0	0.00%	$0	0.00%
500-539	$6,706,585	7.07%	$11,196,904	7.83%	$7,390,866	1.26%	$25,294,356	3.07%
540-579	$5,567,517	6.61%	$7,117,812	4.88%	$4,265,026	0.66%	$16,950,354	1.94%
580-619	$5,032,973	7.00%	$4,982,422	3.60%	$2,592,541	0.34%	$12,607,936	1.29%
620-659	$2,759,962	5.45%	$3,553,085	2.84%	$1,688,794	0.18%	$8,001,840	0.72%
660-699	$356,078	1.69%	$566,464	0.99%	$927,227	0.14%	$1,849,769	0.25%
700+	$638,163	4.67%	$563,157	1.33%	$948,843	0.14%	$2,150,163	0.29%
Grand Total	$21,061,278	6.25%	$27,979,844	4.29%	$17,813,297	0.42%	$66,854,418	1.27%

APPENDIX "G"

Loan Servicing

New Century is committed to offering fast, convenient, customer-friendly service that meets our customer's needs on their terms. We offer customer assistance by telephone, as well as online help through our website, www.newcenturymortgage.com. Our customer service representatives are available 8:30 a.m. – 5:30 p.m. Pacific Time, Monday through Friday, at 1-800-561-4567 and speak both English and Spanish.

We offer a variety of services at no cost as part of our ongoing commitment to our customers. These services include the following:

- Impound account set up or cancellation;
- Payoff Requests;
- Payment History;
- Requests for copies of loan documents;
- Requests for copies of the property appraisal;
- Year-End Statements; and
- Faxing Documents

New Century seeks to maintain its high levels of customer service by regularly conducting customer satisfaction surveys and mystery shopping to evaluate our performance. Our quality assurance programs regularly monitor calls and correspondence to ensure they meet our high standards of integrity and professionalism. Our Customer Service Leadership Team oversees all aspects of our customer service. We welcome thoughts and suggestions about how we can improve our service.

New Century understands that not all customer service issues are the same. For particularly complex issues, we have a specially trained Customer Advocacy Group that will take care to resolve an issue that requires extra attention.

To provide customers with the highest level of customer service, New Century devotes significant resources to training. Before our associates can begin working with customers, they are enrolled in 40 hours of training that emphasizes our corporate values of conducting business with the highest levels of professionalism and integrity. Each employee in the servicing department must understand our Servicing Practices. Our collectors are trained to strictly follow all laws and regulations governing fair debt collection practices and procedures. They also are extensively trained to assist customers if they are faced with problems managing their mortgage debt. All new associates are also given additional one-on-one coaching and cross-training courses covering other service and compliance issues. During their first year, most associates complete an additional 20 to 30 hours of training and take some of the 40 courses we provide to employees. Training courses are regularly updated to reflect changes in regulatory and compliance issues, as well as changes in our policies and procedures.

APPENDIX "H'

New Century's Commitment To Financial Education And Affordable Housing Initiatives

In the last forty years, we have witnessed a tremendous amount of growth in the financial services industry. The development of a wide range of products and services offered in the marketplace has created a complex environment that calls for a more sophisticated borrower. While a generation ago a simple understanding of how to balance a check book was sufficient, today, it is imperative that consumers possess a fundamental understanding of how to navigate through the endless choices of products and services.

To meet the need for increased literacy in the marketplace, financial education programs have been established around the country. As one of the nation's largest non-prime mortgage lenders, New Century understands that a lack of financial education is one of the primary obstacles to obtaining a mortgage and owning a home. Borrowers are often intimidated by the mortgage lending process or are discouraged from applying for a loan because of their previous credit history. To eliminate these barriers, we have taken internal and external steps to bring financial education to consumers. Internally, our Emerging Markets Department is developing a project whose objective will be to educate consumers about what it takes to be able to own a home and help them achieve their goal of homeownership. Our external initiatives include sponsorship of both national and local programs geared toward educating consumers on credit, mortgage lending, and home ownership.

Below you will find a list of a few of the consumer and financial education programs New Century has and continues to support.

- **New Century Brochures.** Since 2001, New Century has published informational brochures that help borrowers evaluate loan terms, understand the mortgage refinancing process and find a HUD-approved housing counseling agency. The brochures also include information on the New Century Fair Lending Hotline for prospective borrowers. Borrowers who visit **www.newcenturymortgage.com** have access to Loan University, which provides a tutorial for the mortgage applications process.

- **CHCI National Housing Initiative.** The NHI is aimed at addressing the lagging Hispanic homeownership rate and helping more Latino families achieve the American dream of owning their own home. The effort will target 63 Congressional districts – in 11 states and the Commonwealth of Puerto Rico – where Latinos comprise at least 25 percent of the population.

- **CBCF With Ownership Wealth (WOW) Housing Initiative.** New Century is a national supporter and advisory committee member of the Congressional Black

Caucus Foundation's CBCF WOW Initiative. The goal of the WOW Initiative is to help prepare African-Americans and other minorities to buy and keep homes of their own, so they can build intergenerational wealth. Each local WOW program directs consumers to sources of tangible assistance - education, credit counseling, down payment resources, etc.- and stays with them as they move toward their goal of becoming homeowners.

- **Borrowsmart Public Education Foundation.** The Foundation's mission is to educate homeowners about the home equity borrowing process, prevent abusive lending practices, inform borrowers of their rights and responsibilities, and show consumers how to get help if they encounter financial trouble. New Century has been a sponsor of Borrowsmart since February 2002. For more information, visit www.borrowsmart.org .

- **Los Angeles and Chicago Neighborhood Housing Services (NHS).** The NHS programs help troubled borrowers keep their homes and provides pre- and post-homeownership counseling to low-to moderate-income families, among other things

- **"America Saves"** National **Savings Education Program.** In 2004, New Century became an underwriter of the AmericaSaves quarterly newsletter produced by the Consumer Federation of America. America Saves is a nationwide campaign in which a broad coalition of nonprofit, corporate, and government groups helps individuals and families save and build wealth. Through information, advice, and encouragement, America Saves assist those who wish to pay down debt, build an emergency fund, save for a home, save for an education, or save for retirement

- **Detroit Financial Literacy Consortium.** The Consortium is a group of community leaders representing the school district, financial service organizations, businesses and community organizations coming together to provide a comprehensive strategy for economic literacy education in Detroit. The Consortium will act as a clearinghouse for coordinating and publicizing the existing resources available to promote financial literacy and economic empowerment.

Suffice it to say that New Century is committed to supporting financial literacy education for consumers and looks for substantial ways that we can give back to the communities we lend to so that more consumers can enjoy the benefits of homeownership. We continue to be opposed to predatory lending practices in any form and we will continue to be strong supporters of education and enforcement initiatives, as well as strengthening existing federal laws, that help stamp out these practices. Predatory lenders give our industry a bad name and we support them being driven from the marketplace through the implementation of strong, reasonable national standards.

APPENDIX "I'

Customer Testimonials

For the past 16 years, Rhonda O. has been a Los Angeles probation officer, working with juvenile offenders seeking to make a fresh start on life. Always quick to help others, Rhonda's big heart almost cost her an opportunity to own her own home and build wealth. After buying a home with her husband on the block where she grew up, Rhonda's marriage ended. As she was starting over, Rhonda wound up with consumer debt from five credit cards and the responsibility of supporting her young daughter.

To secure her home, Rhonda needed a mortgage to buy out her former husband's portion of the house. She also wanted to pay off the credit card debt and knew that because rates had fallen since she got her first loan in 1999, she might get a better term. The only problem with that plan was that several years earlier, Rhonda had co-signed for a loan for a friend, whose home fell into foreclosure on more than one occasion. Foreclosures stay on a consumer's credit report for as long as 10 years and make it almost impossible to get a loan.

"I knew that the foreclosure was on my record. It was always on my mind," Rhonda said. "Because the foreclosure was still on my credit report, I wasn't sure that I was going to be able to get a loan."

After securing a mortgage loan through a broker approved by New Century, Rhonda went from an 11 percent loan to 7.75 percent fixed-rate loan for 30 years. Even after taking out more than $30,000 to pay off her credit card bills, her payment remained the same as her previous loan amount because she was able to secure a far better rate.

"Having all that debt was horrible, to stay the least," Rhonda said. "I already had a mound of debt from when I was married and I also have a small girl who goes to private school. People were calling me about the debt. I had to find a way to get all of those monkeys off my back. Words can't express what a relief it was to get that loan. "

Rhonda believes the house she purchased five years ago for $139,000 is now worth at least $250,000. "My whole financial perspective is bright, extremely bright, thanks to my broker and New Century. I'm able to save money. I don't have to cringe at the first of every month when my daughter's tuition bill comes."

Now that she is in full charge of her financial future, Rhonda's plan is to refinance her home if rates fall, pull money out, and buy another house as an investment property. "We are living the American dream. For the average person, real estate is all there is."

Rhonda O. represents just one of millions of homeowners across the country who have benefited from receiving a nonprime loan. Frequently, those consumers who were able to purchase a home, finance a college education, consolidate credit card debt and make

home improvements as a result of securing a nonprime loan are overlooked in the policy debate over predatory lending legislation.

In the haste to address the unscrupulous actions of a relatively small proportion of lenders and brokers in the nonprime market, testimonials of consumers who have been victimized are highlighted while Rhonda's story and millions of other stories similar to hers are forgotten.

To highlight the significant impact that nonprime loans have made in the lives of those consumers who do not qualify for prime loans, we have provided excerpts from New Century borrower testimonials. These testimonials represent a few.

Herculano T.

Now I am very happy. Smiling all the time no worries. I feel like I am on top of the world again. You really made a big difference.

Dee E.

We are starting on restructuring the kitchen on Feb. 7, and with the money, we will have more left to get new carpet for the dining room and the living room and new chairs for the dining table. Thanks!

Valerie S.

I wanted to express my sincere thanks and gratitude to you for all your help during my refinance/loan process with New Century Mortgage. I am particularly pleased with the fact that, throughout the tedious process, I never once felt as if I were any less of a person simply because my credit was in disarray. You treated me with respect, and you showed an exemplary level of patience throughout the long process. A blemished credit history isn't exactly a point of pride, yet you encouraged me and continued to offer suggestions as to how I could improve my credit rating, especially during this critical two-year period prior to possible refinancing of this new loan.

Cliff and Maria H.

Maria and I would like to thank you for all the advice and assistance you provided to us in our attempt to refinance our mortgage. I know that putting this loan together and getting us through the process took a considerable amount of your time and energy. Although the process took sometime and willingness to work with us and to clearly explain the process each step of the way went a long ways towards alleviating some of the fears and/or anxieties often associated with refinancing a loan as complicated as ours.

Michelle L.

This letter is to inform you that I am so happy with New Century!!! Shane at the Summerlin office was absolutely wonderful and helped me SO much it was incredible. I am more than happy with him, hid personality and his professionalism. Beyond that I am

in awe of the information and the general knowledge that New Century has readily available to new loan purchasers about payment options etc.

Robert O.

You have handled yourself in a courteous, businesslike, professional and friendly manner at all times. You've kept this process simple for us to understand. You are an asset and great representative for your employer, and we won't hesitate to recommend you and your company to others. Things were getting pretty gray for us, you've helped us start turning that color around. You've shown us that there could be a light at the end of the tunnel and it isn't a train.

Written Testimony By Anthony M. Yezer
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U.S. House of Representatives
Committee on Financial Services
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
March 30, 2004

Mr. Chairman and members of the Committee, thank you for this opportunity to discuss what economic research has been able to determine about the role and function of the market for subprime mortgage credit. I have done research on high-risk lending for over 25 years, beginning with my work as for the Federal Trade Commission as an external consulting evaluating the economic effects of the Credit Practices Rule. Most recently, I have, along with Michael Staten who is also testifying here, edited the papers for two special issues of the *Journal of Real Estate Finance and Economics* on the topic of subprime lending. These issues, which are forthcoming, reflect the current thinking of economists on the topic. My remarks here will be based in large part on the most significant findings in these papers. However, much remains to be learned and I believe it is important to point that our also. I understand that you are particularly interested in the characteristics of services provided in this market and the households making use of subprime mortgage credit and I will try to address these issues in some detail.

Current definition and measurement of the market

A first task is definition of what is meant by prime versus subprime mortgage lending and methods that are used to measure the volume and characteristics of lending. For purposes of this discussion, subprime mortgages will be those first mortgages priced (exclusive of mortgage insurance) 125 or more basis points above the prevailing prime or "A" rate at the time of commitment or endorsement. Most mortgages are prime, and are priced at a relatively invariant rate plus a mortgage insurance premium that depends only on the downpayment rate.

We currently have no measure of the amount of subprime lending in the U.S.. Accordingly, one can dismiss many studies of subprime lending on account of their data deficiencies alone. The Home Mortgage Disclosure Act (HMDA) is the most common source of information on subprime lending. This legislation, initially intended to monitor behavior of larger depository institutions, has been extended to include reporting requirements for some mortgage bankers. As more reporters have been added, the number of lenders whose mortgage products are classified as subprime has grown. Thus HMDA data gives the false impression of explosive growth in subprime lending based on expansion of the sample frame. Extension of HMDA reporting to more, and particularly smaller, reporters is problematic from another perspective. Given that HMDA reports the year, census tract, mortgage amount, and mortgagee and that local property report the transaction year, property

address, price, mortgagee, and name of the owner, it is possible to identify the precise individual whose mortgage appears in HMDA data unless a lender is very active in a particular census tract. I have done this matching in my own research and found that I can identify up to 60% of mortgagors. Put another way, there is no privacy protection in HMDA data for those whose mortgagee was an very active lender in the area!

Other sources of information on subprime lending come from records of cooperating lenders, securitized mortgages, and similar selected samples. None of these pretend to be a census of subprime lending and all give a selected slice of the market.

I am not suggesting that HMDA data or selected samples from a subset of subprime lenders cannot be useful in economic research. We can test the application of economic models in such limited samples. However, these sources are not adequate to track the extent and character of subprime lending overall.

In conclusion, current data sets are a selected subsample of subprime lending. Projections from these data sets to the entire market, particularly growth rates of overall subprime lending, should not be taken seriously. Studies that have been done, both inside and outside government, on the presumption that HMDA or other data represented subprime lending should be dismissed. Second, someone should consider the privacy issues inherent in HMDA data, particularly when the sample is extended to cover smaller lenders. I suspect that members of Congress and the general public would not be happy to learn that it is possible to match their individual names with the information revealed in HMDA records!

Proposed definition and measurement of the market

I have no quarrel with the current definition of subprime lending as far as it goes. However, our discussions would advance if we were to disaggregate the subprime market further. Most of these definitional issues will arise naturally in subsequent points. One obvious issue is the separate treatment of manufactured housing from other subprime lending. Another division is low documentation or no documentation lending.

Measurement of the market will require a different approach. Fortunately property records contain information on mortgagees and mortgagors as well as transactions prices and property location. My own research has indicated that a significant percentage of the mortgagees are NOT HMDA reporters. Indeed, they appear to be either individuals or very small private lenders. As will be clear in subsequent discussion, I am both curious and suspicious of this segment of the mortgage market. A random sample of mortgages endorsed in a given year taken from property records could then be matched with other records, particular credit history, using the name of the mortgagor. The records could then be depersonalized and location aggregated before they were used in any analysis. The data obtained in this process, would not only provide an unbiased sample of subprime lending, it would also enable one to disaggregate the lending by type and by characteristics of the borrower, including credit history.

In conclusion, I believe that it is possible to assemble a data set appropriate for analysis of trends

and developments in overall subprime lending as well as various submarkets using the new approach based on property records.

Many features of the subprime market indicate that it works well

Many features of the subprime mortgage market, insofar as we can observe them based on data limitations, appear in good agreement with simple models of an efficient credit market. First, the market provides a variety of products, including "no documentation" loans, to appeal to borrower preferences. Second, credit risk is priced in the subprime market. Borrowers with lower credit scores pay more for credit. If anything, the problem of inefficiencies and inequities due to failure to price credit risk occurs in the prime market where borrowers with credit scores (such as the standard FICO score) 100 points apart are charged the same price. Third, the separation of borrowers into prime and subprime loans appears to be based on risk categories. Fourth, delinquency and default rates are higher for subprime loans. Fifth, the subprime market appears to be competitive there are many lenders who appear to price aggressively. Sixth, it does not appear that subprime lenders earn extraordinary profits - indeed one study has found that profitability in subprime automobile lending is low and, if anything, inversely related to average interest rates charged.

In sum, there are many aspects of the subprime mortgage market that appear to be in close agreement with the model of an efficient perfectly competitive credit market that we all learned about in our freshman economics courses. Indeed, compared to the prime market where differences in credit risk measured by FICO score are not priced, pricing in the subprime market seems efficient. It may be that the subprime market is perceived to have problems because it is pricing credit risk efficiently while there is price discrimination in the prime market where applicants with FICO scores of 740 pay the same price as those with FICO scores of 640. This apparent price discrimination against low risk applicants in the prime market indicates a potential problem; it is not a sign of efficiency.

"Strange" features of the subprime market that are not a problem

Although economists have not had the perfect data to test hypotheses about subprime lending, they have noted that the subprime market has a number of features that appear strange at first but which can be understood with the application of economic theory. I will first review these unusual aspects and then give an intuitive explanation of their consistency with economic theory.

Casual observation indicates that the subprime mortgage market operates rather differently than the high-risk credit card market. True, subprime lenders charge higher interest rates than prime lenders as with credit cards. However, subprime lenders (at least those we can observe in current data sources) have higher rejection rates than prime lenders - just the opposite of what we find for credit cards. Pricing of mortgage credit between the prime and subprime markets involves a discrete jump rather than the relative smooth range of charges for credit cards. Subprime lenders tend to be distinct entities whereas consumer credit is often supplied to prime and subprime borrowers by the same firm. Finally, the prepayment behavior of subprime mortgages is far different than that of prime mortgages. Taken one at a time, these differences seem curious, but all together they appear

suspicious indeed.

These strange and distinctive features of subprime lending are actually consistent with economic theory. I provide an intuitive discussion here but the arguments can be demonstrated mathematically. Subprime lenders have underwriting costs that are much larger than application fees. This is a product of the high-risk population of applicants and the unwillingness of applicants to bear the risk of rejection by paying high application fees. Subprime lenders have higher rejection rates because low-risk applicants self-select into the prime market. This combination of high rejection rates and underwriting costs exceeding application fees means that the underwriting cost per endorsed mortgage is much higher for subprime lenders. This cost must be recovered by setting interest rates substantially above prime lenders whose cost advantages arise from self-selection of low-risk, easily underwritten applicants into the prime market. Thus the discrete jump between interest rates on prime and subprime mortgages is the result of what is termed in economics a "separating equilibrium" in which applicants self-select into the two market segments based on their risk characteristics. Because the market relies on this self-selection, it is organized so that there is a physical separation between the two types of lenders. Finally, prepayment rates on subprime mortgages tend to be more rapid and less sensitive to interest rate movements because subprime borrowers who improve their credit histories can then refinance into the prime market.

Why is the market for credit cards organized so differently? Credit card issuers have a separate instrument that they can use to control risk - the credit limit. They can provide credit to high risk borrowers with low underwriting cost by controlling losses through a credit limit. This is infeasible in mortgage lending where the minimum amount of funds requested is very large and a strategy of lending to applicants at a moderate to high loan-to-value ratio with minimal underwriting would be a disaster.

The previous discussion applies to much of the subprime market. However there is another segment, lending with little or no documentation, where high underwriting costs are not the issue. In this type of lending, self-selection is also very important and the differential between prime and subprime rates is based on the rise in credit risk due to the problem of adverse selection in the pool of those seeking to borrow without providing documentation.

In conclusion, there are good reasons to expect, based on economic theory, that the organization and supply of mortgage credit will be different than the market for other consumer credit. Differences are not necessarily an indicator of a problem. As is often the case, good economic modeling should be an integral part of any attempt to understand or regulate a credit market.

Concerns about the operation of the subprime market

I wish to raise two concerns about the operation of the subprime market that may be of interest to the Committee. As noted above, I dismiss many possible sources of concern as arising from a misunderstanding of the way in which an efficient mortgage market should operate. However, the two concerns presented here persist even after considering the points made above.

1. The "home equity trap" and demand for subprime mortgages. Households in the U.S. hold a substantial portion of their wealth in the form of home equity. Indeed, the proportion of home equity appears so large that understanding this behavior has been a significant preoccupation in recent economic research. For example, the median home-owning household in the U.S with head under 50 years of age holds zero percent of its portfolio in common stocks, and virtually all of its portfolio in home equity and government-guaranteed assets. Quite frankly, to many economists this appears to be an obvious misallocation of resources and contradicts what we teach our students in class.

Since the 1930's, the prime mortgage market has been dominated by the long term (first 15 and then 30) year fixed-rate, self-amortizing, mortgage. This one-size-fits all approach to mortgage credit supply along with the substantial cost of refinancing has made accumulation of housing equity and automatic feature of household budgeting. While there has been dramatic innovation elsewhere in financial markets, attempts to change mortgage characteristics have been conspicuously unsuccessful - although things may be changing. The current mortgage instrument has the property that prepayment which raises home equity, changes the date of maturity but not the monthly payment or the requirement for prompt payment to avoid delinquency and technical default.

The strange preference for housing equity and self-amortizing mortgage, taken together give rise to what I call the "home equity trap." Households who experience what economists call a negative income shock - lose your job, health, or spouse - and whose wealth consists of government-guaranteed assets and home equity will find themselves caught in a home equity trap. Their first adjustment to the income shock will be a combination of spending the government-guaranteed assets and raising consumer credit obligations. Given high transactions costs or cash-out refinancing and the penalty for missing a mortgage payment, they view housing equity as illiquid. However, when they have exhausted liquid assets, they find that lack or income and rising consumer credit make it impossible to do a cash-out refinancing in the prime mortgage market. Accordingly they must turn to subprime lenders for refinancing or sell their homes to raise cash. This is the basis of the home equity trap.

Homeowners act as if home equity is equivalent to stocks, bonds, and other risk assets as a store of value. In fact it is not equivalent because cash out refinancing in the prime market may not well be possible when the funds are most desperately needed. I would be remiss if I did not also note that, from the point of risk diversification, home equity is inferior to other risk assets.

I do not know how much of the demand for subprime mortgages arises from households caught in the home equity trap. Note that these households are better off because there is a subprime market but this is a second-best solution. The first best result would be for them to hold less housing equity and more risk assets - stock and bond mutual funds - in their portfolio.

2. Deceptive lending practices and the subprime market. Survey evidence indicates that borrowers in the subprime market appear to have less education, shop less for mortgage credit, and be less aware of mortgage credit pricing alternatives than borrowers in the prime market. Of course, such survey results may arise because individuals with lower credit scores either know or care less about the way in which credit markets work.

Do we have evidence that substantial numbers of subprime borrowers could have qualified for prime mortgages at substantial savings? Unfortunately, such determination would require a thorough examination of the loan file. Rejection in the prime market is often for problems such as "unverifiable information" that are nearly impossible to quantify or evaluate without access to the original application and would not be a cause for rejection by a subprime lender.

The evidence of deceptive and perhaps even fraudulent lending practices appears, at this point, to be anecdotal and has not been the object of formal economic analysis or measurement. Accordingly, my comments on the issue should be regarded as speculative rather than scientific. The greatest potential for deceptive practices is in the portion of the subprime market that we are not observing in available data. The small, local, highly specialized lender who does not report its transactions to any source currently subject to statistical analysis surely has the most potential for engaging in deceptive lending practices. Loan officers who engage in deceptive practices and have the choice of working with firms that report their activity or those who do not report, surely prefer the latter. Also, firms whose loans are reported and available for statistical analysis, are more likely to question loan officers whose pricing is unusually high. Recall that, based on property records, there is a substantial amount of mortgage lending by non-reporters. Therefore loan officers should have the choice to affiliate with either type of lender.

If my suspicion regarding the concentration of deceptive lending practices in the small, non-reporting firms is correct, then there is a danger that regulation will have unintended consequences. To the extent that regulation raises costs for larger firms whose lending activities are more readily examined compared to the smaller firms where deceptive problems are concentrated, increase regulation may result in a rise in deceptive lending. Note that, because we do not currently monitor this component of the subprime sector, regulators may actually claim success in reducing subprime lending while deceptive lending rises.

In conclusion, part of the demand for subprime mortgages may arise because households hold too much housing equity in their portfolios without recognizing that a negative income shock may make it impossible to refinance in the prime market. This is NOT a problem of the subprime market. Rather it is a problem due to lack of mortgage innovation in the prime market and failure to educate the public regarding the benefits of diversification and liquidity. The population served by the subprime market may be particularly susceptible to deceptive lending practices. The potential for such tactics is largest in the currently unmonitored segment of subprime lending and regulations that raise costs and discourage larger, reputable subprime lenders could have the unintended consequence of allowing the market share of deceptive lenders to rise.

Thank you again for allowing me the opportunity to present these thoughts.

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Quercia, R.G., Stegman, M.A., and Davis, W.R. 2003. "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment." Center for Community Capitalism, University of North Carolina at Chapel Hill.

THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT

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June 25, 2003

The authors acknowledge receipt of financial support from the Center for Responsible Lending (CRL). However, the views expressed herein are those of the authors and do not necessarily represent the views of CRL.

The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment

Abstract

In this study, we examine changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented in 1999 and 2000. Previous studies have noted a decline in overall subprime lending following the law's enactment. We suggest that such a finding is to be expected given that the purpose of the law was to reduce the number of subprime loan originations with predatory or abusive terms. To us, the relevant question is what component(s) of subprime lending declined, and which remained stable or increased after the law was implemented.

Using an analysis database of 3.3 million subprime loans covering 1998-2002, supplied to us under license by the company, Loan Performance, Inc., we find that the reduction in subprime originations observed from 1999 to 2000 is due to a decline in the number of refinance originations, while purchase originations actually increased. Most importantly, we find a large decline in subprime refinance originations with abusive or predatory terms. This is not unexpected since the law's intent was to curtail this type of lending. Overall, we conclude that after the North Carolina predatory lending law was fully implemented, the subprime market behaved essentially as the law intended: There was a reduction in predatory loans but no change in the cost of subprime credit or reduction in access to credit for high-risk borrowers.

Introduction

The 1990s were characterized by the aggressive expansion of credit to populations traditionally considered underserved, including those with limited or impaired credit histories, such as many minorities and recent immigrants. Financial institutions became more active in this so-called subprime area as a result of technological changes, a robust economy, and the need for new markets. Subprime borrowers have benefited from this expansion of credit, and institutions have seen profits increase through growth (Harvey and Nigro 2002).

In fact, subprime mortgage lending grew significantly over a very short period of time. Across the country, the volume of subprime mortgage originations grew from $35 billion to about $213 billion in only 8 years (1994-2002) (Mortgage Market Statistical Annual 2003). This increase reflects the growing involvement of secondary market institutions such as Fannie Mae and Freddie Mac in securitizing subprime mortgages. Securitized subprime loans increased from $11 billion to $83 billion from 1994 to 1999 (Harvey and Nigro 2002).

Subprime lending serves a wide range of borrowers, from those with minor credit imperfections to those with serious credit problems. In theory, the cost of borrowing increases as the quality of a borrower's credit declines, with the highest fees and rates charged to borrowers with the lowest credit quality. Problems may arise if unscrupulous lenders take advantage of uninformed

borrowers by charging fees and rates not reflective of the risk, by not informing borrowers of their least expensive loan alternatives, and by offering products and services without full disclosure of terms and options.

The term "predatory lending" refers to a set of abusive lending practices concentrated in the subprime sector. These include making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan, often repeatedly, in order to charge high points and fees on the refinance ("loan flipping"); and engaging in fraud and deception to conceal from an unsuspecting or unsophisticated borrower the true nature of the loan obligation (Gramlich 2000). For service providers, regulators, and legislators, dealing with predatory lending requires a balancing act, because curbing these practices may curtail credit to some borrowers. Some borrowers may be so uncreditworthy that they can only get credit under conditions that are considered predatory. Historically, however, government has acted to curb abusive lending practices even if the regulations limit the flow of certain kinds of credit.

Predatory lending can have a devastating effect on families. Loans made without regard to a borrower's repayment ability are likely to erode the borrower's home equity position. This is especially true for minority and low-income families, for whom home equity comprises over 60 percent of their net worth (State of the Nation's Housing 2002). In addition, most older

homeowners depend on equity to supplement other savings after retirement (Quercia 1997). The importance of home equity for these financially unsophisticated or vulnerable populations makes them potential targets of predatory practices (Carr and Kolluri 2001).

In the absence of direct evidence, and because predatory lending is largely a subset of subprime lending, the potential for abuse can be deduced by observing overall subprime lending patterns and changes over time. For instance, subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white ones. Furthermore, homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. Similarly, subprime loans are three times more likely among older borrowers than among younger borrowers (AARP 2003). These figures suggest that the negative impacts of abusive or predatory subprime practices may fall most heavily on those who have less access to prime credit (HUD 2000).

Unfortunately, there is no single, agreed-upon definition of what constitutes predatory lending. Those that exist are largely based on the definition of high-cost loans in the federal Home Ownership and Equity Protection Act (HOEPA) of 1994, which bans certain practices and requires additional disclosures and borrower protections. In 2000, about one percent of all subprime mortgage loans was estimated to fall under HOEPA (Gramlich

2000).[1] By contrast, estimates of predatory lending and actual settlements entered into by large subprime lenders suggest the true incidence may be considerably higher (for example, see Richardson 2003). Since 1994, several states and local jurisdictions have enacted HOEPA-like regulations and ordinances, so that high-cost or predatory loans have come to be defined as loans featuring one or more specified terms and underwriting practices, including exorbitant points and fees, balloon payments, prepayment penalties, loan flipping, as well as not requiring adequate documentation of repayment ability, and including interest rates on real estate-secured loans in and above the credit card range.

Critics have questioned whether legislative efforts to curb predatory practices would also increase the cost of serving particular segments of the market, reduce the supply of mortgage credit and raise the cost of borrowing (Elliehausen and Staten 2002 and 2003). Because North Carolina was the first state to enact anti-predatory legislation, its 1999 Anti-Predatory Law has received a great deal of attention. Examinations of the law's impact to date have had varied results.

This study is the first in a series to be prepared by the Center for Community Capitalism, a research center based in the Kenan Institute of Private Enterprise in the University of North Carolina at Chapel Hill, on the

[1] In 2002, revisions to Regulation Z (Truth in Lending act) expanded the definition of high-cost loans under HOEPA.

impacts of the North Carolina law and other issues related to subprime lending; all of which are to be supported by a database of subprime loans licensed to us by the company, Loan Performance, Inc.

This initial paper is entirely descriptive. We begin by enumerating the characteristics of the North Carolina Anti-Predatory Law and reviewing the literature to assess what is known of its impacts. Next, we describe the methodology and data used in this study; we introduce the Loan Performance database and compare subprime lending activities in the U.S., in selected Southern states, including North Carolina, and in the rest of the South. We examine changes in the number of subprime loans, both purchase and refinance, before and after implementation of the North Carolina law. We also examine changes in two measures that capture basic concerns about such laws: access to credit and the cost of credit for subprime borrowers. Next, we examine changes in subprime refinance originations with characteristics considered abusive or predatory.

Prior work on the impacts of the North Carolina law has focused on the overall subprime market. In contrast, the focus of our work is more properly on the impact of the law on specific market segments and on the supply of subprime credit with abusive or predatory features. In the final section, we discuss the directions for our future research.

The North Carolina Anti-Predatory Law: What Do We Know?

Enacted in 1999, North Carolina's Anti-Predatory Lending Law prohibits certain types of lending activities that are considered to be detrimental to consumers.[2] See Exhibit 1 for key characteristics of the law.

The law was enacted in two phases. In the fourth quarter of 1999, three elements of the law took effect. First, prepayment penalties were banned for loans up to $150,000. Second, permissible classes of fees were defined for loans secured by real property and for fees to be paid to third parties in association with the loan. Finally, consumer home loan refinancing transactions were prohibited where they failed to provide a borrower with a *reasonable, tangible net benefit* (the "no flipping" provision). The remaining requirements of the law took effect on July 1, 2000.

We have identified five studies that have examined the impacts of the NC law to varying degrees. The first, conducted by the trade publication, Inside B&C Lending (2001), reviewed rate sheets of several top subprime lenders to assess the range of products and prices offered in NC after enactment of the law. This study finds that subprime lenders in North Carolina were continuing to offer a full array of products and that there was little or no variation in rates charged. Moreover, while some companies opted to leave the

[2] (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00) (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00).

market, the study concludes it was not clear what role, if any, the predatory lending law played in those decisions.

Elliehausen and Staten (2002 and 2003) used loan-level data from nine members of the American Financial Services Association (AFSA) to compare subprime lending originations in North Carolina to those in Virginia, South Carolina, and Tennessee. The authors find that the North Carolina law resulted in a decline in overall subprime originations and in originations to low-income borrowers (<=$50,000 income) in North Carolina relative to the other two states.

Ernst, Farris, and Stein (2002) examined the volume of subprime originations before and after enactment of the law using Home Mortgage Disclosure Act (HMDA) data to compare 1999 and 2000 subprime originations for North Carolina with the rest of the nation. They find that there was an overall decline in the subprime market in North Carolina between those two dates, but that North Carolina was still among the most active subprime origination markets in the nation. They also found that despite the overall decline in subprime lending in North Carolina, the percentage of all subprime originations to lower-income borrowers remained unchanged. On the basis of this finding, the authors conclude that the overall decline was not just in the lower-income portion of the market but was distributed across the income spectrum. They also calculate that the law saved an estimated $100 million for North Carolina borrowers over the study period.

Morgan Stanley (2002) surveyed 280 subprime branch managers to assess the impact of predatory lending laws on lending activity across the country, and found that subprime residential lending volumes were not reduced in any significant way. The report specifically finds that "Even the toughest new laws, in states like North Carolina for example, do not seem to be affecting branch volumes" (Morgan Stanley: 2).

Finally, Harvey and Nigro (2002) examined loan application and denial rates in North Carolina and neighboring states using 1998-2000 HMDA data. They find that the law reduced the overall level of subprime mortgage lending activity in North Carolina relative to Virginia, Tennessee, South Carolina, and Georgia. However, they also report that the North Carolina decline was caused by a change in subprime loan application rates, not a change in denial rates. This suggests that the decline is a result of less demand rather than reduced supply.

Methodology and Data

As described above, all of the prior studies on the North Carolina Anti-Predatory Law focus on the impacts of the law on the overall subprime market. In contrast, we think the focus should properly be on the impacts of the law on market segments and market practices targeted by the law; in other words, on the law's impacts on the incidence of loans with predatory or potentially predatory characteristics. Thus, if the law has its intended effects, we would

expect to find a decrease in subprime refinance originations, since most predatory loans are refinances, but not in purchase originations. We would also expect to find a decrease in refinance loans with abusive or predatory features, such as long-term prepayment penalties, balloon payments, and loans with combined loan-to-value ratios (LTV) for second lien refinances over 110 percent. We use the latter as a proxy for loans that do not reasonably offer tangible net benefits to borrowers.[3]

Our analysis is based on loan-level information for 3.3 million securitized subprime loans originated from 1998 through 2002. As indicated earlier, the data were supplied under license by Loan Performance, Inc. (formerly Mortgage Information Corporation), a private company founded 20 years ago to provide mortgage market research for regional banks. Over the years, Loan Performance developed a system to track the performance of agency and non-agency loans and securities and in 1997 started tracking subprime loans. The data for the analysis come from the company's Asset Based Securities (ABS) loan-level database.

[3] Repeated refinancing of first mortgages with financed loan fees secured by second liens is common to loan flipping practices, and are likely to result in high combined loan-to-value ratios in the range of 110 percent or more. That very high combined loan-to-value (LTV) ratios are indicative of abusive lending practices is suggested in, among others, a recent report from the Washington State Department of Banking, where the state regulator criticized one subprime lender for "steering borrowers into larger first mortgages" and "situations where the borrowers were required to take out a second mortgage primarily to pay points on the first mortgage...." (Washington 2002). The NC law aims to reduce this predatory practice through its prohibition on originating refinance loans that do not provide the borrower a net tangible benefit. High combined LTV ratios also serve as a deterrent to prepayment, locking a borrower into high interest rate loans by making it economically infeasible for a responsible lender to offer a refinance loan (Washington 2003).

The Loan Performance (LP) database represents a significant share of the overall subprime market, ranging from approximately 41.6 percent in 1998 to about 51 percent in 2002 (see Table 1) (Mortgage Market Statistical Annual 2003). There is an overlap between the LP database and HMDA, although we cannot define it with full certainty. Many ABS lenders and issuers that report data to Loan Performance also report data under HMDA, including eight issuers on HUD's list of subprime lenders (HUD 2001) and a major lender active in both the prime and subprime mortgage markets. Ten of the top 25 ABS home equity issuers for 2002 report to LP (Koren 2003).

Relative to Elliehausen and Staten's database of about 300,000 subprime originations from nine AFSA members in 1998 (2002 and 2003), our LP database for the same year is twice as big, containing approximately 640,000 loans, and 3.3 million subprime loans for the overall study period, that ranges from Q1 1998 through Q3 2002.

Changes in the Subprime Market from 1998 through 2002

In this section, we examine overall trends in the subprime market from 1998 through 2002. First, we examine national trends in subprime originations using LP data and compare them with data from other sources. Second, we examine these trends at the regional level and for North Carolina and selected neighboring states. Third, we examine purchase and refinance subprime activity nationally and then regionally and in the selected states. Next, in the same areas, we examine changes in overall subprime lending, and for purchase

and refinance activity, before and after the North Carolina law was implemented. Finally, we examine two specific concerns that have been raised about the law: its impacts on subprime borrowers' access to credit, and the cost of credit (Elliehausen and Staten 2002, 2003).

In comparing lending activity before and after the North Carolina Anti-Predatory Lending Law was enacted, it should be noted that the law was implemented in two steps that covered a transition period of three-quarters, or nine months. The first phase of the law became effective for loans originated on or after October 1, 1999 (i.e., at the start of the fourth quarter), and the second phase became effective on July 1, 2000 (the start of the 3rd quarter). Because this transition period was a time of uncertainty and adjustment for market participants that had to familiarize themselves with the new law, we do not believe that any short run changes in lending activity that occurred during this time are indicative of any long-term impacts of the law. This is why Tables 5-12 contain origination data going back seven quarters before the NC law was enacted, and seven quarters after the law was fully implemented, ignoring changes in activity that occurred during the 9-month transition period.

Decline in Subprime Originations

Nationally, there was a sharp decline in the total number of subprime loans originated from 1999 to 2000 (see Table 1), from almost $160 billion in 1999 to about $138 billion in 2000, a decline of about $22 billion (14.3 percent). Since then, there has been a steady increase in originations, and they have surpassed the 1999 level ($213 billion in 2002). The LP database shows

similar declines and increases over time. The main difference is an increase in national subprime lending in the LP database of about 43 percent in 2001, compared with an increase of 25 percent for the same year reported elsewhere. The main reason for this disparity is that the LP database covered a larger proportion of the total subprime market in 2001 than it did in 1999.[4]

Subprime loan originations in the Southern census region, seen in Table 2, follow the same national pattern depicted in Table 1.[5] When the data are disaggregated, North Carolina and each of its neighboring states follow the same pattern observed nationally, with declines in all areas. From 1999 to 2000 subprime originations in North Carolina declined by 24 percent, in South Carolina by 18 percent, and in Virginia, by 17 percent. Tennessee, Georgia, and the rest of the South also experienced declines in subprime originations on a smaller scale.[6]

Although North Carolina experienced a somewhat greater decline in subprime originations from 1999 to 2000, it has also experienced a greater growth in such originations in 2001 and 2002 than the neighboring states of

[4] If we adjust for the increased market coverage from 1999 to 2000, the growth in the LP database is 25.5%. Similarly, for 1998 to 1999, after adjusting for the increase in market coverage, the LP growth rate is 13.8%.

[5] In addition to North Carolina, the Southern Census Region includes MD, DE, VA, SC, TN, GA, FL, AL, MS, LA, TX, OK, and AR.

[6] It should be noted that Georgia's anti-predatory law took effect on the last quarter of 2002. It is possible that there was a big increase in originations in months immediately before the law took effect—originations of loans that would fall under the protection of the new law on 10/1/2002—inflating the 3rd quarter numbers. Because we estimate the 2000 annualized figures in Tables 3 and 5 based on originations for the first three quarters of 2002, we may be overestimating the amount of actual 4th quarter originations in Georgia.

South Carolina and Tennessee. More broadly, the percentage increase in the number of loans originated in North Carolina after 2000 is comparable with that of the rest of the South.

Two general trends can be observed in the number and relative change in subprime purchase and refinance lending, both nationally and regionally (see Tables 3 and 4). First, the 1999-2000 decline in subprime originations was for refinance loans only, not for the market as a whole. Specifically, North Carolina's 2000 growth in the purchase segment is in line with the rest of the South and only slightly smaller than the national trend. Second, since 2000, refinances have grown nationally and in some comparison states but not in North Carolina or in some other Southern states. In contrast, originations of purchase loans show big jumps in North Carolina and some other states but not in others.

Nationally, subprime purchase lending grew consistently from 1998 to 2002, with annual growth rates ranging between 6.7 percent and 13.1 percent (Table 3). From 1999 to 2000, the nation saw subprime purchase loan originations increase by 7.2 percent, while subprime refinances actually declined by more than 17 percent. In contrast, subprime refinances increased nationally in 2001 and 2002.

We find in North Carolina overall patterns similar to those for the country as a whole, in the South, and in other selected Southern states (Table

4). With regard to these overall trends in subprime lending, there seems to be nothing unique about North Carolina. Like the national trend, the number of subprime purchase originations in North Carolina from 1999 to 2000 did not decline. In fact, the number of subprime purchase loans grew steadily from 1998 to 2002, with a growth of more than 35 percent in 2001.

As before, subprime refinance activity declined from 1999 to 2000 throughout the South: in North Carolina, by 26 percent; in Virginia by almost 25 percent; in Georgia by 16 percent; in Tennessee by 14 percent; in South Carolina by 12 percent; and by about 13 percent in the rest of the region.

Lending Activity Before and After Implementation of the Law

Our research shows that in all geographies, the declines over time in subprime lending were due to drops in refinance activity and not in purchase lending originations. We explore this in more detail by examining changes in subprime lending before and after the North Carolina Anti-Predatory Lending Law was fully implemented. We examine trends for both purchase and refinance loans. If no declines are observed in purchase activity after implementation, we can infer that the North Carolina law is not keeping people from becoming homeowners by constraining the flow of subprime credit.

With the exception of Virginia and Georgia, subprime originations declined between pre and post implementation in North Carolina as well as in other neighboring states, the rest of the South, and the U.S. as a whole (see

Table 5). In North Carolina, however, where subprime originations declined by almost 5,300 loans, the relative decline was much greater than in other areas—17 percent compared with 8.2 percent or lower.

Looking at subprime refinance loans only before and after implementation of the law (Table 6), we find a decline of 20 percent in North Carolina with declines of 9 percent in South Carolina, 7 percent in Tennessee, and about 3 percent overall in the United States. During the same period, Virginia experienced no change in refinance originations while Georgia had a 10 percent increase. The more detailed analysis presented below indicates that North Carolina's decline in subprime refinance lending is largely in loans with characteristics that could be considered abusive or predatory.

When we examine the number and relative change in subprime purchase first lien loans before and after implementation (Table 7), we find that originations increased by 43 percent in North Carolina, with comparable increases in Virginia (44 percent) and Tennessee (39 percent). Georgia, the rest of the South, and the U.S. as a whole, experienced slower growth in this sector.

We conclude from this that the law does not limit access to subprime credit for North Carolina homebuyers, an issue that is examined in more detail below.

Effect of Predatory Lending Law on Credit

In this section, we examine two criticisms about predatory lending laws such as the one in North Carolina: that they will likely restrict access to credit for high-risk borrowers and increase the cost of credit because of lenders' unwillingness to serve this market (Elliehausen and Staten 2002 and 2003).

Access to Credit for High-Risk Borrowers

Concerns have been raised about the potential of the North Carolina law to curtail access to credit for high-risk borrowers. Elliehausen and Staten (2002 and 2003), using low income as a proxy for high-risk borrowers, find a decrease in the number of subprime loans to borrowers in North Carolina with incomes at or below $50,000.

There is a growing consensus among researchers in the field that the best measure of credit risk or creditworthiness is a borrower's credit score rather than income (Roche 2000), with a score below 580 considered to be a strong indication of high risk for default.[7]

Significantly, the North Carolina data show that loans to borrowers with credit scores below 580 have actually increased by almost one-third since the law was fully implemented (Table 8). This growth is consistent with that in neighboring states (except Tennessee), suggesting that changes in North

[7] Borrowers with credit scores below 580 are generally considered B- and C- quality borrowers (Calomiris and Mason 1999, p. 27)

Carolina's regulatory environment have had no detrimental impact on the supply of subprime credit to these high-risk borrowers.[8]

At the same time, we also find a relative decrease in the number of originations to borrowers with credit scores at or above 660 (Table 9). Although we are unable to determine the actual reason for this decline due to limitations of the LP database, such a decline is consistent with the proposition that the NC law may have curtailed the extent of steering creditworthy borrowers--whose credit scores are high enough to qualify for lower cost, prime loans--to the subprime market.[9]

The Cost of Credit after Implementation of the NC Law

Concerns have also been raised that predatory lending laws will increase the cost of credit for subprime borrowers. Elliehausen and Staten (2002 and 2003) report that North Carolina's regulation has reduced the flow

[8] A word of caution is warranted. Some proportion of the increase is due to two factors. First, there was an increase in the coverage of the LP data, from 41 percent to 50 percent of the total subprime market over the study period. Second, there was an improvement in data reporting in LP. The percentage of records with missing FICO scores was reduced by more than half between 1998 and 2001. It is possible that lower credit scores are over-represented among the missing data. However, there's no reason to think those two factors would have a greater impact on North Carolina than in other Southern states. Thus, the conclusion that the experience in North Carolina has been similar to that of other states is still warranted.

[9] For instance, in 2000, Fannie Mae clarified its policies to minimize the potential steering of creditworthy borrowers to subprime products, and one would expect that borrowers with credit scores of 660 or higher would be among those referred to here. "For loans delivered to Fannie Mae, the company expects that lenders will have determined the borrower's ability and willingness to repay the mortgage debt regardless of the underwriting method the lender uses. In addition, lenders should have practices and procedures to offer mortgage applicants the full range of products for which they qualify, and should specifically avoid the steering of borrowers to high-cost products that are designed for less creditworthy borrowers if the applicants can qualify for lower-cost products. Similarly, consumers who seek financing through a lender's higher-priced subprime lending channel should be offered (or directed toward) the lender's standard mortgage product line if they are able to qualify for one of the standard products" (Raines 2000).

of subprime capital into the state. We do not agree. If the decline in overall originations had been due to lower capital flows, interest rates would be expected to rise in North Carolina relative to other states without predatory lending laws. If, however, the decline in subprime capital flows were demand-induced (i.e., the result of fewer subprime loan applications) interest rates would not be expected to rise. We examine this issue by comparing changes in the mean origination interest rates before and after implementation of the law, and discern no unique pattern in North Carolina compared with other states and the nation as a whole (Table 10). In fact, interest rates in North Carolina increased by 33 basis points (.33 of 1 percent) over the study period, which is below the corresponding national figure of 40 basis points.

Declines in Subprime Refinance Originations with Predatory Terms

As the earlier analysis indicates, after the law was implemented, North Carolina experienced a sharper decrease in subprime lending than neighboring states, with most of this decline concentrated in the refinance market. This pattern may be consistent with the intent of the law, because the refinance sector of the subprime market is generally more associated with abusive and predatory practices than other sectors.

We explore changes in the number of subprime refinance originations for loans containing at least one characteristic considered abusive or associated with predatory lending: prepayment penalty terms of 3 years or greater (Table 11), balloon payments (Table 12), and loan-to-value ratios of 110 percent or

greater (Table 13). As suggested earlier, the latter is a proxy for loans with no "net tangible benefit" to borrowers. We expect originations of refinance loans with these abusive characteristics to have declined relatively more in North Carolina after the implementation of the law.

From the pre- to the post-law period, the number of refinance loans with prepayment penalty terms of three years or greater increased everywhere except in North Carolina (Table 11). There the number of such loans declined by 72 percent, a reduction of over 2,800 loans. In comparison, the number of such loans increased elsewhere, from a low of 35 percent in Georgia and the United States as a whole to a high of 260 percent in South Carolina.[10]

Looking at the number of subprime refinance loans with balloon payments originated before and after implementation, we find a decline of 53 percent, or over 1,600 loans, in North Carolina, although the contrast with neighboring states is not as clear as in the prior finding (Table 12). There were significant decreases in the number of these loans in two other states (South Carolina and Tennessee) and smaller decreases nationally and in the rest of the South. Only Virginia had an increase.

[10] We should mention, though, that South Carolina still has a very low incidence of originations with long pre-payment penalties. For example, prior to the NC law, only 5 percent of South Carolina's subprime originations had a 3-year or greater prepayment penalty. After the law, 16.6 percent of South Carolina originations had such penalties-- this compares favorably to a national average of 45.8 percent (and to VA, TN, and GA all with over 60 percent).

The number of refinance loans originated with a combined LTV equal to or greater than 110 percent pre- and post-implementation decreased by 35 percent, or about 650 loans, in North Carolina (Table 13). Half of the other study areas experienced an increase, while the others had declines much smaller in magnitude than in North Carolina.[11]

Conclusions

In this study, we examined changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented. Using a database of 3.3 million subprime loans, we find a reduction in subprime originations from 1999 to 2000 due to a decline in the number of refinance originations, not loans for purchase, with most of the decline associated with loans having abusive or predatory terms. Rather than criticizing North Carolina's anti-predatory lending law for curtailing this kind of credit, it should be celebrated. Such a decline is not unexpected, since the law was enacted to curtail this type of lending. Moreover, we find that access to credit for high-risk borrowers and the cost of subprime borrowing in North Carolina have followed patterns similar to those elsewhere. Overall, we conclude that, after the law was fully implemented, the subprime market in North Carolina behaved essentially as the law intended—there was a reduction

[11] The findings in Tables 11-13 need to be put in context. This is because of two factors. First, there was an increase in the coverage of the LP database, from 41 percent to 50 percent of the total subprime market, over the study period. Second, there was an improvement in data reporting in LP, such that there is more missing information on loan characteristics in earlier than in later years. However, there is no reason to think these two factors would have a greater impact on North Carolina than in the other states. Moreover, if abusive or predatory characteristics were under-reported in early years, then our pre-post law examination is likely to understate actual declines in the number of loans with these features.

of loans with predatory terms without a restriction in access to or increase in the cost of loans to borrowers with blemished credit.

The analysis indicates an overall reduction of about 5,300 subprime loans pre- and post-implementation. Although we cannot estimate at the moment the precise degree of overlap, the analysis also indicates that this decline is largely due to a decrease in the number of loans with abusive characteristics. These include about 2,800 fewer loans with prepayment penalty terms of three years or more, about 1,600 fewer loans with balloon payments, and about 650 fewer loans with combined loan-to-value ratios over 110 percent. From this perspective, the observed decline cannot be considered undesirable or unanticipated by policymakers.

In closing, the findings from our initial study are strongly suggestive that the North Carolina Predatory Anti-Lending Law is doing what it is supposed to do. However, these findings cannot be considered definitive. In our future research, within a multivariate framework, we will incorporate confounding variables in the analysis (e.g., economic influences) to isolate the impacts of the North Carolina law on subprime lending activities.

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Exhibit 1
Key Features of the North Carolina Anti-Predatory Law

- Prohibits prepayment penalties on first-lien mortgages of less than $150,000;
- In high-cost home loans, prohibits the financing of fees, balloon payments, negative amortization, and lending without regard to a homeowner's ability to repay, where high-cost was defined generally as loans with fees in excess of 5 percent, or annual percentage rates over federal law trigger level, which is currently more than 8 percent above comparable U.S. Treasury Securities;
- Prohibits lenders from refinancing an existing home loan when there is no reasonable, tangible net benefit to a borrower;
- Prohibits the financing of single premium credit insurance; and
- Requires that would-be borrowers of high-cost loans receive financial counseling before entering into the transaction.

Source: N.C. Session. Law 1999-332, Section 5.

Table 1
Subprime Loans in the National LP ABS Database
Number and Volume
U.S. 1998-2002

Year	Number Of Loans, LP Database	Percentage Change	Total Volume, LP Database ($billions)	Percentage Change	Total National Subprime Volume ($billions)	Percentage Change	LP Database as Percent of All Subprime
1998	649,726	--	$62.4	--	$150.0	--	41.6%
1999	718,873	10.6%	$66.2	6.1%	$160.0	6.7%	41.4%
2000	616,254	-14.3%	$61.4	-7.3%	$138.0	-13.8%	44.5%
2001	696,324	13.0%	$87.6	42.7%	$173.3	25.6%	50.6%
2002*	769,745	10.5%	$108.4	23.7%	$213.0	22.9%	50.9%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and the 2003 Mortgage Market Statistical Annual, vol. 2

Table 2
Subprime Loans in the LP ABS Database
Number and Volume
Selected Southern States and Remainder of the South, 1998-2002

State	Year	Number Of Loans	Percent Change	Total Volume ($millions)	Percent Change
North Carolina	1998	16,174	--	$1,162	--
	1999	19,647	21.5%	$1,459	25.6%
	2000	14,893	-24.2%	$1,183	-18.9%
	2001	15,664	5.2%	$1,564	32.2%
	2002*	16,413	4.8%	$1,796	14.8%
South Carolina	1998	8,767	--	$569	--
	1999	10,355	18.1%	$717	26.0%
	2000	9,229	-10.9%	$713	-0.6%
	2001	8,834	-4.3%	$890	24.8%
	2002*	8,908	0.8%	$965	8.5%
Virginia	1998	12,862	--	$1,098	--
	1999	15,277	18.8%	$1,252	14.0%
	2000	12,605	-17.5%	$1,105	-11.7%
	2001	16,602	31.7%	$1,855	67.9%
	2002*	18,688	12.6%	$2,427	30.8%
Tennessee	1998	12,349	--	$871	--
	1999	15,072	22.1%	$1,091	25.3%
	2000	13,226	-12.2%	$996	-8.7%
	2001	13,679	3.4%	$1,137	14.2%
	2002*	13,764	0.6%	$1,191	4.7%
Georgia	1998	20,624	--	$1,763	--
	1999	24,069	16.7%	$2,066	17.2%
	2000	20,998	-12.8%	$2,046	-1.0%
	2001	25,218	20.1%	$2,815	37.6%
	2002*	28,323	12.3%	$3,295	17.0%
Rest of South	1998	133,137	--	$9,785	--
	1999	151,529	13.8%	$11,258	15.1%
	2000	136,672	-9.8%	$10,830	-3.8%
	2001	144,284	5.6%	$13,698	26.5%
	2002*	157,380	9.1%	$16,560	20.9%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 3

Subprime Loans in the National LP ABS Database
Purchase and Refinance Loans
U.S., 1998-2002

Year	Purchase, 1st Lien	Percent Change	Refinance	Percent Change	Other/ Missing
1998	160,003	--	386,572	--	73,792
1999	179,204	12.0%	472,258	22.2%	44,423
2000	192,019	7.2%	389,909	-17.4%	20,441
2001	204,950	6.7%	435,697	11.7%	5,683
2002*	231,871	13.1%	458,804	5.3%	1,861
Total	968,047		2,143,240		146,200

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 4
Subprime Loans in the LP ABS Database
Purchase and Refinance Loans
Selected Southern States and Remainder of the South, 1998-2202

State	Year	Purchase, 1st Lien	Percent Change	Refinance	Percent Change
North Carolina	1998	3,050	--	10,151	
	1999	3,490	14.4%	14,070	38.6%
	2000	3,694	5.8%	10,369	-26.3%
	2001	5,021	35.9%	9,982	-3.7%
	2002*	5,115	1.9%	10,280	3.0%
South Carolina	1998	1,426	--	5,840	
	1999	1,974	38.4%	7,213	23.5%
	2000	2,474	25.3%	6,355	-11.9%
	2001	2,541	2.7%	6,023	-5.2%
	2002*	2,653	4.4%	5,887	-2.3%
Virginia	1998	2,678	--	7,663	
	1999	3,087	15.3%	10,567	37.9%
	2000	3,275	6.1%	7,955	-24.7%
	2001	4,305	31.5%	9,879	24.2%
	2002*	5,276	22.6%	9,981	1.0%
Tennessee	1998	2,500	--	7,894	
	1999	2,954	18.2%	10,470	32.6%
	2000	3,626	22.7%	9,015	-13.9%
	2001	3,953	9.0%	8,699	-3.5%
	2002*	4,177	5.7%	8,026	-7.7%
Georgia	1998	6,253	--	11,602	
	1999	6,558	4.9%	15,455	33.2%
	2000	6,747	2.9%	13,025	-15.7%
	2001	7,231	7.2%	15,553	19.4%
	2002*	8,039	11.2%	16,483	6.0%
Rest of South	1998	39,781	--	73,381	
	1999	45,717	14.9%	91,885	25.2%
	2000	48,367	5.8%	80,353	-12.6%
	2001	49,759	2.9%	84,911	5.7%
	2002*	54,499	9.5%	85,916	1.2%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 5
Number and Relative Change in Subprime Loans 7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	31,184	16,284	24,629	23,550	38,660	245,600	1,190,755
Post-Law (Q3 2000 – Q1 2002)	25,898	14,948	26,979	22,583	41,689	242,537	1,157,489
% Change [(pre-post)/pre]	-17.0%	-8.2%	9.5%	-4.1%	7.8%	-1.2%	-2.8%

Source: Loan Performance database and authors' calculations

Table 6
Number and Relative Change in Subprime Refinance Loans
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	20,710	10,989	15,732	15,595	23,092	140,754	740,378
Post-Law (Q3 2000 – Q1 2002)	16,499	10,026	15,736	14,506	25,492	140,001	716,683
% Change [(pre-post)/pre]	-20.3%	-8.8%	0.0%	-7.0%	10.4%	-0.5%	-3.2%

Source: Loan Performance database and authors' calculations

Table 7
Number and Relative Change in Subprime 1st Lien Purchase Loans
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	5,622	2,845	4,949	4,666	11,054	73,168	289,042
Post-Law (Q3 2000 – Q1 2002)	8,037	4,404	7,127	6,488	12,251	85,255	350,523
% Change [(pre-post)/pre]	43.0%	54.8%	44.0%	39.0%	10.8%	16.5%	21.3%

Source: Loan Performance database and authors' calculations

Table 8

Number and Relative Change in Subprime Loans to Borrowers with FICO below 580
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	6,608	3,976	3,656	5,602	7,814	53,164	220,911
Post-Law (Q3 2000 – Q1 2002)	8,671	5,253	5,017	6,712	10,319	68,124	289,392
% Change [(pre-post)/pre]	31.2%	32.1%	37.2%	19.8%	32.1%	28.1%	31.0%

Source: Loan Performance database and authors' calculations

Table 9

Number and Relative Change in Subprime Loans to Borrowers with FICO 660 and Above
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	4,771	2,176	6,093	3,239	7,129	35,993	369,881
Post-Law (Q3 2000 – Q1 2002)	3,432	2,099	5,920	2,973	6,431	36,471	356,139
% Change [(pre-post)/pre]	-28.1%	-3.5%	-2.8%	-8.2%	-9.8%	1.3%	-3.7%

Source: Loan Performance database and authors' calculations

Table 10
Changes in Mean Origination Interest Rates
7 Quarters Before and After NC Law
All Subprime Loans
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	10.27	10.34	10.34	10.20	10.01	10.16	9.88
Post-Law (Q3 2000 – Q1 2002)	10.60	10.60	10.42	10.60	10.31	10.57	10.27
% Change Pre to Post	3.3%	2.5%	0.8%	3.9%	3.0%	4.0%	4.0%
Basis Points Change Pre to Post	33	26	9	40	30	41	40

Source: Loan Performance database and authors' calculations

Table 11

Percentage of Subprime Refinance Loans with Prepayment Penalty Terms of 3 years or Greater
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3968	435	5170	7535	11653	53577	247573
Post-Law (Q3 2000 – Q1 2002)	1101	1569	8530	9318	14605	63895	296457
% Change [(pre-post)/pre]	-72.3%	260.7%	65.0%	23.7%	25.3%	19.3%	19.7%

Source: Loan Performance database and authors' calculations

Table 12
Number and Percent Change in Subprime Refinance Loans with Balloon Payments
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3092	1273	1427	1720	2172	10276	68146
Post-Law (Q3 2000 – Q1 2002)	1451	430	1981	766	1544	7566	57480
% Change [(pre-post)/pre]	-53.1%	-66.2%	38.8%	-55.5%	-28.9%	-26.4%	-15.7%

Source: Loan Performance database and authors' calculations

Table 13

Number and Percent Change of Subprime Refinance Loans
With a Combined Loan-to-Value of 110 Percent or Greater
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	1,827	783	3,160	815	2,152	11,067	55,792
Post-Law (Q3 2000 – Q1 2002)	1,189	809	2,923	1,122	2,056	13,308	56,818
% Change Pre to Post	-34.9%	3.3%	-7.5%	37.7%	-4.5%	20.2%	1.8%

Source: Loan Performance database and authors' calculations

Do Predatory Lending Laws Influence Mortgage Lending?
An Analysis of the North Carolina Predatory Lending Law

April 2003

ABSTRACT

In this paper, we examine the effect of the 1999 North Carolina predatory lending law on mortgage activity in that state as compared to other states in the Southeastern United States. Using 1998-2000 HMDA data, we find that the North Carolina law reduced the overall level of subprime mortgage lending activity. Furthermore, we find that the North Carolina decline was caused by a decline in loan application volume and not by a change in loan denial rates, suggesting less aggressive marketing in that state after the imposition of the law. Finally, the impact of the legislation was different by both the type of financial service provider and borrower. Specifically, non-bank subprime lending contracted faster in North Carolina when compared to the control group, while both minority and Low-income applicants were also less likely to get loans following the legislation. These results have wide ranging policy implications given that several predatory lending proposals are currently before Congress, as well as proposed in almost forty other states.

JEL: G21, G28

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The opinions expressed are those of the authors and do not necessarily represent those of the Office of the Comptroller of the Currency or the Treasury Department. The authors thank M. Cary Collins, Larry Mote and David Nebhut for very useful comments.

I. Introduction

Over the past decade, borrowers with limited or impaired credit histories have experienced a tremendous expansion in their to access to credit as both new and traditional lenders became aware of the profit potential of the previously untapped market for subprime credit. Banks and other financial service providers have become active players in this market due to both the robust economy and to increasing competition and shrinking margins on loans to high quality borrowers. Borrowers in the subprime market have benefited from the increased entry into this traditionally underserved market, while some financial service providers have enhanced their earnings through higher fees and rates and by their ability to cross-sell other products and services.

There is a growing body of anecdotal evidence that suggests that a subset of subprime lenders engage in abusive or "predatory" lending practices that strip subprime borrowers of their equity and increase the risk of foreclosure. It has also been argued that these predatory practices exploit lower-income, minority, and elderly borrowers, where traditional banking services are less accessible.[1] These concerns have led financial service providers, banking regulators, and legislators to focus on methods to curb predatory lending abuses, while simultaneously not reducing the growth of the vibrant subprime lending market.[2]

Lenders argue that any regulatory and legislative initiatives to combat predatory practices are unnecessary and are very likely to impede credit flows, especially to low-income applicants. Instead, they believe that self-regulation and better enforcement of existing laws are the optimal solution to predatory practices. Financial regulators have issued guidance and encouraged more stringent enforcement of current lending statutes to target several subprime lenders engaging in predatory

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[1] For example, according to "Curbing Predatory Home Mortgage Lending: A Joint Report", June 2000, subprime loans are three times more likely in low-income neighborhoods than in their high-income counterparts and account for 51 percent of all refinance loans in predominantly black neighborhoods compared with only 9 percent in predominantly white ones. Meanwhile, elderly borrowers have been cited as targets of equity stripping (See, "Borrower Beware: Equity Strippers are Preying on Elderly Homeowners," Federal Reserve Bank of Boston, Communities and Banking, Spring 1999.)

[2] Predatory lending practices generally do not occur in the prime market because there is greater competition among lenders, more homogeneity in loan terms, and a higher degree of financial literacy. Furthermore, although finance companies, a major player in the subprime market, are subject to consumer protection laws, they are not subject to as much oversight as their federally supervised counterparts (e.g., banks, thrifts, and credit unions).

practices over the past few years.[3] Finally, there have been several legislative initiatives designed to curb predatory lending based on the argument that none of the best practices currently offered by subprime lenders is sufficient to address the problem. Among several proposed legislative fixes is "The Predatory Lending Consumer Protection Act of 2002", which was recently introduced by Senator Sarbanes, the Chairman of the Senate Banking, Housing, and Urban Affairs.[4] The legislation is designed to restrict abusive predatory lending practices, expand consumer protections, and strengthen enforcement of existing protections by enhancing civil remedies and statutory penalties. Several proponents of the legislation argue that the large number and diversity of the state proposals dealing with predatory practices require that these issues be dealt with on a nationwide basis. For example, currently over fifteen states have enacted legislation or adopted regulations to curb these lending abuses, while over 20 other states are considering similar legislation.[5]

Foremost among the state level predatory lending laws is that of North Carolina, which was the first state to enact legislation in mid-1999. Key provisions of the law impose limitations on loan terms such as balloon payments, negative amortization, default interest rate increases, prepayment penalties, call provisions, debt-to-income ratios, and other characteristics that might result in abusive practices. Since the law has been in place since 1999, it provides an excellent ground for testing the impact of these types of laws on both the level and distribution of mortgage credit.[6] Given the substantial numbers of state level predatory lending laws pending and the possible introduction of Federal legislation possible in the near future, knowledge of the effect of the North Carolina law on access to credit and subprime lender activity could have very important policy implications.

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[3] In 2001, Financial regulators issued guidance on subprime to deal more directly with these lenders. See "Agencies Expand Subprime Lending Guidance," *ABA Bank Compliance*, Vol. 22, No. 3, March 2001 for more details. Similarly, the Justice Department has announced that it is contemplating focusing more of their fair lending efforts on subprime lenders that have high foreclosure rates in minority neighborhoods See "Department of Justice May Target Lenders with High Foreclosure Rates," *National Mortgage News*, May 13, 2002.

[4] See American Banker, "In Brief: Preemption Talk Raises Subprime Hopes," May 6, 2002. Senators Schumer (D-NY), Representatives LaFalce (D-NY) and Schakowsky (D-IL) introduced anti-predatory bills in the previous year.

[5] Several municipalities including Oakland, Denver, and Washington DC have also enacted predatory lending statutes. See "Prey Tell...Predatory Lending Update," *RMA Journal*, April 2002 for a complete listing of the states, as well as localities, that have initiated or enacted predatory lending legislation.

[6] Recently, North Carolina instituted a second law that went into effect in July 2002. This law requires mortgage lenders and brokers to get a license from the state's banking commissioner. Previously, lenders and brokers only had to register with the state. See "N.C. Passes Second Predator Law," *American Banker*, September 21, 2001.

The remainder of the paper is organized as follows. Section II provides a brief review of the literature on predatory lending. Section III describes the data and provides descriptive statistics on mortgage lending activity in the Southeast for the 1998-2000 time period. This section includes descriptive statistics on the number of applications, originations, and lenders, with a particular focus on low-income and minority borrowers. Section IV outlines several of the empirical tests used to examine the changes in mortgage flows that followed the implementation of the predatory lending law in North Carolina. Specifically, we examine the impact of the legislation on denial probabilities and changes in the percent of low-income and minority lending and attempt to determine whether the legislation had a greater impact on non-bank lenders than on banks. Section V provides the results of the multivariate analysis. Finally, Section 6 summarizes the findings of the study, draws some policy implications, and outlines some areas of future research.

II. Literature Review

A. Predatory Lending Practices

The concept of predatory lending does not have a unique or agreed upon definition. In fact, the term has been used by community organizations, policymakers, regulators and researchers to refer to a wide variety of practices. Engel and McCoy (2001), however, broadly define a predatory loan as one that meets one or more of the following conditions: loans with no net benefit to the borrower, loans designed to earn supranormal profits, loans involving fraud or deceptive practices, loans involving other misleading nondisclosures that are nevertheless legal and loans that require the borrower to waive meaningful redress. Some of these terms or practices include high points, high interest rates, high or duplicative closing costs and fees, loan-to-value ratios (LTV) in excess of 100 percent of the underlying collateral, loan flippings, loan steering, excessive prepayment penalties, abusive collection and foreclosure practices, and loan features such as negative amortization, balloon payments and unnecessary credit insurance. Ernst (2001) estimates the costs to consumers of these predatory practices at over $9.1 billion annually.

Loans with higher interest rates than those seen in the conventional market, however, are not all predatory. The higher interest rates on these loans may simply reflect higher risks and costs associated with subprime lending. Subprime loans are designed for borrowers with impaired or limited credit histories that

make it difficult for them to secure credit from the prime market or traditional lenders.[7] Lenders argue that these higher rates are justified by the need to be compensated for the greater risk that these borrowers pose.[8] They also argue that the higher rates charged reflect a lack of standardization in underwriting that makes it more costly to originate and service loans to borrowers with blemished credit histories, limited discretionary income and cash-flow concerns.[9] Predatory lenders, however, may be defined as those that go beyond risk-based pricing and set loan terms high above what is necessary to offset costs and earn a return that compensates them for their risk. Given the lack of publicly available information on loan terms and practices, however, it is very difficult to distinguish between the two. It is generally agreed, however, that the predatory lending market is a segment of the subprime market.

B. Research on Subprime and Predatory Lending

A significant amount of research on subprime lending activity has been conducted at the Department of Housing and Urban Development (HUD) where for the past several years' researchers have compiled a list of subprime lenders.[10] Using this list, HUD and other researchers have documented the high rates of subprime lending in low-income and minority communities. For example, in 2000, HUD issued a report entitled "Unequal Burden: Income and Racial Disparities in Subprime Lending in America" documenting the concentration of these lenders in low-income and minority communities in five cities including Atlanta, Los Angeles, Baltimore, New York and Chicago. They found that subprime loans were three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white neighborhoods. More recently, the Bradford (2002) study on subprime lending patterns in all of the nation's 331 metropolitan areas found that there are "widespread" racial disparities in

[7] The banking regulators designate a "subprime" borrower as having one of the following characteristics: two or more 30-day delinquencies; one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge-off in the prior 24 months; bankruptcy in the last 5 years; a high default probability as measured by a credit score of 660 or below; or a debt-to-income ratio of 50% or greater. See OCC Bulletin 2001-6.

[8] Zorn (2000) finds that up to 100 basis points of the rates charged by subprime lenders could not be explained by credit risk of the borrowers.

[9] Subprime loans are also typically smaller in size which make the associated fees not only greater in absolute amounts but also as a percentage of the loan amount.

[10] The names, identification numbers and methodology to identify subprime home lenders compiled each is outlined in Scheessele (1998), " HMDA Highlights", Housing Finance Working Paper series, Department of HUD. See http://www.huduser.org/datasets/manu.html for lenders on the annual list.

subprime lending activity nationwide, and the top six areas with the most widespread disparities are all in California.[11]

Several other researchers have examined subprime lending in specific large cities and states. Immergluck (1999) focused on the growth rate of subprime lending in Chicago's minority and low-income community. He found that prime lenders active in white and upper-income communities tended to be less active in minority and lower-income neighborhoods and that subprime lenders have filled this vacuum. Marsico (2001) examines 1999 Home Mortgage Disclosure Act (HMDA) data for New York and found similar patterns with subprime lenders having a greater presence in low-income and minority communities. Finally, Canner, Passmore and Laderman (1999) demonstrated that subprime lenders are oriented more toward low-income and minority applicants and that changes in denial rates over the 1993 to 1998 time period can be partially attributed to the increase in the number of subprime lenders.

Staten and Elliehausen (2001) examined the possible impact of the proposed revisions to Regulation Z that would alter the criteria for a mortgage loan to be covered by the Home Ownership and Equity Protection Act (HOEPA). They argued that the broadening of loans covered by HOEPA could have a large impact on subprime lending because inclusion of a wider class of loans would limit purchases by Freddie Mac and Fannie Mae, who have announced that they would not purchase loans that triggered HOEPA disclosures.[12] This lack of a liquid secondary market raises the costs of lending and may impact credit flows to these borrowers. A data collection effort commissioned by the American Financial Services Association assembled loan-level data on subprime mortgages from nine member companies. Using that data set, Staten and Elliehausen (2001) examined the possible effects of the broadening of HOEPA, as well as the impact of the North Carolina law on the flow of credit by subprime lenders. They found that a broadening of HOEPA coverage might significantly reduce the supply of subprime credit.[13] They also found, using univariate techniques, that the North Carolina law appears to have impacted the volume and type of originations in North Carolina relative to South Carolina and Virginia. Specifically, they found that first mortgage originations to North Carolina borrowers with incomes less than

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[11] Specifically, the paper found that African Americans and Latinos are disproportionately represented in the subprime lending market and that these patterns persist across all income levels and throughout the nation.

[12] See American Banker "Freddie Mac Defends Purchase of Subprime Mortgages," April 6, 2000.

[13] The Federal Reserve did not believe that the broadening of HOEPA regulations would hurt credit availability and new rules were issued in December 2001. The goal of the expansion was to curb some of the most flagrant predatory lending abuses without impairing the growth of legitimate subprime lending. See Remarks by Governor Edward M. Gramlich, at the Housing Bureau for Seniors Conference, January 2002.

$25,000 and between $25,000-$50,000 fell precipitously when compared with originations to borrowers in the two other states during the fourth quarter of 1999 when the majority of the laws provisions were implemented. Finally, Ernst, Farrow, and Stein (2002), using HMDA data, argued that subprime lending in North Carolina continued to thrive after the imposition of the law, that all borrowers continue to have a wide range of choices, and that the North Carolina law has saved borrowers more than $100 million. Their data, however, also show a decline in North Carolina subprime lending relative to the rest of the nation following the enactment of the legislation.

This paper extends Staten and Elliehausen (2001) and Ernst, Farrow and Stein (2002) in several ways. First, we employ a different data set (HMDA) than Staten and Elliehausen (2001) that includes the mortgage activity of all lenders, not just the subprime lenders in the American Financial Services Association database. A major downfall of employing this publicly available data set, however, is that we do not have several of the borrower credit quality characteristics that Staten and Elliehausen employ. Employing HMDA data, however, permits us to get a broader picture of the mortgage market and to examine mortgage flows by both prime and subprime lenders after the imposition of the legislation. Second, we conduct more sophisticated tests using HMDA data than Ernst, Farrow and Stein (2002) to provide more robust evidence on the effects of the law. Finally, we include a broader control group of four states (Georgia, South Carolina, Tennessee, and Virginia), as opposed to the two (South Carolina and Virginia) employed in the earlier research. The next section describes the data in more detail.

III. The Data

In this paper we employ quarterly HMDA data for five Southeastern states, including North Carolina, for the 1998 - 2000 time period. Incorporating a control group of neighboring states that did not enact similar legislation allows us to put the changes in the North Carolina subprime market in context.[14] We identify low income applicants as those with annual incomes of less than $25,000 as reported in HMDA data. We omit from the sample applications with missing income. We classify applicants identified as either black or Hispanic on the HMDA file as minorities. Applicants not identified as white, black or Hispanic are omitted from the sample used to conduct a race analysis, but are included in the other overall sample. Applications that were withdrawn or closed are excluded from the analysis of denial rates, but are included in the overall sample. Subprime

[14] Non-MSA tracts in these regions are omitted from the analysis.

lenders are identified using the lender list compiled annually by HUD.[15] Loan applications are classified into pre- and post-legislation (beginning with July 1999) periods according to the action date on the application.

A. Descriptive Statistics

Loan Applications. Table 1 examines the total number and distribution of mortgage applications made in North Carolina and the control group states over the pre- and post-legislation periods. The table includes figures on the number and percent of loans made by subprime and prime lenders separately, as well as the number and percent of loans made to both low-income and minority borrowers, including growth rates for each category. Panel A includes all applications, while Panels B and C provide a breakdown of the subprime and prime market segments. Tables 2 and 3 provide similar data for loan originations and denial rates, respectively.

The data in Panel A of Table 1 show that both North Carolina and the control group experienced large declines in the number of total applications between the two periods. Total applications declined 23.9 percent in North Carolina compared to 16.5 percent in the control group states, for a difference of 7.4 percent. The most striking difference, however, is in subprime applications, which declined 23.4 percent in North Carolina while growing by 0.5 percent in the control group for a difference of 23.9 percent. By comparison, this growth rate differential in the prime market was only 3.2 percent. After taking into account the changes in the prime and subprime markets, the North Carolina subprime share of the market held steady at 25.0 percent, while in the control states the share increased to 24.5 percent from 20.4 percent.

Panels B and C of Table 1 provide information on the subprime and prime markets separately for both the pre- and post-legislation periods. The panels show that minorities and low-income applicants comprise a larger proportion of the subprime market than of the prime market. For example, in North Carolina during the pre-legislation period minorities and low-income applicants comprised 37.7 percent and 21.1 percent respectively, of the subprime market compared with only 13.2 percent and 9.1 percent of the prime market. The differences in growth rates between North Carolina and the control states reported in the bottom row of Panel A indicate that the legislation had an especially severe impact on minority applicants, while low-income applicants experienced results similar to those of the overall sample. Total application volume in North

[15] The subprime lender list is comprised of all subprime lenders who primarily engage in this activity. Thus, the list omits some prime lenders who may have a small subprime portfolio, as well as some identified subprime lenders who are active on the prime market.

Carolina contracted 7.4 percent more than the control group, while for the minority segment this difference was almost double at 13.3 percent. For the low-income segment the difference was 8.6 percent.

Loan Originations. Table 2 shows that the contraction in applications resulted in similar relative declines in North Carolina loan originations across market segments. Most importantly, the data for the subprime market in Panel B show North Carolina subprime originations contracted 14.7 percent compared with growth of 2.5 percent in the control group for a difference in growth rates of 17.2 percentage points. The larger relative decline in North Carolina subprime originations resulted in even larger differences in growth rates in minority subprime lending which declined 16.1 percent in North Carolina compared with an increase of 15.8 percent in the control group, for a difference of 31.9 percentage points. Similar to the application data, however, the differences were not as pronounced for low-income originations, with North Carolina subprime originations declining by 12.9 percent compared to a decline of 5.5 percent in the control states, for a difference of 7.4%.

Denial Rates. The differences in North Carolina loan originations and the control states may be affected by any relative change in denial rates between the two groups. The data in Table 3 show, however, that denial rates had a much smaller influence on lending volume than application levels. Panel A of Table 3 shows that while denial rates increased significantly across market segments and sub-populations across the two periods, the increases are fairly similar when comparing North Carolina with the control states. For example, the overall denial rate increased 4.0 percentage points in North Carolina (20.7 percent to 24.7 percent) compared with a 5.0 percentage point increase in the control group (20.2 percent to 25.1 percent). Panels B and C of Table 3 show similar changes in denial rates occurred across the prime and subprime segments, in general, as well as for low-income and minority applicants.

B. Univariate Results.

Table 4 provides difference of means tests for changes in market share for the application, origination, and denial rate data. To conduct the statistical tests, we first create MSA-level observations for the percent share of subprime, LOW-INCOME and minority loans, as well as the respective denial rates, in each MSA market for both time periods. We then calculate the means of these MSA-level observations in each time period, and the differences across time periods in each of the two groups. Table 4 shows the results of t-tests of the differences between the North Carolina changes and the control group changes, as well as the within market

changes across time periods, in each of the market shares and denial rates figures. The t-statistics are given below each of the difference values. Panel A contains the results for the total sample while Panels B and C break down the subprime and prime markets, respectively.

The results in Panel A show that the increase in the subprime share of total market applications in North Carolina, 0.2 percent, was significantly less than the increase in the control states, 4.1 percent. The growth in the minority market share in North Carolina, 4.5 percent, was significantly below that of the control states (6.3 percent), while the LOW-INCOME difference was not significant. Similar results hold for the originations data as well, although here the minority change is significant at the 10 percent level only. Changes in denial rates for the subprime and minority markets in North Carolina were similar to those in the control group, resulting in insignificant t-statistics for both segments. For the low-income segment, however, the increase in the denial rate for North Carolina was lower than that for the control group, although the difference is significant at the 10 percent level only. This change dampened the impact of lower subprime applications for North Carolina low-income applicants compared with the control group, contributing to the lack of significance in the loan originations data for this group noted above.

Panel B of Table 4 shows that within the subprime market minority applicants in North Carolina fared worse than those in the control group for loan originations, and this can be attributed to a significant relative decline in applications, while denial rate differences were not significant. For low-income applicants the results were reversed, showing improvement in the share of originations as a result of improved application share compared with the control group, while the denial rate differences again were not significant. Panel C of Table 4 shows that for the prime market none of the differences in changes in applications, originations or denial rates were statistically significant.

Overall, the univariate results support the conclusion that a large decline in North Carolina subprime application volume led to a similar decline in origination volume, leading to significant declines in total subprime and minority segment shares when compared with the control states. Increases in the low-income applicant share within the North Carolina subprime market, however, coupled with a smaller increase in denial rates compared with the control states, mitigated the impact of the overall decline in subprime lending on this segment of the market.

C. Number of Lenders.

We examine data on the number of lenders in each market to determine whether the North Carolina predatory lending laws influenced the level of subprime lender participation. Panel A of Table 5 shows the number and type of lenders in each market across the two periods. The data show small increases in the number of total lenders, but rather large declines in the number of subprime lenders in both groups. The number of subprime lenders active in North Carolina dropped by 30, compared to 29 in the control group. We also examined the change on market share for the 10 largest lenders in the pre-legislation period each group. For North Carolina the market share for these lenders declined in the post-legislation period by 15.9 percentage points, from 45.8% to 29.9%. However the control group lenders experienced a similar decline of 12.9 percentage points. Thus, the differences in changes in application volume noted earlier do not appear to be a result of a difference in the number of lenders active in each market.

Poor economic conditions are probably at least partly responsible for the declines in the number of lenders for both.[16] In fact, several major players in the subprime market withdrew during the 1999-2000 time period at least in part for reasons other than legislation such as large prepayment rates, lack of sustainable volume, poor performance, and regulatory pressure.[17] For example, a major player in the industry, United Companies Financial Corporation, filed for bankruptcy in March 1999, while in February 2000, United PanAM Financial Corporation discontinued its subprime mortgage originations and had a charge of over $7 million. More recently, Bank of America announced in August 2001 that it was selling its entire $26 billion subprime loan portfolio along with its loan origination, fulfillment, and servicing operations. Finally, although its problems were not mortgage related, troubled subprime credit card issuer Providian Financial Corp eliminated its poorly performing subprime lending activity as part of an agreement with federal bank regulators.[18]

Panel B of Table 5 goes beyond the number of lenders by providing a breakdown of the origination data into bank and non-bank components. Panel B shows that total subprime originations declined by 14.7 percent in North Carolina while they grew by 2.5 percent in the control states. Breaking down this information into its

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[16] The weak economy is causing the risk of default on newly originated, nonprime credit quality mortgages to rise above "normal" levels. See Subprime Lending Forecast: Defaults Will Edge Up on New Production, *National Mortgage News*, June 17, 2002 p14,

[17] During this same time period, banking regulators realizing that these lenders were experiencing credit losses at twice the rate of traditional lenders were demanding greater levels of capital. See "FDIC Chief Urges Tighter Capital Rules On Subprimes," *American Banker*, Oct 12, 1999, p1.

[18] See "Providian Ordered Out Of Subprime," *American Banker*, November 29, 2001.

bank and non-bank components, however, gives even more interesting results. Panel B of Table 5 shows that bank originations increased by similar amounts in both North Carolina (38.5 percent) and the control states (40.4 percent), but non-bank originations in North Carolina declined by 36.5 percent compared with a much smaller 17.6 percent decline in the control states.

Similar in its construction to Table 4, Panel C of Table 5 presents t-tests of the difference in the MSA-level observations on the non-bank shares of the subprime market in North Carolina and the control group states, as well as the within market changes over time, in each of the market shares. The results show that across periods, within both of these markets, the non-bank subprime share was significantly lower. The North Carolina decline (18.1 percent), however, is significantly greater than the decline experienced in the control group (12.8 percent). These results suggest that the imposition of the predatory lending law in North Carolina had a greater impact on non-bank lenders in that state relative to the non-bank lenders in the control group.

IV. Empirical Methods

Since the univariate results do not account for other sources of variation in subprime lending such as applicant characteristics or changes in the economy that may influence both the supply and demand for mortgage credit, this section lays out several tests that examine the robustness of the univariate results. Specifically, the remainder of this section outlines five separate tests that examine whether the implementation of the North Carolina legislation had an impact on subprime loan application and origination volumes, denial rates of subprime lenders, and the market share of non-bank lenders compared with their bank counterparts.

Model 1: Denial Probabilities

The first model examines how the implementation of the predatory lending law in North Carolina may have altered denial probabilities of subprime lenders in North Carolina relative to the control group. Although the univariate results in Panel B of Table 3 show a general increase in post-legislation denial rates for both low-income and minority applicants, with slightly higher increases for North Carolina, these results do not take into account other market forces that might affect denial rates. Thus, we estimate a logit model for subprime applications in which the dependent variable is a binary coded 1 for a rejection and 0 for an approval.

The applicant-level denial model is specified in equation 1 as:

$$DENY = \alpha + \beta_1 NC + \beta_2 POSTLAW + \beta_3 NCPOSTLAW + \beta_4 INCOME + \beta_5 LOAN2INC + \beta_6 \overline{CENSUS} \quad (1)$$

The explanatory variables in Equation (1) control for the characteristics of the applicants and their neighborhoods. These include applicant income (INCOME), the applicant's loan-to-income ratio (LOAN2INC), and a number of relevant census tract characteristics (CENSUS). We expect applicants with higher incomes to be less likely to be denied loans, while applicants with higher loan to income ratios should experience higher denial probabilities. We also expect applicants from census tracts with less favorable characteristics to be more likely to be denied. Finally, we include several binary and interactive variables that control for both North Carolina and time effects. These include a binary variable (NC) coded 1 for North Carolina applications and zero for control group applications to control for North Carolina fixed effects, a binary variable representing the pre- and post-legislation periods (POSTLAW) that is coded one for the post-legislation period and zero otherwise to test whether the probability of a loan approval is different across the two periods, and most importantly an interactive variable that combines the North Carolina and post-legislation binary variables (NCPOSTLAW) to assess the impact of the legislation on denial probabilities. We employ the latter three variables in all of the models described below. The variable definitions are provided in Table 6.

Models 2 and 3: Subprime Application and Origination Probabilities

The univariate results in Tables 1 and 2 show that subprime applications and originations contracted faster in North Carolina than in the control group post-legislation. We specify two logit models, one each for applications and originations, to assess whether a loan is likely to be made at a subprime versus a traditional lender in the pre- and post-legislation period. The binary dependent variable, SUBPRIME, is coded 1 for subprime applications and zero for non-subprime applications in Model 2, while an identical variable is coded for subprime originations in Model 3.

Several control variables are included in the model. As in the denial model, we include both income (INCOME) and the ratio of loan to income (LOAN2INC) because since we expect applicants with weaker incomes and higher ratios of loan amount to income to be more likely to seek a loan from a subprime lender. Similarly, applicants from census tracts (CENSUS) with less favorable characteristics may be more likely to apply for subprime credit. We also include the set of binary and interactive binary variables that controls for North Carolina (NC), time (POSTLAW), and most importantly any North Carolina specific effect of the legislation (NCPOSTLAW) in both Models 2 and 3. Both the application and origination model are given by equation 2:

$$SUBPRIME = \alpha + \beta_1 NC + \beta_2 POSTLAW + \beta_3 NCPOSTLAW + \beta_4 INCOME + \beta_5 LOAN2INC + \beta_6 \overline{CENSUS} \quad (2)$$

Model 4: Bank vs. Non-bank Effects

The fourth model tests whether North Carolina subprime applicants are more likely to get their loan from a bank versus a non-bank subprime lender after the implementation of the law. A finding that subprime applicants in North Carolina were more likely to rely on bank financing than control group applicants after the change in the law would indicate that the law had a unique impact on non-bank lenders that are commonly perceived as more likely to engage in predatory lending. These lenders may also have felt a differential impact of the law since they are not subject to the same level of federal oversight as their bank competitors. The model, specified in equation 3, controls for similar applicant and census tract characteristics as in the prior equations and includes subprime originations only:

$$NONBANK = \alpha + \beta_1 NC + \beta_2 POSTLAW + \beta_3 NCPOSTLAW + \beta_4 INCOME + \beta_5 LOAN2INC + \beta_6 \overline{CENSUS} \quad (3)$$

The nonbank variable (NONBANK) is coded 1 for loan originations at non-bank subprime lenders and 0 for bank subprime lenders.[19] The hypothesized sign on the income (INCOME) variable is negative since we expect lower income applicants to be more likely to rely on non-traditional providers of credit than on banks.[20] Alternatively, we expect a positive sign on the loan-to-income variable (LOAN2INC), again because applicants with lower incomes are more likely to rely on non-bank providers. We also expect that applicants from neighborhoods with less favorable census (CENSUS) tract characteristics may be more likely to rely on non-bank credit. Finally, we include the binary and interactive variables that control for North Carolina effects (NC), time effects (POSTLAW), and most importantly the interactive variable (NCPOSTLAW) that assesses post-legislation changes in North Carolina.

Model 5: Subprime Market Share

The final model incorporates MSA and state-level economic variables to test whether the changes in subprime market shares described in Table 4 are different for North Carolina than for the control states, after controlling for changes in the economies of the areas. The MSA-level model is specified in equation 4 as:

[19] The HMDA data includes "agency" codes that permits us to separate out banks from non-banks.
[20] See Vermilyea and Wilcox (2002) for a discussion of "banked and unbanked" consumers.

$$\%SUBPRIME = \alpha + \beta_1 NC + \beta_2 POSTLAW + \beta_3 NCPOSTLAW + \beta_4 GSP + \beta_5 BANKRUP + \beta_6 UNEMPL \quad (4)$$

To estimate the model, we calculate the subprime share of total loan originations (%SUBPRIME) in each of the North Carolina and control group MSAs on a quarterly basis for the 1998-2000 period.[21] Economic data, including quarterly information on gross state product (GSP), state-level bankruptcy claims (BANKRUPT) and the MSA-level unemployment rate (UNEMPL) are obtained from the HAVER database. The signs of these economic variables are difficult to assess a priori because borrowers do migrate out of this market when economic conditions improve, but this effect is offset by the tendency of financial service providers to lower underwriting standards simultaneously with improvements in the economy, leading to an increase in the subprime share. Finally, as in previous models, we control for state-specific effects (NC), time-specific effects (POSTLAW), and most importantly whether the North Carolina experience was different following the enactment of the legislation (NCPOSTLAW).

V. Multivariate Analysis Results

The models outlined in the previous section were developed to assess whether mortgage activity in North Carolina was influenced by the 1999 predatory lending legislation. In this section, we present multivariate results for each of the models outlined in the previous section. The multivariate results in Table 7 strongly support the univariate findings that the legislation had a unique impact on North Carolina subprime applications, originations, non-banks, and market share, while there was no impact on denial probabilities. The remainder of this section discusses the multivariate results in detail.

Denial Probabilities. Column 1 of Table 7 shows the results of equation 1 for subprime denial probabilities. The control variable North Carolina (NC) is negative and significant at the one percent level, indicating a lower subprime denial rate in North Carolina that in the control group for the entire test period. The indicator variable for the post-legislation period (POSTLAW) is positive and significant, consistent with the univariate finding of an increase in subprime denial rates for the full sample during the post-legislation period. Of the two variables controlling for applicant characteristics, the income variable (INCOME) is significant with the expected negative sign, while the loan-to-income variable (LOAN2INC) is insignificant. Most importantly, the test variable examining whether applicants were more likely to be denied in North

[21] There sample includes twelve North Carolina MSAs and thirty-one from the control group, resulting in 43 observations in each quarter for a total of 516 observations (i.e., 43x 12).

Carolina during the post-legislation period (NCPOSTLAW) is insignificant. This result is consistent with the univariate finding that denial rates in North Carolina did not change significantly in the post-legislation period relative to those in the control group.

Subprime Application and Origination Probabilities. The univariate results suggest that a decline in application volume, rather than denial rate differences, led to the large decline in subprime originations in North Carolina compared with the control group. The results in column 2 of Table 7 for subprime versus traditional application probabilities confirm this finding. Column 2 shows that North Carolina experienced higher subprime application shares throughout the period as shown by the positive and significant coefficient on the North Carolina (NC) variable. In general, however, there was also a post- legislation increase in the subprime application share for the entire sample, as denoted by the positive and significant coefficient on the variable (POSTLAW). The primary test variable that compares North Carolina with the control group post-legislation (NCPOSTLAW), however, is negative and significant at the 1 percent level. This result is consistent with the observed decline in subprime applications in North Carolina compared to the control group during the post-legislation period.

Column 3 of Table 7 shows similar results for subprime originations. Subprime originations were significantly more likely in North Carolina (NC) over the full sample period and during the post-legislation period (POSTLAW). The significant negative coefficient on NCPOSTLAW in Column 3 also shows, however, that among subprime originations, these loans were significantly less likely to be originated in North Carolina during the post-legislation period. Taken together, the results suggest that the predatory lending law may have reduced the level of marketing of subprime loans in North Carolina, resulting in a decline in both application and origination volume, while denial probabilities held relatively steady compared with those in other states.

Non-Bank Lender Probabilities. Column 4 of Table 7 shows the results of the analysis of bank versus non-bank lender effects. The results show that non-bank lenders were more active in North Carolina (NC) than in the control group throughout the entire period, as shown by the positive coefficient. Non-bank lending overall, however, declined significantly in the post-legislation period (POSTLAW), as shown by the negative coefficient. More importantly, the negative and significant coefficient on the NCPOSTLAW variable shows that non-bank lending in North Carolina declined faster than in the control group following the enactment of the legislation.

The non-bank lender result suggests the North Carolina predatory lending law may have had a unique effect on non-bank lenders, perhaps because these lenders are more likely to engage in underwriting the types of loans that became subject to the new criteria. This finding may indicate that the law is at least in part achieving its stated goal of reducing predatory lending practices. The limitations of our data, however, which do not include loan terms, do not allow us to test this claim in a more robust manner.

Subprime Market Share. The results of the subprime shares model controlling for the impact of regional economic variables are shown in Column 5 of Table 7. The signs on the economic variables are consistent with deteriorating regional economic conditions resulting in more loan applicants migrating to the subprime market. The GSP variable is negative and significant, while the BANKRUP and UNEMPL variables are both positive and significant. The significant negative coefficient on the North Carolina post-legislation variable (NCPOSTLAW) demonstrates that, after controlling for the influence of economic conditions on the subprime market share, North Carolina experienced a significant decline in this share relative to the control states after the new law, consistent with the results of the applicant-level models.

VI. Conclusion

In this paper, we find that the volumes of both subprime mortgage applications and originations declined significantly in North Carolina compared with those of a control group of four other Southeastern States following the enactment of the North Carolina predatory lending law. The decline in North Carolina originations is attributable to a large decline in applications rather than to differences in denial rates. This result suggests that subprime lenders active in North Carolina may have been less aggressive in marketing loans during the post-enactment period because the data do not show any major difference in the changes in the total number of subprime lenders active in the two regions.

Our analysis of loan volume by type of lender, however, indicates that non-bank subprime lending in North Carolina slowed much faster than subprime lending by bank lenders. This may be the result of non-bank lenders having greater exposure to the types of credits subject to the legislation, and may indicate that the law is curbing predatory lending practices to some degree. While the limitations of our data do not allow us to test this hypothesis, the results definitely suggest that non-bank lenders felt the impact of the law to a greater degree than their bank counterparts. They also suggest that further investigation is warranted to determine whether any future predatory legislation should be directed at all financial service providers.

An examination of the results by race and income classes indicate that minority applicants exhibited significantly smaller growth rates in applications and originations in North Carolina than in the control group, largely due to their heavier reliance on the subprime market as compared with majority applicants. Low-income applicants were affected to a lesser degree. Although we find that the North Carolina law reduced the level of subprime lending in that state and that its impact was not felt equally across racial and income classifications, the HMDA data do not allow us to discern how much of this reduction in lending was predatory in nature.

Future research should attempt to disentangle whether the majority of the reduction in North Carolina subprime lending was predatory in nature. This would require a data set that includes more information on pricing and applicant credit-worthiness or, alternatively, more detailed information on the lenders that operate in this area. Finally, future research could also examine the impact of more recent predatory lending statutes in other states and municipalities to determine the robustness of the results and whether different provisions lead to smaller or larger declines in subprime lending.

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Table 1. Loan Applications by market segment in the pre- and post-legislation periods.

Panel A: Total Market

Market	Total Applications	Subprime	Percent Subprime	Prime	Percent Prime	Low Income	Percent Low Income	Minority	Percent Minority
Applications:									
North Carolina									
1998 - Q2 1999	502,314	124,936	24.87%	377,378	75.13%	60,542	12.05%	63,035	16.62%
Q3 1999 - 2000	382,267	95,693	25.03%	286,574	74.97%	43,459	11.37%	57,022	21.12%
Change	(120,047)	(29,243)	0.16%	(90,804)	-0.16%	(17,083)	-0.68%	(6,013)	4.50%
Control Group									
1998 – Q2 1999	1,535,036	312,644	20.37%	1,222,392	79.63%	176,515	11.50%	216,034	18.19%
Q3 1999 - 2000	1,281,931	314,177	24.51%	967,754	75.49%	141,827	11.06%	224,217	24.50%
Change	(253,105)	1,533	4.14%	(254,638)	-4.14%	(34,688)	-0.44%	8,183	6.31%
Growth Rates:									
North Carolina	-23.90%	-23.41%		-24.06%		-28.22%		-9.54%	
Control Group	-16.49%	0.49%		-20.83%		-19.65%		3.79%	
Difference	-7.41%	-23.90%		-3.23%		-8.57%		-13.33%	

Panel B: Subprime Market

Market	Applications	Low Income	Percent Low Income	Minority	Percent Minority
Applications:					
North Carolina					
1998 - Q2 1999	124,936	26,330	21.07%	19,901	37.68%
Q3 1999 - 2000	95,693	19,350	20.22%	16,132	39.91%
Change	(29,243)	(6,980)	-0.85%	(3,769)	2.23%
Control Group					
1998 - Q2 1999	312,644	68,386	21.87%	56,180	39.27%
Q3 1999 - 2000	314,177	61,587	19.60%	66,805	45.43%
Change	1,533	(6,799)	-2.27%	10,625	6.15%
Growth Rates:					
North Carolina	-23.41%	-26.51%		-18.94%	

Panel C: Prime Market

Market	Applications	Low Income	Percent Low Income	Minority	Percent Minority
Applications:					
North Carolina					
1998 - Q2 1999	377,378	34,212	9.07%	43,134	13.21%
Q3 1999 - 2000	286,574	24,109	8.41%	40,890	17.81%
Change	(90,804)	(10,103)	-0.65%	(2,244)	4.60%
Control Group					
1998 - Q2 1999	1,222,392	108,129	8.85%	159,854	15.31%
Q3 1999 - 2000	967,754	80,240	8.29%	157,412	20.49%
Change	(254,638)	(27,889)	-0.55%	(2,442)	5.18%
Growth Rates:					
North Carolina	-24.06%	-29.53%		-5.20%	

Control Group	0.49%	-9.94%	18.91%	-20.83%	-25.79%	-1.53%
Difference	-23.90%	-16.57%	-37.85%	-3.23%	-3.74%	-3.67%

Table 2. Loan Originations by market segment in the pre- and post-legislation periods.

Panel A: Total Market

Market	Total Originations	Subprime	Percent Subprime	Prime	Percent Prime	Low Income	Percent Low Income	Minority	Percent Minority
Originations:									
North Carolina									
1998 - Q2 1999	343,490	41,203	12.00%	302,287	88.00%	28,595	8.32%	37,832	12.83%
Q3 1999 - 2000	246,024	35,157	14.29%	210,867	85.71%	20,231	8.22%	34,025	17.17%
Change	(97,466)	(6,046)	2.29%	(91,420)	-2.29%	(8,364)	-0.10%	(3,807)	4.35%
Control Group									
1998 - Q2 1999	1,095,435	105,222	9.61%	990,213	90.39%	87,438	7.98%	136,869	14.55%
Q3 1999 - 2000	836,036	107,897	12.91%	728,139	87.09%	64,931	7.77%	135,628	20.10%
Change	(259,399)	2,675	3.30%	(262,074)	-3.30%	(22,507)	-0.22%	(1,241)	5.55%
Growth Rates:									
North Carolina	-28.38%	-14.67%		-30.24%		-29.25%		-10.06%	
Control Group	-23.68%	2.54%		-26.47%		-25.74%		-0.91%	
Difference	-4.70%	-17.22%		-3.78%		-3.51%		-9.16%	

Panel B: Subprime Market

Market	Originations	Low Income	Percent Low Income	Minority	Percent Minority
Originations:					
North Carolina					
1998 - Q2 1999	41,203	7,878	19.12%	8,482	36.75%
Q3 1999 - 2000	35,157	6,859	19.51%	7,116	38.53%
Change	(6,046)	(1,019)	0.39%	(1,366)	1.78%
Control Group					
1998 - Q2 1999	105,222	18,982	18.04%	23,653	37.53%
Q3 1999 - 2000	107,897	17,936	16.62%	27,388	43.06%
Change	2,675	(1,046)	-1.42%	3,735	5.53%
Growth Rates:					
North Carolina	-14.67%	-12.93%		-16.10%	
Control Group	2.54%	-5.51%		15.79%	
Difference	-17.22%	-7.42%		-31.90%	

Panel C: Prime Market

Market	Originations	Low Income	Percent Low Income	Minority	Percent Minority
Originations:					
North Carolina					
1998 - Q2 1999	302,287	20,717	6.85%	29,350	10.79%
Q3 1999 - 2000	210,867	13,372	6.34%	26,909	14.98%
Change	(91,420)	(7,345)	-0.51%	(2,441)	4.19%
Control Group					
1998 - Q2 1999	990,213	68,456	6.91%	113,216	12.90%
Q3 1999 - 2000	728,139	46,995	6.45%	108,240	17.71%
Change	(262,074)	(21,461)	-0.46%	(4,976)	4.81%
Growth Rates:					
North Carolina	-30.24%	-35.45%		-8.32%	
Control Group	-26.47%	-31.35%		-4.40%	
Difference	-3.78%	-4.10%		-3.92%	

Table 3. Denial Rates by market segment in the pre- and post-legislation periods.

Panel A: Total Market

Market	Total Applications	Subprime	Prime	Low Income	Minority
Denial Rates:					
North Carolina					
1998 - Q2 1999	20.69%	41.53%	13.79%	37.96%	30.08%
Q3 1999 - 2000	24.73%	46.97%	17.30%	42.21%	31.10%
Change	4.04%	5.45%	3.51%	4.25%	1.02%
Control Group					
1998 - Q2 1999	20.16%	45.51%	13.68%	38.36%	28.50%
Q3 1999 - 2000	25.11%	50.70%	16.80%	44.23%	30.62%
Change	4.95%	5.19%	3.12%	5.87%	2.13%
Growth Rates:					
North Carolina	19.55%	13.11%	25.45%	11.20%	3.38%
Control Group	24.54%	11.41%	22.81%	15.30%	7.47%
Difference	-4.99%	1.71%	2.65%	-4.11%	-4.09%

	Panel B: Subprime Market			Panel C: Prime Market		
Market	Total	Low Income	Minority	Total	Low Income	Minority
Denial Rates:						
North Carolina						
1998 - Q2 1999	41.53%	46.31%	40.16%	13.79%	31.54%	25.43%
Q3 1999 - 2000	46.97%	51.33%	43.65%	17.30%	34.88%	26.15%
Change	5.45%	5.02%	3.49%	3.51%	3.34%	0.72%
Control Group						
1998 - Q2 1999	45.51%	51.29%	42.92%	13.68%	30.18%	23.43%
Q3 1999 - 2000	50.70%	58.25%	45.94%	16.80%	33.47%	24.13%
Change	5.19%	6.96%	3.01%	3.12%	3.29%	0.70%
Growth Rates:						
North Carolina	13.11%	10.84%	8.69%	25.45%	10.59%	2.83%
Control Group	11.41%	13.57%	7.02%	22.81%	10.90%	2.99%
Difference	1.71%	-2.73%	1.67%	2.65%	-0.31%	-0.16%

Table 4. Difference of means tests for changes in market shares and denial rates in the pre- and post-legislation periods.

Panel A: Total Market

Market	North Carolina	Control Group	Difference
Applications:			
Percent Subprime	0.16%	4.14%***	-3.98%***
	0.31	16.47	7.61
Percent Low Income	-0.68%**	-0.44%**	-0.25%
	2.37	2.45	0.90
Percent Minority	4.50%***	6.31%***	-1.80%**
	11.40	11.62	2.33
Originations:			
Percent Subprime	2.29%***	3.30%***	-1.01%***
	8.35	16.21	2.84
Percent Low Income	-0.10%	-0.22%	0.11%
	0.26	1.13	0.38
Percent Minority	4.35%***	5.55%***	-1.20%*
	10.57	12.55	1.81
Denial Rates:			
Subprime	5.45%***	5.19%***	0.26%
	7.27	8.52	0.11
Low Income	4.25%***	5.87%***	-1.62%*
	6.34	11.59	1.72
Minority	1.02%**	2.13%***	-1.11%
	2.51	5.11	1.5

	Panel B: Subprime Market			Panel C: Prime Market		
Market	**North Carolina**	**Control Group**	**Difference**	**North Carolina**	**Control Group**	**Difference**
Applications:						
Percent Low Income	-0.85%*	-2.27%***	1.42%	-0.65%**	-0.55%***	-0.10%
	2.06	4.79	1.44	2.40	3.90	0.53
Percent Minority	2.23%***	6.15%***	-3.92%**	4.60%***	5.18%***	-0.58%
	4.03	8.42	2.62	10.72	11.46	0.64
Originations:						
Percent Low Income	0.39%	-1.42%***	1.81%**	-0.51%	-0.46%***	-0.05%
	0.75	2.91	2.18	1.75	2.96	0.20
Percent Minority	1.78%***	5.53%***	-3.75%***	4.19%***	4.81%***	-0.62%
	3.34	9.15	2.75	10.11	12.29	0.86
Denial Rates:						
Low Income	5.02%***	6.96%***	-1.94%	3.34%***	3.29%***	0.05%
	4.77	8.63	1.45	4.61	5.31	0.07
Minority	3.49%***	3.01%***	0.48%	0.72%	0.70%**	0.02%
	3.41	3.79	0.08	1.73	2.44	0.1

*** Indicates significance at the 0.01 level.
** Indicates significance at the 0.05 level.

Table 5.

Panel A. Number and type of lenders by market segment in the pre- and post-legislation periods.

Market	1998 - Q2 1999					Q3 1999 – 2000				
	Number of Lenders	Number of Subprime Lenders	Percent Subprime Lenders	Number of Non-bank Subprime Lenders	Percent Non-bank Subprime Lenders	Number of Lenders	Number of Subprime Lenders	Percent Subprime Lenders	Number of Non-bank Subprime Lenders	Percent Non-bank Subprime Lenders
Number of Lenders:										
North Carolina	1,024	186	18.16%	148	14.45%	1,059	156	14.73%	119	11.24%
Control Group	1,887	218	11.55%	162	8.59%	1,977	189	9.56%	137	6.93%
Growth Rates:										
North Carolina						3.42%	-16.13%		-19.59%	
Control Group						4.77%	-13.30%		-15.43%	

Panel B: Subprime Market Originations by Lender Type

Market	Subprime Originations	Bank Originations	Percent Bank	Non-Bank Originations	Percent Non-bank
Originations:					
North Carolina					
1998 - Q2 1999	41,203	11,998	29.12%	29,205	70.88%
Q3 1999 - 2000	35,157	16,615	47.26%	18,542	52.74%
Change	(6,046)	4,617	18.14%	(10,663)	-18.14%
Control Group					
1998 - Q2 1999	105,222	36,484	34.67%	68,738	65.33%
Q3 1999 - 2000	107,897	51,238	47.49%	56,659	52.51%
Change	2,675	14,754	12.81%	(12,079)	-12.81%
Growth Rates:					
North Carolina	-14.67%	38.48%		-36.51%	
Control Group	2.54%	40.44%		-17.57%	
Difference	-17.22%	-1.96%		-18.94%	

Panel C: T-test for change in non-bank share of Subprime market.

Market	North Carolina	Control Group	Difference
Non-bank Share	-18.14% ***	-12.81% ***	-5.33% ***
	18.73	17.71	3.93

*** Indicates significance at the 0.01 level.

Table 6. Variable Definitions

Variable Name	Definition
1. HMDA Variables	
DENIAL	Indicator variable =1 if Denied; 0 otherwise
INCOME	Applicant income reported on HMDA
LOAN2INC	Ratio of requested loan amount to Applicant Income
NONBANK	Indicator variable =1 if non-regulated institution; 0 if regulated, i.e., bank, thrift, and credit union.
2. Census Variables[22]	
MEDINC	Median income in the applicant MSA
% MINORITY	Percentage of Minorities in the applicant MSA
% PUBLIC	Percentage of Families on Public Asssistance in the applicant MSA
% RENTAL	in the applicant MSA
% VACANT	in the applicant MSA
% FEMALEHH	Percentage of female head of households in the applicant MSA
AGEHOUSE	Average age of the housing stock
3. Macroeconomic data	
GSP	Quarterly gross state product
Bankrupt	Quarterly state level bankruptcy filings
UNEMPL	Quarterly MSA level unemployment rate
4. Variables Isolating North Carolina and Effects of Legislation	
NC	Indicator variable: North Carolina = 1; 0 otherwise
POSTLAW	Indicator variable: Time period post North Carolina Legislation=1; 0 otherwise
NCPOSTLAW	Indicator variable: Post legislation in North Carolina=1; 0 otherwise

[22] 1990 Census information was used due to the lack of availability of 2000 Census information at the MSA level.

Table 7. Multivariate Analysis.

Dependent Variable	DENIAL		SUBPRIME APPLICATION		SUBPRIME ORIGINATION		NONBANK ORIGINATION	
Model #	(1)		(2)		(3)		(4)	
Explanatory Variable	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value
INTERCEPT	0.3655 ***	0.0001	0.1234 ***	0.0001	-0.9258 ***	0.0001	0.5275 ***	0.0001
NC	-0.1837 ***	0.0001	0.1582 ***	0.0001	0.1503 ***	0.0001	0.3586 ***	0.0001
POSTLAW	0.2163 ***	0.0001	0.2140 ***	0.0001	0.2945 ***	0.0001	-0.6227 ***	0.0001
NCPOSTLAW	0.0071	0.4864	-0.2280 ***	0.0001	-0.1208 ***	0.0001	-0.3667 ***	0.0001
INCOME	-0.0011 ***	0.0001	-0.0079 ***	0.0001	-0.0080 ***	0.0001	0.0005 *	0.0773
LOAN2INC	0.0003	0.2242	0.0012 ***	0.0001	0.0004	0.1040	0.0123 ***	0.0001
MEDINC	-0.0009 ***	0.0001	-0.0003 ***	0.0001	-0.0003 ***	0.0001	0.0001 ***	0.0001
% MINORITY	0.0025 ***	0.0001	0.0101 ***	0.0001	0.0112 ***	0.0001	-0.0017 ***	0.0001
% PUBLIC	0.0009	0.2183	-0.0144 ***	0.0001	-0.0153 ***	0.0001	-0.0035 ***	0.0001
% RENTAL	-0.0002	0.2781	-0.0092 ***	0.0001	-0.0108 ***	0.0001	0.0013 ***	0.0001
% VACANT	-0.0018 ***	0.0001	-0.0092 ***	0.0001	-0.0074 ***	0.0001	0.0007	0.1293
% FEMALEHH	-0.0080 ***	0.0001	0.0207 ***	0.0001	0.0293 ***	0.0001	0.0029 ***	0.0001
AGEHOUSE	-0.0086 ***	0.0001	-0.0027 ***	0.0001	0.0015 ***	0.0001	-0.0006 **	0.0327
GSP								
BANKRUPT								
UNEMPL								
-2 LOG LIKELIHOOD	1102035		3481746		1567284		1060512	
R-SQUARE								

*** Indicates significance at the 0.01 level.
** Indicates significance at the 0.05 level.
* Indicates significance at the 0.10 level.

REGULATION OF SUBPRIME MORTGAGE PRODUCTS: AN ANALYSIS OF NORTH CAROLINA'S PREDATORY LENDING LAW

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November 2002

REGULATION OF SUBPRIME MORTGAGE PRODUCTS: AN ANALYSIS OF NORTH CAROLINA'S PREDATORY LENDING LAW

Introduction

The development of the subprime mortgage market in the 1990s expanded availability of mortgage credit to low-income and high-risk consumers, many of whom would previously have had difficulty qualifying for mortgage credit. For these consumers, subprime mortgage credit has provided access to home ownership and the opportunity to borrow against accumulated home equity. However, lending abuses have also occurred. For example, the imposition of high fees on subprime loans, sometimes in conjunction with repeated refinancings (loan "flipping") of a loan within a short period of time have led to charges of "equity stripping," as well as an increased risk of foreclosure. Because subprime loans may be used relatively more often by certain groups of borrowers considered "vulnerable" (e.g., lower-income and minority borrowers), the aggressive marketing of subprime loans to these groups has sparked proposals for increased regulation to curb "predatory lending."

The federal Home Ownership and Equity Protection Act (HOEPA) typifies the prevailing regulatory approach to curbing predatory lending. Since its passage in 1994, HOEPA has classified mortgage loans with relatively high interest rates and fees as potentially predatory and imposed upon them a package of additional consumer protections, including disclosure requirements and limits on certain contractual features. However, in recent years many state and local governments have enacted or proposed their own regulations that impose even more restrictive regulation than does HOEPA.

The first statute below the federal level for regulating high-cost mortgage loans was enacted in North Carolina in July, 1999. North Carolina Senate Bill 1149 utilizes a definition for high-cost loans that covers more loans than the federal law, and its restrictions on such loans are more severe. All such regulations increase to some degree a lender's cost of making high-cost mortgage loans to consumers. Economic analysis indicates that lenders would respond to higher costs by reducing the supply of mortgage credit.

The following sections test these implications by analyzing the impact of the North Carolina statute on the originations of subprime mortgage loans to North Carolina consumers. The results indicate that after accounting for a variety of factors that influence supply and demand, creditors appear to have sharply restricted lending to higher risk customers in North Carolina—but not to customers in neighboring states or to lower risk customers in North Carolina—after passage of the law. The findings support the hypothesis that creditors rationed the highest risk customers in response to the higher costs imposed by the North Carolina anti-predatory lending statute.

These results are important because, as mentioned, many states and local governments have proposed laws containing provisions similar to and even more restrictive than those in the North Carolina law. The observed decline in North Carolina in response to the law suggests that adoption of this regulatory approach in other localities may take back some of the benefits of increased availability of mortgage credit that low-income and high-risk consumers obtained during the 1990s. The regulatory remedy to predatory lending may unintentionally harm many of its potential beneficiaries.

Background

A. HOEPA and the Cost of Subprime Lending Responding to reports that lending abuses were on the rise in the subprime mortgage market, in December 2000 the Federal Reserve Board (FRB) proposed revisions to Regulation Z that would expand the number of loans covered under HOEPA and introduce new restrictions on covered loans. At various times through the subsequent public comment period, the Board indicated that its proposal was intended to strike a balance between curbing a variety of abuses that have been termed "predatory lending" and impeding the general growth of the legitimate subprime mortgage market. In this regard, the federal regulators signaled an awareness that an overly-protective anti-predatory lending statute runs the risk of impeding the flow of subprime mortgage credit, thereby harming more people than it helps.

Recent events provide reasons to worry that broad expansion of HOEPA-style regulations could reduce the flow of credit to subprime borrowers. In response to state and local initiatives that impose HOEPA-like tests and restrictions on mortgage loans, several major lenders have announced a reduction or exit from the affected markets.[1] In the spring of 2000, Freddie Mac announced that it would not purchase any mortgage loan that triggers HOEPA disclosures and protections.[2] Fannie Mae has adopted a similar policy. Both actions sharply reduce the liquidity of HOEPA loans by truncating demand for such loans in the secondary market.[3] This raises the cost to a lending institution of making such loans and would likely reduce a lender's appetite for extending higher cost loans to higher risk borrowers.

An FRB staff memorandum explicitly voiced the concern that further extension of HOEPA coverage "could have a chilling effect and raise regulatory costs in a segment of the subprime mortgage market. This might deter interest of some predatory lenders in the market. It seems unlikely this effect would be restricted to predatory lenders alone,

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[1]For example, *see* Erick Bergquist, "Industry Hits Back on Lending Abuse Laws," *American Banker*, January 26, 2001, pp. 1,9; Helen Egger, Testimony on behalf of Equicredit Corporation before the Federal Reserve Board, July 27, 2000; Erick Bergquist, "Georgia Predator Law Drives Out Some Lenders," *American Banker*, October 1, 2002 pp 1,12.

[2]*See* editorial by David A. Andrukonis, Chief Credit Officer, Freddie Mac, "Freddie Mac Defends Purchase of Subprime Mortgages," *American Banker*, April 6, 2000, also available at www.freddiemac.com/news/analysis/ambankerlet.html.

[3] Freddie Mac has taken a similar stance with respect to loans designated as "high-cost" loans under some state laws (e.g., Georgia), regardless of whether they are already classified as HOEPA loans. See Bergquist (2002), p 12.

however, and it could cause some potential legitimate competitors to forego entry into this market where competition currently is alleged to be low."[4]

Regulations imposed by the HOEPA-style statutes typically prohibit certain contract terms (e.g., balloon payments, prepayment penalties, single premium credit insurance), mandate lending procedures (e.g., require that borrowers complete credit counseling), and impose documentation requirements (e.g., demonstrate that a refinancing provides a "net tangible benefit" to the borrower; document that the borrower has sufficient ability to repay the loan) on mortgage loans that have annual percentage rates or fees that exceed various threshold amounts. Such measures may or may not inhibit the abusive and deceptive marketing tactics that are frequently cited by victims of "predatory lending", but they certainly raise the lender's cost of making such loans. In particular, some of the documentation requirements may impose unacceptable risks of legal liability for some creditors (predatory and legitimate) who offer high-cost mortgage loans.[5] Thus these measures risk restricting credit beyond those loans offered by predatory lenders. The impact on the supply of such mortgages depends on two components of the regulation, the pricing threshold values (expressed in terms of loan APR and fees) that determine how many loans will be designated "high-cost" loans and subject to coverage, and the stringency of the package of additional consumer protections triggered when the loan pricing exceeds the designated thresholds.[6]

B. North Carolina's High-Cost Mortgage Law

In July 1999 the North Carolina General Assembly passed a law that was intended to reduce predatory lending by banning certain practices on all mortgage loans and creating a new category of high-cost mortgages subject to additional restrictions. The statute was enacted in phases. Some features became effective for loans originated on or after October 1, 1999.[7] The rest of the anti-predatory features became effective on July 1, 2000.

The anti-predatory features included a HOEPA-like trigger mechanism for classifying closed-end mortgage loans as "high-cost" loans.[8] Limits on the features of high-cost loans include the following:

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[4]Durkin and Canner (2000), pp. 3-4.

[5] For example, the Georgia predatory lending law which took effect on October 1, 2002 requires lenders to document that a refinancing of a loan less than five years old provides a "net tangible benefit" to the borrower. The *American Banker* reported that this provision convinced Ameriquest Mortgage Co. (Orange, CA), the nation's seventh-largest subprime originator, to stop making all subprime loans in Georgia. Adam Bass, a senior vice president with Ameriquest commented on the net-tangible-benefit clause, "Nobody has explained that to me and I haven't seen anything from the Georgia department of banking that defines what that is and how you comply." See Bergquist (2002), p 12.

[6] Because the more stringent anti-predatory lending laws could choke off mortgage credit at prices above the trigger thresholds, these laws have been described as "stealth" usury laws. See Calomiris (2001).

[7]These features included a ban on prepayment fees on first mortgages less than $150,000.

[8]The "high-cost" loan triggers are exceeded if a loan meets any of the following criteria: 1) APR would qualify the loan for HOEPA protections, 2) points and fees exceed 5 percent of the loan amount for loans greater than or equal to $20,000 or the lesser of $1,000 or 8 percent of the loan amount for loans less than $20,000, or 3) the loan allows for the assessment of a prepayment fee more than 30 months after closing.

- Lender must confirm that a borrower received home-ownership counseling prior to closing the loan
- Lender must document borrower's ability to repay
- Limits on loan features include
  - No call provision
  - No balloon payment
  - No negative amortization
  - No increased interest rate as a consequence of default
  - No modification or deferral fees
- No financing of fees or charges if the borrower refinances a loan from the same lender.

In addition, for all mortgage loans (regardless of whether they are classified as high-cost) originated on or after July 1, 2000 the statute bans the financing of premiums on credit insurance (i.e., bans the sale of single-premium credit insurance) and also prohibits the refinancing of mortgage loans without demonstrating a reasonable, tangible benefit to the borrower.

These requirements impose more stringent restrictions on mortgage lenders than prevailed under the federal HOEPA rules at the time of passage. In essence, the "package" of restrictions imposed on high-cost mortgage loans in North Carolina raised lenders' cost of servicing the higher-risk segment of the market by (1) limiting or prohibiting certain contractual features that could be used to mitigate or compensate for higher credit or prepayment risk, (2) imposing new disclosure or procedural requirements, and (3) expanding lender legal and reputational liability.

C. Prior Studies of the Impact of the North Carolina Anti-Predatory Lending Statute

To our knowledge, only two studies have been released that attempt to document the impact of the North Carolina statute on subprime originations. One is a study prepared by a North Carolina-based nonprofit advocacy group, the Center for Responsible Lending (CRL). That study claims to show that North Carolina's 1999 anti-predatory lending law saved consumers $100 million on home mortgages originated during the year 2000.[9] The authors evaluated data reported under the Home Mortgage Disclosure Act (HMDA) from 1998- 2000 and concluded that subprime mortgage lending continued to "thrive" in North Carolina after passage of the statute and low-income borrowers continued "to have access to a wide range of choices when selecting a home loan."

A careful review of the CRL report reveals a different story. The evidence presented does not support, and often contradicts, the report's conclusions. All of CRL's

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Note that the statute protections triggered by designation as a "high-cost" loan apply only to closed-end mortgage loans, and do not apply to open-end, home equity loans.

[9] Keith Ernst, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform," Center for Responsible Lending, Durham, NC, August 13, 2002.

conclusions regarding the volume and composition of subprime mortgage lending in North Carolina are based on simple tabulations of HMDA reports filed for 1998-2000. Notwithstanding the fact that HMDA data have serious weaknesses when used to analyze changes in the volume of ***subprime*** lending, the data actually show that the HMDA measure of subprime originations per capita declined in 2000, both for the U.S. in general and for North Carolina in particular. Indeed, the decline in North Carolina was larger than the decline in the U.S. average, hardly proof of a "thriving" subprime market.

Even more problematic, is that the HMDA data do not contain information on borrower risk characteristics. Consequently, the data cannot be used to detect shifts in underwriting guidelines that might have been triggered by the 1999 statute. As noted above, an economic model of a lender's reaction to higher costs of servicing higher-risk borrowers (consequent to passage of the 1999 North Carolina statute) predicts that lenders would reduce the supply of loans to higher-risk borrowers. A lender could remain active in the subprime market, but set higher acceptance standards, so that borrowers judged to be higher risk would be denied loans, even though borrowers with the same risk profile were accepted prior to the 1999 statute. Again, because it focuses on the number of originations, as opposed to the characteristics of borrowers, the HMDA database can't be used to confirm or refute this prediction.[10]

In the other prior study on North Carolina (Staten and Elliehausen 2001) we compared year-to-year changes in the subprime mortgage originations of nine large finance companies between Q1 1998 and Q2 2000 in North Carolina and two neighboring states

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[10] Since the CRL report relies exclusively on HMDA data in drawing its conclusions, it is helpful to review the limitations of the data. First, HMDA data do not identify a particular mortgage loan as subprime. The Department of Housing and Urban Development (HUD) annually produces a list of lenders believed to be *predominately* subprime lenders. Researchers using the HMDA data must assume that all loans made by lenders on the HUD subprime list are subprime (although some of these lenders are known to make prime loans) and that no other lenders make subprime loans (although many lenders who are not considered *predominately* subprime lenders nevertheless make large numbers of subprime loans). Thus, analysis that relies on the HUD subprime lender list omits some subprime loans from other lenders and includes prime loans from listed lenders.

There are many institutions that are not required to report under HMDA, and their lending activity is not reflected in the HMDA data at all. During the period covered by the CRL study (1998-2000), a non-depository institution was required to report under HMDA only if its annual lending for home purchase and refinancing equals 10% or more of the dollar value of its loan originations (mortgage and non-mortgage). Many non-depository institutions (e.g., consumer finance companies) have long specialized in making loans of all kinds to "subprime" borrowers. Subprime mortgage loan originations from many of these companies are also missing from the HMDA database. As a consequence, use of the HUD subprime list in conjunction with the HMDA data produces, at best, a very rough approximation of subprime mortgage lending.

More importantly, the HMDA data do not include any information on loan pricing or borrower risk characteristics (other than income). Consequently, the HUD/HMDA subprime data cannot be used to identify the impact of changes in underwriting standards, e.g., tightening of credit to higher risk borrowers. Of course, such changes are precisely the adjustments that subprime lenders would likely make when confronted with a new statute that imposes restrictions on high-cost loans.

that had not passed any legislation to curb predatory lending. The results suggested that something was affecting the volume and type of originations in North Carolina, relative to other states, following passage of the anti-predatory statute. For borrowers with incomes less than $25,000, first mortgage originations fell precipitously in the fourth quarter of 1999 relative to the same quarter one year earlier, and the year-over-year decline continued through the end of the second quarter, 2000. Originations in South Carolina and Virginia did not display the dramatic decline in activity for these lower-income borrowers (see Chart 1). A similar pattern is evident for borrowers with incomes between $25,000 and $50,000. However, originations for the group of borrowers with incomes of $50,000 - $74,999 (Chart 2) and also for the group with incomes of $75,000 and higher do not display markedly different patterns across the three states. These findings suggested that lenders may have scaled back their promotion of closed-end subprime mortgage loans in North Carolina simultaneous with the phased-in enactment of the law.

In the following sections we investigate more rigorously the effects of the North Carolina law. We develop and test an empirical model of the supply and demand for subprime loan originations, and apply multivariate statistical techniques to control for other factors that may have been influencing loan volumes. We utilize a large and unique database of closed-end subprime loans that contains sufficient borrower characteristics to test the hypothesis that closed-end mortgage credit was reduced for higher-risk borrowers.

The Model

We specify aggregate county-level supply and demand functions to test statistically for a decline in the volume of subprime mortgage loan originations in North Carolina following passage of the 1999 statute. We use a before-after comparison group design for the analysis. Comparison groups are counties in adjacent states (South Carolina, Tennessee, and Virginia). The comparison group counties permit stronger conclusions about the possible effects of the law (Phillips and Calder 1979, 1980). An observed decline in North Carolina originations can reasonably be attributed to North Carolina's high-cost mortgage law if declines are observed in North Carolina counties but not in the comparison group counties following passage of the law.

Demand and supply for subprime mortgage credit

The demand for subprime mortgage credit Q_{it}^{D} in county i in period t is a function of price, P_{it}; income, Y_{it}; existing debt, D_{it}; house values, V_{it}; percent of borrowers with flawed credit histories, H_{it}; life-cycle characteristics of the population, L_{it}, and market size (population) S_{it}. That is,

$$Q_{it}^{D} = f^{D}(P_{it}, Y_{it}, D_{it}, V_{it}, H_{it}, L_{it}, S_{it}) + e_{it}, \qquad (1)$$

where e_{it} is a random error term.

Generally, we expect mortgage loan demand to increase with county-level average income. However, increases in demand for ***subprime*** credit likely become smaller at successively higher levels of income. Higher income borrowers typically accumulate larger amounts of savings and assets and become less vulnerable to financial distress. Consequently, with the resulting improvement in their risk profile they would become eligible for *prime* mortgage loans.

Subprime borrowers typically have high existing levels of debt, provide little equity, or have a history of repayment problems. We expect demand for subprime loans to increase with the level of existing debt. House value should be inversely related to demand for subprime mortgages because the pledge of collateral coupled with a higher probability of default makes the expected cost of default higher for the subprime borrower (Barro, 1976; Benjamin, 1978). And we expect greater numbers of borrowers with flawed credit histories to be associated with greater demand for subprime mortgages.

Consumers in early stages of the family life cycle tend to have strong demand for debt. Such consumers are generally relatively young and have children. They typically expect income to increase, as they have not yet reached peak earning years. For many such consumers the rate of return on household durables is relatively high, justifying the use of high-cost credit. Consequently, some early life-cycle borrowers may demand greater amounts of credit than allowed by mainstream creditors. Such borrowers may turn to subprime creditors. Thus, life-cycle borrowing should be positively related to demand for subprime loans.

The supply of subprime credit Q_{it}^{S} is a function of price; income; house values; factor input prices, F_{it}; regulatory structure, R_{it} and market size. That is,

$$Q_{it}^{S} = f^{S}(P_{it}, Y_{it}, D_{it}, V_{it}, F_{it}, R_{it}, S_{it}) + u_{it}, \qquad (2)$$

where u_{it} is a random error term. Supply should be positively related to income and inversely related to the level of other debts because subprime creditors rely on periodic payments from current income to repay the debt. We expect supply to be positively related to the house value, as collateral can be sold to repay the loan. We expect supply to be inversely related to factor prices.

The regulatory structure proscribes or restricts mortgage terms and lending procedures for mortgage loans, and consequently influences the cost of extending credit. State laws dictate a large part of this regulatory structure and differ across state borders. In particular, North Carolina's high-cost mortgage primarily affects loans in the subprime market (i.e., those with APR and fees above the trigger thresholds). As this law imposes new restrictions on subprime lending and thereby raises costs, we expect that the law would reduce the number of subprime mortgages originated in North Carolina.

Because many lenders offer subprime mortgages we treat the subprime market as a competitive market, making Q_{it} and P_{it} endogenous. Solving equations (1) and (2) for Q_{it} produces the reduced-form equation

$$Q_{it} = f^* (Y_{it}, D_{it}, V_{it}, H_{it}, L_{it}, F_{it}, R_{it}, S_{it}) + v_{it} \quad (3)$$

for estimation.

Data, Hypotheses, and Estimation

Data

The data on the number of subprime mortgages are from a large and unique database collected for the American Financial Services Association (AFSA). In the summer of 2000, AFSA commissioned PriceWaterhouseCoopers (PWC) to collect loan-level data on subprime mortgages from nine AFSA member companies. All of the loans in the resulting data set are closed-end loans secured by residential real estate (either first or second lien). More specifically, the data set includes ***all*** such loans ***originated*** by the subprime divisions of the participating companies in the U.S. between July 1, 1995 and June 30, 2000; a total of 1,410,643 loans. Table 1 displays the number and average dollar size of these originated loans by year and type of lien. The originated loans in the data set include an aggregate loan volume of $48.1 billion in first mortgages and $15 billion in second mortgages.

How representative are these data of the subprime mortgage market? Statistics on the magnitude of the subprime market are limited. However, using data reported under HMDA, a joint study issued by the U.S. Departments of the Treasury and Housing and Urban Development reported that 790,000 refinancing loans were originated by subprime lenders in 1998.[11] By comparison, the AFSA database contains approximately 306,000 subprime loans originated in 1998. Since not all AFSA member companies are required to report under current HMDA rules, we do not know the extent to which the AFSA loans are counted in the loans reported under HMDA. Regardless, it is clear that the volume of subprime lending activity captured in the AFSA database is a substantial component of all subprime lending.[12]

The data include information on the loan terms, the location of the property, the characteristics of the borrower, and payment performance. Because the AFSA data set contains information on the Zip Code of the property securing the loan, it can be used to test for changes in the volume and characteristics of loans originated in North Carolina over time and relative to surrounding states.

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[11]U.S. Department of Housing and Urban Development and U.S. Department of Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000.

[12]Origination volume in the database for 1998 was equivalent to approximately 39% of the volume originated that same year by subprime lenders required to report under HMDA.

The analysis database for this paper includes all subprime mortgage loans in the AFSA database that were originated in four states (North Carolina, Virginia, South Carolina, and Tennessee) between the first quarter of 1997 and the second quarter of 2000, a total of 83,567 first mortgages and 60,944 second mortgages. Chart 3 shows the distribution of loans across states.

The data used for estimation of the empirical model form a cross-section, time-series panel. The dependent variable is the number of subprime mortgages originated in a county in a given quarter. The individual loans were aggregated to quarterly, county level data. We utilize observations from the first quarter of 1997 to the second quarter of 2000 in 366 counties for first mortgages and 363 counties for second mortgages. Variables were created for the total number of loans originated, the number of loans originated for borrowers with incomes below $50,000, and the number of loans originated for borrowers with incomes of $50,000 or more. There were 4,811 county-quarter observations for first mortgages and 4,553 county-quarter observations for second mortgages. Table 2 provides the mean and standard deviation of the quarterly county number of originations.

Table 3 provides the definition, sources, and descriptive statistics for the explanatory variables. Income is measured by county-level personal income per adult and the square of personal income per adult. Existing debt is measured by county-level non-mortgage debt per borrower. This variable was calculated using quarterly county-level aggregate data for non-mortgage debt from Trans Union, LLC's TrenData database.[13] Average house value is estimated from county-level Census data for 1990 and Freddie Mac's quarterly state-level conventional home mortgage price index.

The model contains three credit history variables: the percentage of borrowers whose worst delinquency during the last 4 years was 30 to 59 days, the percentage of borrowers whose worst delinquency during the last 4 years was 60 to 89 days, and the percentage of borrowers whose worst delinquency during the last 4 years was 90 or more days. These data are quarterly county-level data from the TrenData database.

We include three variables reflecting life-cycle characteristics of the population. The relative number of consumers in early life-cycle stages is measured by the percentage of the population between 25 and 44 years of age. The prevalence of children is measured by the percentage of the population that is less than 16 years of age. Family size is measured by the average number of persons in the household. Factor price variables are average compensation for employees in financial firms and the three-month commercial paper rate paid for financial firms.

[13] TrenData is a product of Trans Union, one of the three major U.S. credit bureaus. The database is based on a series of random large random samples of U.S. consumer credit histories drawn quarterly since 1992. Each quarterly sample contains approximately 30 million depersonalized credit reports. From this underlying sample, variables are built describing various borrowing and payment attributes of consumers aggregated to the county level.

As mentioned, the regulatory structure consists in large part of state regulations. These regulations affect credit costs, causing creditors' supply functions to differ systematically across the states. Accordingly, we model regulatory structure with state-specific dummy variables. The effect of North Carolina's high-cost mortgage law is modeled as a mean shift after passage of the law. Similar post-law variables were created for comparison-group states.

Hypothesis

We hypothesize that the provisions of the 1999 North Carolina anti-predatory lending statute made subprime mortgage lending more costly, especially for loans extended to high-risk borrowers. This would shift the supply curve for loans to such borrowers to the left, resulting in a reduction in the number of loans extended. We further hypothesize that, because the statute was phased in over 12 months, the effects of the regulation would be seen on originations before the final implementation date (July 1, 2000). Consequently, we expect the coefficient for the post-law dummy variable for North Carolina counties to be negative. We would not expect coefficients for post-law dummy variables for South Carolina, Tennessee, and Virginia counties to be negative or significant.

Admittedly, the window for detecting changes in lending patterns following passage of the North Carolina statute is narrow because the AFSA database contains loans originated through the end of June 2000, but not beyond. However, parts of the statute (most notably, the ban on prepayment penalties) became effective as early as October 1, 1999 and all of the new regulations were known as of July 1999. It seems reasonable to expect that creditors would not wait for the law to be effective to adjust their operations. Marketing expenditures affect revenues in both current and future periods. If the law makes high-cost mortgages more expensive and hence less profitable, the net present value of marketing expenses would decline, leading to a reduction in marketing efforts. Lower marketing expenditures would reduce current originations. Furthermore, an expected reduction in current and future originations would likely make some currently marginal offices unprofitable. All of this suggests that creditors would begin consolidating operations as soon as the information affecting expected future revenues becomes available. They would not wait for the effective date of the law.

Estimation by income groups permits additional tests of hypotheses about the impact of the North Carolina law. A law regulating high-cost mortgages would be expected to have a greater effect on the highest risk borrowers than on less risky subprime borrowers. Consequent adjustments should be observed for North Carolina counties but not in comparison-group counties.

Estimation

We estimate a population-averaged panel model using the general estimating equation extension of the generalized linear model (Liang and Zeger 1986; Zengler, Liang, and Albert 1988). The population-averaged model describes how the average response across

counties changes with the explanatory variables. The population-averaged model provides a response for a given explanatory variable that is directly estimated from the data without specific assumptions about the heterogeneity across individual counties in the population.

Let q_{it} be the number of originations and $\mathbf{x}_{it}$ be a $p \times 1$ vector of fixed explanatory variables at time $t = 1, ..., n$ for county $i = 1, ..., m$. The model focuses on the marginal expectation

$$\mu_{it} = \mathrm{E}(q_{it})$$

for the number of subprime originations. The model assumes that

$$h(\mu_{it}) = \mathbf{x}_{it}\mathrm{N}\,\exists \text{ and } \mathrm{var}(q_{it}) = g(\mu_{it}) \cong N,$$

where h is a link function, $\exists$ is a vector of coefficients, and g is a variance function. A parameter $\exists$ is the population-averaged response for a given explanatory variable value x_{it}.

To estimate regression coefficients, let $\mu_{it} = \mathrm{E}(q_{it}) = [h^{\cap}(\mathbf{x}_{i1}\mathrm{N}\exists), ..., h^{\cap}(\mathbf{x}_{in}\mathrm{N}\exists)]$ and $\mathbf{A}_i = \mathrm{diag}[g(\mu_{i1}), ..., g(\mu_{in})]$. For independent observations, cov $(\mathbf{Y}_i) = \mathbf{A}_i \cong N,$. Since repeated observations for a county are correlated, let $\mathbf{R}_i(\forall)$ be a "working" correlation matrix depending on an $s \times 1$ vector of unknown parameters. $\exists$ is estimated by solving the generalized estimating equation

$$\mathbf{U}(\exists) = 3_i\,(\mathrm{M}\boldsymbol{\mu}_i\mathrm{N}/\mathrm{M}\exists)\,\mathbf{V}_i^{\,!1}\,(\forall)(\mathbf{Y}_i\,!\boldsymbol{\mu}_i) = \mathbf{0},$$

where $\mathbf{V}_i\,(\forall) = \mathbf{A}_i^{1/2}\,\mathbf{R}_i(\forall)\mathbf{A}_i^{1/2}$ (see Liang and Zeger 1986).

Because the number of mortgage originations is a count (that is, a non-negative integer), we assume that the dependent variable has a negative binomial distribution, an extension of the basic Poisson distribution.[14] Because observations are correlated over time, we also assume a first-order autoregressive structure for loan originations within a county. Except for the dummy variables, logarithms of the values of the explanatory variables were used for estimation.

We estimated this model using the total number of subprime mortgages as the dependent variable. We also estimated the model separately for first and second lien mortgages. In addition, we grouped each lien category into loans for borrowers with incomes less than

[14] Negative binomial models for panel data were used by Hausman, Hall, and Griliches (1984) for investivgating the effect of research and development expenditures determinants of the number of patents filed by firms by Cameron, Trivedi, Milne, and Piggott (1988) for investigating the influence of health insurance choice on the use of specific medical services. The negative binomial model is less restrictive than the basic Poisson model, which assumes independence of events over time and equality of the conditional mean and variance of the dependent variable.

$50,000 and loans to borrowers with incomes of $50,000 or higher. Any rationing associated with North Carolina's high cost mortgage law should affect the lower income groups more than the higher income groups.

Results

A total of seven regression models were estimated. Table 4 contains estimates for three equations, one each for all mortgages, first mortgages, and second mortgages. Estimated equations for four additional equations (originated first and second mortgages to lower and higher income groups) are presented in Table 5. All estimated regressions are statistically significant.

To evaluate the "goodness of fit" of these models, we predicted values of each observation using the estimated coefficients of each regression model. The predicted values were then regressed on the actual values. The R-squared values provide an indication of the "goodness of fit" between the two sets of values. Over all subprime mortgages, the model accounted for 90.1% of the variation in the dependent variable. The predictions for first mortgages were somewhat better than those for second mortgages, 83.1% and 79.5%, respectively. The model explained between 76.2% and 81.2% of the variation in the number of subprime mortgages grouped by type of lien and income of borrower.

Supply and Demand Variables

Interpretation of estimated coefficients in reduced form models is not always clear because some variables are used in both supply and demand equations. Nevertheless, a few observations are possible. These observations support our hypotheses.

The coefficients for income and income squared are both significant. Income is positive, and income squared is negative. Thus, the number of subprime mortgages originated per period increases with income, but at a decreasing rate.

Non-mortgage debt per borrower has positive coefficients, but the coefficients are small and sometimes not statistically different from zero. The sign of the debt coefficients is consistent with the demand hypothesis. That is, borrowers with high demand for debt would be expected to turn to the subprime market when they desire leverage beyond that allowed by mainstream creditors.

Coefficients for delinquency are positive. The variables capturing the percentages of borrowers in a county with less serious delinquencies (delinquencies of 30-59 days and 60-89 days), are small and not statistically significant. In contrast, the variables representing the percentage of borrowers with serious delinquencies (90 days or more) are both large and significant. These results suggest that the subprime market is indeed dominated by lending to credit-impaired consumers who would have difficulty obtaining mortgage loans from mainstream, prime lenders. The proportion of consumers with less

serious delinquencies, who might obtain credit from mainstream sources, does not have a significant effect on the aggregate number of subprime loans in a county.

Of the three variables reflecting characteristics associated with heavy life-cycle borrowing, the percentage of the population 25 to 44 years of age and the percentage of the population less than 16 years of age have negative signs, contrary to our expectations. The percentage of the population is generally not significant, however. In contrast, the average size of households is positive and significant. These findings suggest that it is large family size rather than the relative frequency of consumers in the early life-cycle group that stimulates the demand for subprime credit. Large family size is likely correlated with the rate of return on household durables, making use of high-cost credit by such families more likely to be economical.

Of supply variables, employee compensation is positive, but not generally significantly different from zero. The commercial paper rate is generally negative, consistent with our expectations, and significant.

Regulatory Structure and North Carolina's High-Cost Mortgage Law

Across the entire observation period, the results for the state dummy variables indicate that the number of subprime mortgages originated in counties in South Carolina, Tennessee, and Virginia were either lower or not significantly different from that in counties in North Carolina. Differences may result from differences in regulatory structure or perhaps other factors not accounted for by the supply and demand variables not included in the model.

The state dummy variables for loans originated in the fourth quarter of 1999 and later indicate that the subprime originations in North Carolina were significantly lower, relative to the other states. The size of the coefficient indicates that originations in North Carolina were 14% lower in the Q4 1999 to Q2 2000 period than the earlier period.[15] Originations of both first and second mortgages were lower. First mortgages originated by the lender were 27 % lower, and second mortgages were 5% lower than the earlier period. This is consistent with the hypothesis that North Carolina's high cost mortgage law increased the cost of originating subprime mortgages.

The likelihood that the effect observed in North Carolina was the result of the law as opposed to some other factor is suggested by the coefficients for the other states in the fourth quarter or later. Dummies for originations in the fourth quarter of 1999 and beyond in South Carolina, Tennessee, and Virginia are either positive or not significant.

The likelihood that the results for North Carolina are attributable to the law and not some other, unidentified factor is further supported by the regressions for lower and higher income groups. The coefficient for NC1 is negative and significant for first mortgages and negative but not significant for second mortgages to lower income borrowers. The

[15] The percentage change in the dependent variable due to a dummy variable equaling one rather than zero is $\exp(\beta) - 1$, where β is the coefficient of the dummy variable (see Cameron *et al.* 1988).

size of estimated coefficients indicates declines of 27% and 5%, respectively, from the Q1 1997 to Q3 1999 period. In contrast, the coefficients for NC1 are positive and significant for both first and second mortgages to higher income borrowers. These results are consistent with the hypothesis that that higher costs of North Carolina's high-cost mortgage law make the highest risk loans unprofitable and cause creditors to ration high-risk consumers. That this effect is attributable to the law is again supported by the coefficients for the other states in the forth quarter or later. SC1, TN1, and VA1 are positive or not significant for first and second mortgages in both lower and higher income groups.

Further evidence supporting the hypothesis that the decline in originations impacted higher-risk borrowers is displayed in Charts 4 and 5. Chart 4 shows the risk score distribution of subprime loans in the AFSA database that were originated in North Carolina during two periods. One period spans the first quarter of 1997 through the third quarter of 1999, immediately prior to the implementation date of the first set of new regulations under the North Carolina anti-predatory statute. The second period includes originations during the fourth quarter 1999 through the second quarter 2000. In this database the risk score is a statistical index calculated by Fair, Isaac and Co (FICO score), the largest risk scorecard supplier in the U.S. A low FICO score signals a higher risk borrower. The risk distribution of originated loans shifts notably toward lower risk (higher-score) borrowers in the period after the North Carolina law began to be implemented. This shift is statistically significant. In contrast, Chart 5 reveals a much smaller shift away from higher-risk borrowers in the comparison states over the same period.

Additional data suggest that the pricing of these loans reflects the underlying risk. This should not be surprising to economists, but has often been challenged by activists who allege that one of the symptoms of predatory lending in a locale is the lack of correlation between price and borrower risk. They argue that vulnerable and inexperienced borrowers are steered by predatory lenders into loans that are overpriced relative to the borrower's risk profile. Presumably, a law that succeeded in driving out predatory behavior would alter the underlying pricing structure, restoring a positive relationship between risk and the risk premium. One observable implication of their hypothesis would be a shift in the pricing structure of subprime loans following the North Carolina statute to yield a stronger correlation between price and underlying borrower risk.

However, we observe in the database that the average risk premium, defined as the difference between the annual percentage rate and the interest rate for a Treasury security with a comparable term to maturity, declines as the FICO score increases both before and after the North Carolina statute (Chart 6). A positive relationship between risk and risk premiums is evident in both the Q1 1997-Q3 1999 and the Q4 1999-Q2 2000 periods in North Carolina, as well as in the comparison group states. The level of average risk premium in North Carolina and the comparison group states, for loans with scores in the same FICO risk category, differs by no more than about 50 basis points during either period. Consequently, these data do not suggest that the fundamental pricing structure of subprime loans in North Carolina was altered, relative to surrounding states, as a

consequence of the statute's attempt to drive out predatory lending, at least among the nine large lenders represented in the database. This casts further doubt on activist claims that the decline in lending observed in North Carolina following the passage of the anti-predatory lending statute resulted entirely from squeezing out predatory lending.

Conclusions

The decline in the number of closed-end mortgages originated by nine major national lenders in North Carolina following passage of its anti-predatory lending law was significant and large. Overall, the number of subprime mortgage originations declined about 14%. The magnitude of the decline in the number of first mortgages to lower-income borrowers was equal to 27% of quarterly county originations before the law. The magnitude of the decline in the number of second mortgages to lower-income borrowers was equal to 5% of quarterly county originations before the law. Significant declines occurred only in North Carolina and only among the lower-income borrowers. Neither the higher-income borrowers in North Carolina nor borrowers in the other states experienced significant declines. These observations are consistent with the model's prediction that a law raising the cost and risk of making "high-cost" loans would reduce the availability of credit, particularly among the least creditworthy consumers.

One question that remains open for further research is whether lenders in North Carolina adjusted to the new law by shifting higher-risk closed-end applicants to open-end loans. Open-end mortgage loans were not covered by the 1999 statute. Normally, an open-end loan product (essentially, a line of credit) is reserved for lower-risk customers. However, it is possible that lenders could devise an open-end product that remained exempt from the statute but also had sufficient price and risk-mitigation features to make it a feasible alternative for higher risk borrowers who would formerly have received closed-end loans. We intend to address this question in the future, provided that we can obtain additional data on open-end lending activity.

Given that the declines in closed-end subprime mortgage lending in North Carolina counties (relative to other states) were found only in the higher risk segment of the market, it appears unlikely that they result solely from declines in abusive or predatory lending. Moreover, the annual percentage rates on loans in the database before and after passage of the North Carolina statute broadly reflected the loans' risk, as they do in surrounding states. Borrowers with higher incomes and higher FICO scores generally had lower annual percentage rates. Consequently, we conclude that the North Carolina statute did impede the flow of mortgage credit to higher-risk borrowers, and any reductions in predatory lending were achieved at the expense of many legitimate loans.[16]

[16] Some observers may adopt a paternalistic view that high-cost mortgage lending is harmful *per se* and that high-risk borrowers should not be allowed to obtain mortgage credit in the market. An anti-predatory lending statute like North Carolina's could be intended to prevent higher-risk borrowers from incurring risky debts no matter how large the potential benefits might be (although it would also make it more difficult for borrowers who have had financial problems in the past to improve their credit histories). Proponents of this view might consider the decline in originations to higher risk borrowers in North Carolina a positive development.

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Chart 1
Year-over-Year Change in Originated Loans
First Liens: Borrower Income < $25,000

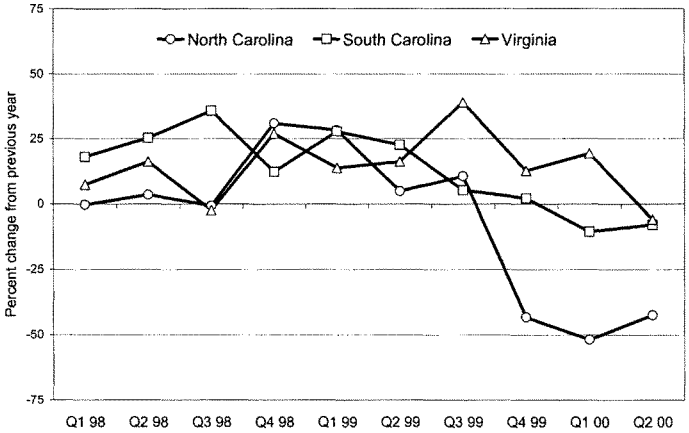

Chart 2
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $50,000-$74,999

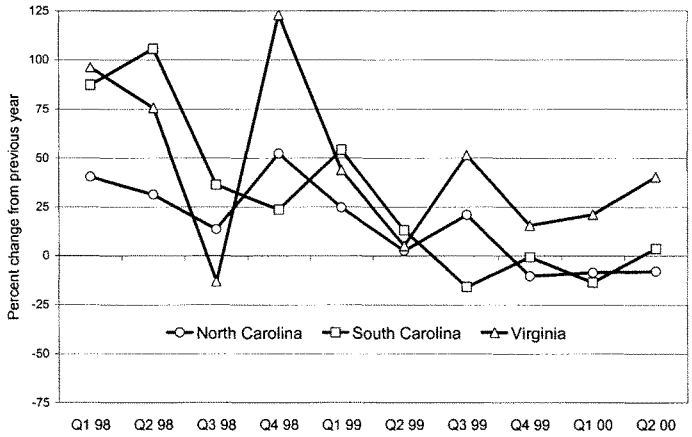

Chart 3
Number of Mortgages Originated,
by State and Lien Type

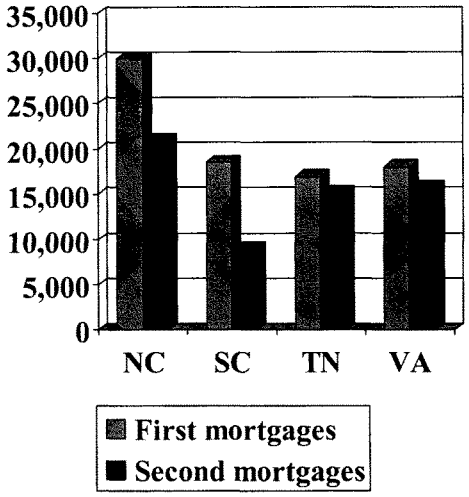

Chart 4
Distribution of First Mortgage Originations in North Carolina, by FICO score

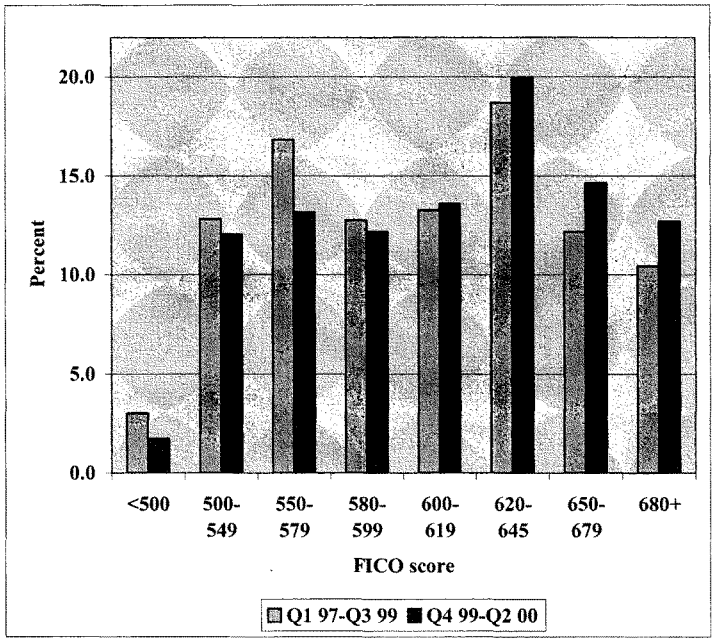

Chart 5
Shift in Distribution of First Mortgage Originations
In North Carolina vs. Comparison Group States

(Change in percent of loans in each FICO score category after October 1, 1999)

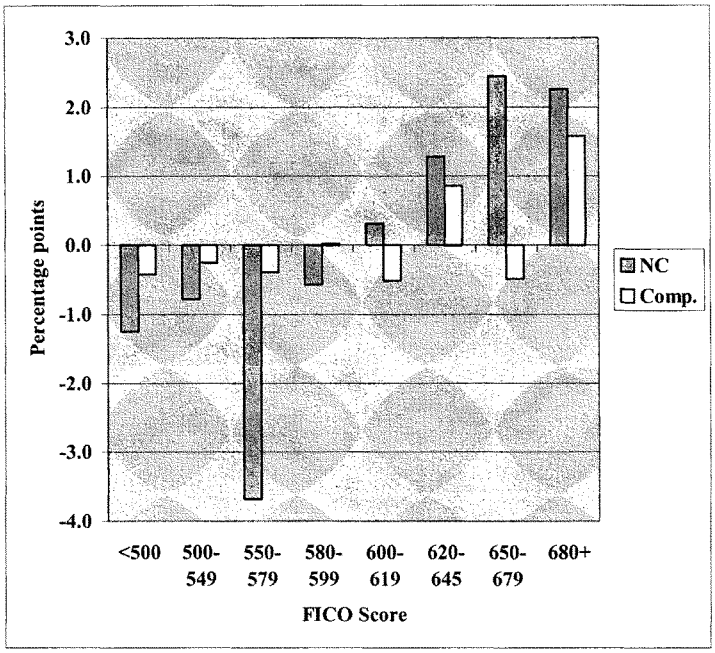

Chart 6
Mean Risk Premiums in North Carolina and Comparison Group States, by FICO score

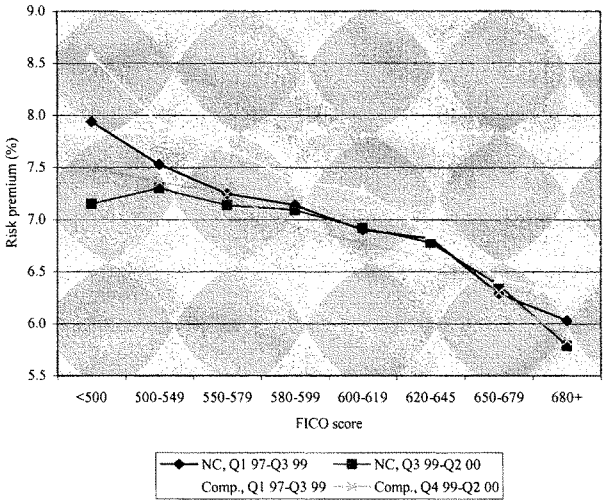

Table 1: Number and Average Dollar Size of Originated Loans, by Type of Lien

	First Mortgages		Second Mortgages	
Year	Number	Average Loan Size (dollars)	Number	Average Loan Size (dollars)
1995 (Q3 and Q4)	26,339	$45,445	49,023	$18,858
1996	90,275	52,462	100,865	19,426
1997	134,256	58,859	119,200	21,056
1998	168,282	68,184	138,187	23,561
1999	204,542	72,335	172,981	22,354
2000 (Q1 and Q2)	104,566	74,085	102,127	24,313
All Years: (July 1, 1995-June 30, 2000)	728,879	65,962	681,764	22,023

Table 2: Descriptive Statistics for Dependent Variables
(Number of loans)

	Mean	Standard deviation
All	50.265	78.709
Originated		
First lien	17.096	23.508
Second lien	13.160	20.052
First lien		
Lower income	13.998	18.747
Higher income	2.605	4.749
Second lien		
Lower income	9.624	14.227
Higher income	3.035	6.418

Table 3: Descriptive Statistics for Explanatory Variables

		Mean	Standard deviation
Demand and supply variables			
PI	Personal income per adult, $000 (BEA and Census)	28.246	6.414
NMD	Consumer debt per borrower, $000 (TrenData, BEA, and Census)	15.999	3.150
HV	Average house value, $000 (Census and Freddie Mac)	91.248	35.459
L30	Borrowers ever 30-59 days past due in last 4 years, % (TrenData)	14.453	1.457
L60	Borrowers ever 60-89 days past due in last 4 years, % (TrenData)	6.504	.859
L90	Borrowers ever 90 or more days past due in last 4 years, % (TrenData)	29.914	6.234
P<45	Population 25-44 years of age, % (Census)	29.431	2.903
P<16	Population under 16 years, % (Census)	21.541	2.482
NHH	Average household size (Census)	2.496	.144
W	Average compensation per employee in financial firms, $000 (BLS)	33.411	9.281
R	3-month commercial paper rate for financial firms, % (FRB of St Louis)	5.483	.410
POP	Total population, 000 (Census)	68.741	106.561
State and regulatory change dummy variables			
NC	North Carolina	.280	.449
SC	South Carolina	.133	.340
TN	Tennessee	.246	.431
VA	Virginia	.340	.474
NC1	North Carolina, Q4 99 or later	.059	.235
SC1	South Carolina, Q4 99 or later	.028	.166
TN1	Tennessee, Q4 99 or later	.054	.226
VA1	Virginia, Q4 99 or later	.074	.261

Table 4: Regression Results

	All loans	First lien	Second lien
PI	6.409**	10.859**	9.650**
	(1.170)	(2.052)	(2.797)
PI^2	- .805**	-1.557**	-1.341**
	(.250)	(.306)	(.426)
NMD	.057	.074 †	.019
	(.031)	(.044)	(.053)
HV	- .031**	- .550**	- .156
	(.098)	(.121)	(.129)
L30	.170	.103	- .075
	(.109)	(.125)	(.146)
L60	.089	.040	- .101
	(.071)	(.075)	(.093)
L90	.674**	.615**	.419**
	(.120)	(.125)	(.146)
P<45	- .348	-1.002**	- .565
	(.279)	(.301)	(.355)
P<16	-1.188**	- .961**	- .719 †
	(.339)	(.340)	(.422)
NHH	2.118**	.777	2.138**
	(.586)	(.662)	(.789)
W	.014	.008*	.049
	(.318)	(.043)	(.049)
R	- .408**	- .789**	.473**
	(.121)	(.145)	(.171)
POP	2.118**	.899**	.996**
	(.586)	(.050)	(.061)
SC	- .171**	- .074	- .339**
	(.061)	(.065)	(.074)
TN	- .293**	- .557**	- .135 †
	(.051)	(.063)	(.070)
VA	- .122**	- .264**	-.094
	(.067)	(.065)	(.072)
NC1	-.146**	- .270**	- .093 †
	(.034)	(.049)	(.049)
SC1	.026	.097*	- .050
	(.036)	(.046)	(.055)
TN1	.110**	.190**	- .047
	(.041)	(.043)	(.046)
VA1	.027	.186**	.136**
	(.047)	(.044)	(.052)
Constant	-15.494**	-22.827**	-20.587**
	(3.163)	(3.572)	(5.033)
Π^2	4,741	3,358	3,086
R^2 (%)	91	84	79

** / * / † Significant at the 1% / 5% / 10% level. Standard errors are in parentheses.

Table 5. Regression Results, by Borrower Income Groups

	Lower income, first lien	Lower income, second lien	Higher income, first lien	Higher income, second lien
PI	11.565**	12.043**	19.407**	12.973**
	(2.586)	(3.756)	(2.732)	(3.254)
PI^2	-1.687**	-1.722**	-2.698**	-1.812**
	(.390)	(.578)	(.395)	(.485)
NMD	.089 †	.004	.173 †	.144
	(.053)	(.064)	(.103)	(.119)
HV	- .675**	- .388**	- .071	.638**
	(.133)	(.147)	(.280)	(.168)
L30	.170	- .301	.369	.168
	(.142)	(.177)	(.280)	(.307)
L60	.032	- .130	- .259	- .410*
	(.084)	(.112)	(.188)	(.196)
L90	.565**	.319*	1.271**	.853**
	(.139)	(.158)	(.217)	(.213)
P<45	-1.148**	- .483	- .244	- .601
	(.345)	(.409)	(.406)	(.460)
P<16	- .871*	- .629	-1.283**	- .871
	(.384)	(.445)	(.473)	(.546)
NHH	.164	1.285	2.915**	3.886**
	(.716)	(.818)	(.798)	(.981)
W	.063	.043	.160†	.129
	(.045)	(.053)	(.093)	(.095)
R	- .772**	.239	-1.665**	-1.147
	(.154)	(.185)	(.294)	(.339)
POP	.886**	.981**	.815	.839**
	(.058)	(.072)	(.106)	(.129)
SC	- .049	-.223**	- .184 †	- .434
	(.068)	(.075)	(.100)	(.091)
TN	- .563**	-.036	- .490**	- .102
	(.067)	(.714)	(.085)	(.088)
VA	- .296**	- .081	- .107	.047
	(.070)	(.076)	(.084)	(.098)
NC1	- .318**	- .048	.226**	.598**
	(.051)	(.056)	(.088)	(.076)
SC1	.106*	.001	.301**	.339**
	(.050)	(.057)	(.085)	(.109)
TN1	.172**	- .014	.552**	.240**
	(.046)	(.052)	(.083)	(.082)
VA1	.194**	.162**	.507**	.673**
	(.050)	(.061)	(.083)	(.085)
Constant	-22.752**	-23.283	-47.535**	-39.468**
	(4.406)	(6.698)	(5.063)	(6.109)
Π^2	2,727	2,312	3,143	3,399
R^2 (%)	82	76	76	78

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE

COMMITTEE ON HOUSE FINANCIAL SERVICES

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

UNITED STATES HOUSE OF REPRESENTATIVES

"Subprime Lending: Defining the Market and its Customers"

March 30, 2004

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers appreciates the opportunity to submit its written testimony concerning predatory mortgage lending to the House Financial Services Subcommittees on Financial Institutions and Consumer Credit and Housing and Community Opportunity. In considering the problem and impact of, and possible responses to, "predatory lending," we emphasize the following key points:

- ***Many abusive practices are the result of outright fraud.*** As we examine the anecdotal descriptions of borrowers being abused, it is clear that many of the abuses resulted from misrepresentation, deception and other practices that violate existing laws. New laws are not needed to address these problems. Rather, there must be a renewed emphasis on devoting the necessary resources to enforce existing law.

- ***"Predatory lending" is hard to define.*** Practices (other than those constituting current illegal conduct) that are often labeled "predatory" can have both adverse and beneficial consequences for consumers. As policy makers consider restricting individual terms and provisions, such as prepayment penalties and yield spread premiums, they must understand that these terms have legitimate uses that can benefit consumers, for example, by reducing interest rates or upfront costs.

- ***It is not in the interests of lenders and servicers to make loans, whether prime or subprime, which result in default or foreclosure.*** Lenders and services do not benefit from defaulted loans. Rather they lose money—often significant amounts. Simply put, a lender whose loans that go into default represent more than a small proportion of its total loans will not long be in the lending business. In fact, because subprime borrowers by definition present a greater risk, subprime lenders must devote additional resources to ensuring that they will not end up with a defaulted loan.

- ***The goal of policymakers in addressing "predatory lending" should be to educate and empower consumers to make appropriate decisions about their financial affairs, not to restrict consumers' option.*** The CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

- ***Current regulatory requirements do not allow consumers to understand their choices. They often act as barriers to competition that could reduce costs.*** Studies have shown that the innumerable disclosures required by a variety of federal and state laws often confuse, and sometimes mislead, consumers who are attempting to shop for loans. In addition, while lenders compete on their offerings based on interest rate and points, because of regulatory restrictions, there is little incentive to compete on the basis of ancillary settlement costs.

The CMC, working with other trade groups, has developed a five-part program that we believe best addresses "predatory lending" without unduly restricting consumer's options or unduly burdening the efficient operation of the mortgage market. The program consists of the following:

- ***Adequate enforcement of existing law***
- ***A nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations***
- ***A comprehensive public awareness and education campaign***
- ***Implementation of Federal regulators' existing authority to address predatory practices***
- ***Reform of mortgage origination regulatory requirements to give consumers simpler, more uniform disclosures that allow them to understand and effectively comparison shop for loans, to give lenders the ability to offer ancillary settlement services at lower cost, and to provide certain substantive protections..***

Following a brief note describing our coalition, we examine each component of this comprehensive solution. In addition, in Tab 1 of this testimony, we describe the subprime market. In Tab 2, we describe the products and practices that often are labeled "predatory," and show how they can be used to the benefit of borrowers and how our solutions would mitigate any abuses they could cause. Finally, in Tab 3, we describe the mortgage origination process, its participants and the compensation each receives for their role.

About the CMC

The CMC was formed, in large part, to pursue reform of the mortgage origination process. From our perspective, one of the principal goals of mortgage reform is to streamline the mortgage origination process so that consumers would be better informed when making credit choices. Complementary to our goal of streamlining the mortgage origination process is the goal of reducing abusive lending practices. We believe that better disclosures and substantive protections can enhance consumer protection. The goal should be to allow consumers to make educated choices in the credit market.

We commend the Committee for its continued attention to the issue of predatory lending. The CMC is particularly concerned because of the damage caused by deceptive lenders to consumers and to the image of our industry. We support the goal of protecting consumers from unscrupulous lending practices and recognize that some elderly and other vulnerable consumers have been subjected to abuses by a small number of mortgage lenders, brokers and home contractors. We share the Committee's objective of developing approaches that prevent predatory lending practices without restricting the supply of credit to consumers or unduly burdening the mortgage lending industry.

The CMC's Alternative: A Comprehensive Solution to Predatory Lending

Rather than further restrictions on products, terms and provisions, the CMC favors a multi-tiered, comprehensive solution to predatory lending, including increased enforcement of existing prohibitions against fraud and deception, coordinated, nationwide enforcement of licensing requirements, and better consumer education on the mortgage process.

Most significantly, the CMC believes that comprehensive reform of the regulation of the mortgage origination process is needed so that all consumers, but particularly those most vulnerable to predatory lending practices, can better protect themselves. As noted above, our solution has five parts.

Part I: Devoting Adequate Resources To Enforcing Existing Laws

We agree with Federal Reserve Board Chairman Alan Greenspan's comments that enforcement of existing laws is the first step that should be taken. Many examples of predatory lending involve fraudulent practices that are clearly illegal under current law. Adequate resources at both the federal and state levels of government need to be devoted to pursuing those committing fraud. Therefore, the appropriate federal and state agencies should advise policymakers of the resources they need to combat mortgage fraud.

Part II: A Nationwide Licensing Registry

We recommend that all mortgage brokers and companies be licensed, and that a federal system be established to ensure that if a broker or company loses its license in one state as a result of predatory practices, all licenses would be revoked, suspended, or put on regulatory alert nationally. A "Consumer Mortgage Protection Board" could be established to maintain a clearinghouse to identify mortgage brokers and companies whose licenses have been revoked or suspended in any state.

The goal of this recommendation is to prevent those engaging in predatory practices from being able to move from one jurisdiction to the next and continuing to prey upon vulnerable consumers while keeping one-step ahead of law enforcement authorities in prior jurisdictions.

This new Consumer Mortgage Protection Board could also be responsible for, among other things, reviewing all new and existing Federal regulations and procedures relating to the mortgage origination process and make recommendations that will simplify and streamline the lending process and make the costs of the process more understandable to consumers. The Board could also be used to initiate and oversee public awareness media programs (described below) that will help consumers evaluate the terms of loan products they are considering.

Part III: Increasing Public Awareness and Improving Consumer Education

Consumer advocates have long advised industry and government officials that certain consumers, particularly elderly seniors, were not able to clearly understand the

loan terms disclosed in the innumerable disclosures provided to consumers during the mortgage process.

We recommend a three-step program to increase public awareness and improve consumer understanding of their loan obligation:

1. *Public Service Campaign.*

   Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

2. *Public Awareness Infrastructure.*

   Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

3. *"Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators*

   The *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* of the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, issued in 1998 ("Joint Fed/HUD Report") recommended that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Since this idea was first discussed in the Mortgage Reform Working Group,[1] mortgage calculators or "smart" computer

[1] The Mortgage Reform Working Group ("MRWG") was an ad-hoc group, comprised of over 20 trade associations and consumer advocate organizations, that was organized at the request of former Congressman Rick Lazio (R-NY) with the goal of reaching a compromise on a comprehensive mortgage reform proposal that would streamline and simplify the mortgage process for consumers

programs have become available online. Since these computer programs were already developed by the private sector and are widely available, a more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products. (Legislation may be needed to advance this initiative. But there may be resources in agencies' current budgets that could be tapped to implement this recommendation.)

Part IV: Use Existing Federal Regulatory Authority to Stop Abusive Practices

Regulators may have existing authority to implement changes to existing regulations to prevent loan flipping and other questionable practices. Where such authority exists, action should be taken to change existing regulations. Regulators may also be able to use their rulemaking powers under existing law to implement some of the mortgage reform proposals discussed in Part V.

Part V: Comprehensive Mortgage Reform

The Joint Fed/HUD Report found that consumers do not understand the disclosures required by the current TILA and Real Estate Settlement Procedures Act ("RESPA"). There is widespread agreement that the mortgage loan origination process is overly complex and that the current legal structure is often an obstacle to improving that process.

Comprehensive mortgage reform would reduce confusion and improve competition, lowering prices for all consumers while discouraging predatory lending. The CMC has been at the forefront of industry efforts to reform and improve the laws and regulations governing the home mortgage origination process in this country. The mortgage reform that we, along with others in the industry, have advocated would directly address many of the weaknesses in current law that allow predatory lenders to operate. We note that some of these reforms can be achieved through regulatory changes while others will require legislation.

Some of the features of mortgage reform that bear directly on the predatory lending problem include:

- ***Early Disclosure of Firm Closing Costs***, leading to greater certainty for consumers on closing costs and increased price competition for both loans and ancillary services required to make the loan. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about the amount of closing costs that he or she would have to

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while simultaneously reducing the liability for the industry. While all parties did not reach an agreement, many of the recommendations that were developed in that process formed the basis for the recommendations made in the Joint Report issued by the Federal Reserve Board and the Department of Housing and Urban Development.

pay. The central feature of mortgage reform is a proposal that mortgage originators disclose to consumers the firm, not estimated, costs of the ancillary services needed to make the loan for which the consumer has applied. If the borrower receives a clear disclosure of firm closing costs early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

The Administration had proposed a rule that, if it had implemented correctly, would have given consumers the option to choose and the industry an option to offer a guaranteed mortgage package. When modified appropriately, the rule would have done what HUD intended it to do – vastly simplify the process by which consumers shop for and obtain mortgage loans in this country and significantly reduce closing costs. While the proposed rule proved to be controversial, the benefits of the Guaranteed Mortgage Package ("GMP"), *if structured correctly*, are extraordinary.

The Administration should be applauded for trying to advance an initiative that would have resulted in consumer savings of $10.3 billion per year – almost $1,000 per mortgage loan -- by removing outdated regulatory barriers. The Administration's RESPA reform proposal, if implemented correctly, would have expanded homeownership opportunities more than any other proposal that we have seen in years. In fact, was the most significant pro-consumer regulatory proposal from any agency ever to have been proposed.

The savings to consumers came from two effects of the proposed rule. First, the elimination of Section 8 for packagers would have allowed, for the first time, for leverage and competition to be brought to the selection and pricing of ancillary settlement services. Today, Section 8 of RESPA effectively prevents volume discounts, average cost pricing, or other cost-reducing arrangements to be negotiated between loan originators and settlement service providers. Removing this regulatory barrier opens this who process up to competition, which would have forced prices down.

Second, bundling of settlement costs into a single guaranteed number makes it easier and much more likely for consumers to comparison-shop based on this number (together with interest rate and points). Borrowers today shop on interest rate and points, but not settlement costs. These costs, which are delineated in a laundry list of items seldom understood, are viewed as an unpleasant, but unavoidable, fact of life. The "packaging" approach would have changed that. With just a few key figures to shop with, borrowers will be better informed, shop better and reach better deals.[2]

[2] It should be noted that services are required as a condition for the borrower to obtain the loan. They are not services that are performed for the benefit of the borrower, but are rather services that are performed for the lender and investor to ensure that their collateral interests are protected.

As mentioned earlier, the Administration's GMP proposal would have also helped prevent predatory lending. Under the packaging approach, consumers will receive relevant, guaranteed information about a loan early in the process to promote comparison-shopping. Moreover, simplifying comparisons will increase the likelihood of consumer understanding of their mortgage loan and make more difficult the deception that characterizes abusive loans. Consumers will no longer face unwelcome surprises at the closing table of increased or hidden fees. Borrowers will be empowered under packaging to make logical, informed choices about settlement fees and costs in the context of a single number that is guaranteed, and loan originators and packagers will have to abide by their guarantee.

The details of any final rule, however, were key to ensuring that the rule would have actually achieved the goals of reducing costs and streamlining and simplifying the mortgage process, while simultaneously reducing the liability and needless litigation that continues to plague the industry.

- ***Simplified, Understandable Disclosures*** of key information about the loan. Mortgage reform would consolidate and highlight disclosures of the key terms of a mortgage credit product so that applicants could easily comparison-shop for loans. It would eliminate confusing disclosures such as the "Amount Financed," which has actually been used to mislead consumers about the true amount of the obligation. The disclosure of firm closing costs, noted above, would have included any mortgage broker fee paid by the borrower.

- ***Proportional Remedies*** so that lenders are the targets of less litigation over harmless or minor errors while consumers can be compensated for actual harms. The remedies in the mortgage reform proposal, in contrast to current law, are structured to ensure that the borrower receives a loan on the terms that were disclosed. Lenders that detect and correct errors quickly will not be penalized, while those that engage in knowing and willful violations will be penalized more severely than under current law.

- ***Substantive Protections against Loan Flipping*** to protect the most vulnerable consumers from abusive loans. The focus of the mortgage reform effort is on reforming the mortgage process for all consumers, but we include an enhancement to the Home Ownership and Equity Protection Act ("HOEPA") in the form of protections against loan flipping. Under the proposal, when making a HOEPA loan that refinances an existing mortgage loan and that is entered into within twelve months of the closing of that loan, the originator may not finance points or fees payable to the originator or broker that are required to close the loan in an amount that exceeds three percent of the loan amount. This limitation does not apply to voluntary items such as credit insurance, nor to taxes and typical closing costs for settlement services such as appraisal, credit report, title, flood, property insurance, attorney, document preparation, and notary and closing services provided by a third party, whether or not an affiliate.

Limiting the financing of points will mean that borrowers would have to bring cash to closing to pay high points and fees. This will mean that borrowers of HOEPA loans will be less likely to be "flipped" numerous times. Consistent with regulations adopted by the New York State Banking Department, the limit on refinancing points does not apply to typical third-party closing costs. Significantly, this restriction is not limited to refinances by the same lender and would thus apply to a much broader number of loans that may not be in the category of "flipped" loans. For this reason, it is appropriate that a reasonable amount of points and fees be eligible to be financed in order to meet real credit needs.

- ***Substantive Protections Affecting Prepayment Penalties.*** On non-HOEPA loans, no prepayment penalty would be permitted after 5 years from the date of the loan. However, prepayment penalties would be authorized during this 5-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of 6 months' interest on the original principal balance.

- ***Foreclosure Reforms*** to provide additional protections to borrowers facing the loss of their home without reducing the value of lender's security interest in the property. Lenders and servicers have in recent years significantly changed their procedures for dealing with delinquent borrowers. Workouts, forbearance and other loss mitigation tools are employed and foreclosure is increasingly seen as an expensive (for everyone) last resort. In addition to this business trend, we would support the enactment of a new "Homeowner's Equity Recovery Act" ("HERA"), which would apply at the time lender notifies consumer of consumer's default and rights under HERA.

  - HERA protections would apply if the consumer's indebtedness (origination balance and interest, junior liens, etc.) is not more than 80% of the origination valuation. A consumer would have the right to list the property with a real estate broker or otherwise make a good faith effort to sell the property.

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We believe that the consumer protections made available through HERA strike a reasonable balance between the rights of lenders and investors for repayment of amounts owed and the consumer's right to "breathing room" if the consumer is attempting to resolve the default. However, we do not support the expansion of mandatory judicial foreclosure because it is costly both to the consumer and lender, and is too time consuming, which, among other things, puts the collateral at risk. In addition, we note that the Federal tax code (REMIC provisions), under

which loans are sold to the secondary market, places limitations on types of compromise that a lender can offer to a defaulting borrower.

- ***Substantive Protections Affecting Collection Practices.*** Under the proposal, the prohibitions contained in Section 806 of the Fair Debt Collection Practices Act ("FDCPA") concerning harassment and abuse would be extended to the collection of mortgage loan debts by a creditor or its affiliates. The law would be clarified to ensure that loan servicers that collect debts as part of their servicing function would not be treated as debt collectors

- ***Uniform, National Rules*** so that lenders can comply with a uniform set of disclosure requirements that will adequately protect consumers and result in lower costs to lenders and lower rates for borrowers. Imposing uniform laws and regulations ensures that consumers – across the nation – are afforded the same protections. Preemption would also reduce the number of documents to be signed by consumers at closing. "Information overload" is an almost universal feature of complaints about predatory lending.

  A uniform set of national rules is particularly important because the need for uniformity has never been greater. There has recently been a proliferation of state and local legislation to combat predatory lending practices. Although well intentioned, these initiatives can be counterproductive because they can impose very high costs on lenders in comparison to the potential number of loans affected.

  In one example, the City of Philadelphia enacted anti-predatory-lending legislation that was so broad in its sweep that it threatened to cut off much legitimate, mainstream lending as well as the practices at which it was targeted. Last-minute legislative intervention at the state level was necessary to prevent this legislation from taking effect and shutting down most mortgage lending in Philadelphia.

  Another example of the unintended negative effects of state and local regulation has recently occurred in Chicago, where the City of Chicago, Cook County, and the State of Illinois have all enacted new laws aimed at preventing predatory lending. Name-brand, well-capitalized lenders and servicers are reluctant to put their capital and reputation at risk to make new loans in Chicago because of the risk that they could be found to be making "predatory" loans under one of the three, varying, and sometimes conflicting and/or unclear definitions (or under the federal HOEPA).

  If the Committee decides that clarification of the existing legislation prohibiting abusive practices is needed, we strongly urge that it support a single, nationwide standard that cannot be undermined by myriad local initiatives.

  In recent years, the Office of the Comptroller of the Currency has taken a leading role in developing detailed regulatory guidance aimed at both predatory lending

and unfair and deceptive acts and practices.[3] Indeed, the final rule recently issued by the OCC addresses these issues directly, creating an anti-predatory lending standard for real estate and consumer lending, and codifying the applicability of the FTC Act to national banks and their subsidiaries in connection with real estate and consumer lending activities.[4] These guidelines serve as an excellent basis for uniform standards to protect consumers.

* * *

The CMC appreciates the opportunity to submit its views on the problem of, and appropriate responses to, "predatory lending." We look forward to working with the Committee on constructive, practical solutions to address abuse practices without restricting the availability of credit, reducing consumers' options, or burdening the efficient operation of the mortgage market.

[3] See OCC Advisory Letter, 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices (Feb. 21, 2003); OCC Advisory Letter 2003-3, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans (Feb. 21, 2003).

[4] See Bank Activities and Operations, Real Estate Lending and Appraisals, 69 Fed. Reg. at 1911 (Jan. 13, 2004).

DESCRIPTION OF SUBPRIME MARKET

Although the involvement of CMC's members in subprime lending varies, all CMC members share an interest in the efficient operation of the mortgage lending market. Subprime lending plays a crucial part in that market, allowing individuals who do not qualify for "prime" loans to make use of the equity in their homes to obtain credit at reasonable rates. As Comptroller of the Currency John D. Hawke, Jr., noted last year in a letter to this Committee—

> "One problem with the fact that 'predatory lending' is not susceptible to precise definition is that many people make the mistake of equating subprime lending to predatory lending. Responsible, risk-based subprime lending, that provides access to credit for individuals with less than perfect credit histories, should not, in and of itself, be considered predatory. The OCC encourages national banks to engage in responsible subprime lending, and has issued guidance to ensure that banks engaging in this type of business do so in a safe and sound manner and consistent with applicable consumer protection law."[5]

Legitimate subprime lending offers many benefits to consumers. A subprime home loan provides financial options to borrowers who cannot obtain prime loans because of problems with their credit history or for other reasons such as a reduction in income or other change in financial circumstances. Subprime credit gives such individuals a chance to buy a home. In other instances, the availability of subprime home-equity credit gives credit-impaired borrowers financial options that would not otherwise be available, including debt consolidation or other purposes.

The Subprime Mortgage Industry

Mortgages are the largest component of the U.S. debt market with over $5 trillion in outstandings. Total first mortgage origination volume in 2000 was over $1 trillion. Subprime mortgage lending accounted for approximately 13% of the entire mortgage industry's production in 2000.

Scale, capital and risk management requirements are driving rapid consolidation in the mortgage banking and servicing sectors of the industry. However, the mortgage origination business remains relatively fragmented.

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[5] Letter from John D. Hawke, Jr., Comptroller of the Currency, to the Honorable Phil Gramm, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 5, 2000.

Subprime Credit Borrowers and the Use of Subprime Credit

Subprime borrowers are like any other borrowers in the U.S. economy. In fact, a study of nearly one million subprime and manufactured housing loans originated in 1998 shows a racial and ethnic borrower profile similar to the racial and ethnic composition of the total U.S. population.[6]

As practiced by mainstream lenders, including those CMC members who participate in the subprime market, subprime lending is also not conceptually different from lending to "prime" borrowers. The process begins when the borrower identifies a need for financing, either for a home purchase or for cash for other purposes. Although a significant portion of subprime loans are made to finance the purchase of a home, the proportion is lower than for prime loans.[7]

More frequently, a subprime borrower will seek cash to consolidate existing debt—the most common use of subprime credit. Home equity financing often allows the borrower to reduce monthly payments dramatically, allowing an overextended consumer to gain control of his or her budget. In addition, subprime loans carry significantly lower interest rates than other forms of credit. Although subprime loans average about 250 basis points (2.5 percentage points) above prime loans, at around 9.5%-10% they are still much less expensive than credit cards and other sources of credit (when those alternative sources are even available to credit-impaired borrowers).

Other common uses of subprime home equity loans include—

- Financing a college education;
- Paying medical bills;
- Providing alternatives for homeowners who fall behind on their mortgage payments; and
- Home improvement and repair.

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[6] An April 2000 SMR Research study of 1998 HMDA data.

[7] An April 2000 SMR Research study of 1998 HMDA data showed the following distribution of loans by loan purpose:

Purchase	Refinancing	Home Improvement	Total
Subprime loans			
197,917	661,876	94,116	953,909
20.75%	69.39%	9.87%	100.00%
Prime loans			
3,968,766	5,863,187	819,393	10,651,346
37.26%	55.05%	7.69%	100.00%

Subprime Credit Grades

In the mortgage industry, loans are graded from "A" (a prime loan) to "D" (the riskiest subprime loan). An "A" loan is a "prime" loan, or a loan of the highest credit value. Typical factors that determine a consumers credit grade are:

- Mortgage delinquency history
- Consumer debt delinquency history
- Bankruptcy or foreclosure
- Collection or judgments
- High debt-to-income ratios
- High loan-to-value ratios
- Low credit risk scores

Although the definitions of the subprime grades are neither precise nor completely uniform throughout the industry, the following examples convey the general concept of credit grading:

- A homeowner who filed for bankruptcy two years ago due to mismanagement of credit and was sixty days late on his current mortgage may qualify for a "B-" credit grade;

- A borrower who was laid off and had to accept a lower-paying job, and, as a result, was occasionally thirty days late in making her mortgage payment may qualify for an "A-" credit grade; and

- A widow who has an excellent credit record but has had difficulty in paying outstanding medical and home repair expenses and needs cash for her son's college education may qualify for a "B" credit grade. In this example, the subprime credit grade is based on income compared to total amount of debt, rather than on credit history.

SPECIFIC PRACTICES OFTEN LABELED "PREDATORY"

In this section we discuss a number of practices that have been attacked as "predatory."[8] As the Board of Governors of the Federal Reserve System has noted, there are two types of abusive practices in home equity lending—blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways. . . .* [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[9]

Fraud and Deception

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements. Examples of "predatory" practices that are prohibited under current law include the following:

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[8] This list of alleged predatory lending practices is largely drawn from Patricia Sturdevant and William J. Brennan, Jr., *The Double Dirty Dozen Predatory Mortgage Lending Practices* (National Association of Consumer Advocates, Inc. 2000).

[9] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Misleading Solicitations

Advertising and marketing material may mislead consumers about the true cost or nature of a loan. These marketing practices are already prohibited under the Federal Trade Commission Act and analogous state laws. In many instances, deceptive solicitations also violate the Truth in Lending Act.

Home Improvement Scams

A home improvement contractor may originate a mortgage loan to finance the home improvements and sell the loan to a lender, or steer the homeowner to the lender for financing. The contractor may mislead the consumer about the work to be performed, fail to complete the work as agreed, damage the property, or fail to obtain required permits.

Current law prohibits all of these practices. In addition, under the Federal Trade Commission's "Holder in Due Course Rule," similar state law provisions, and HOEPA (for HOEPA loans), the lender will generally subject to the same claims and defenses that the consumer has against the contractor (up to the amounts that the consumer has paid on the contract). Thus, if the work is not completed in a satisfactory manner, the consumer will not be responsible for full payment.

As a result of this exposure, subprime mortgage lenders use devices such as joint proceeds checks and progress payments to ensure that home improvement contractors perform the work properly. We would recommend that all lenders these practices.

Falsified or Fraudulent Applications; Forgery of Loan Documents; and Inflated Appraisals

An unscrupulous broker or lender may convince an unsophisticated borrower who cannot repay a loan to sign a blank application form. The broker or lender then inserts false information on the form, claiming income sufficient to make the payments, and sells the loan to an investor on the basis of the false information. Alternatively, the "predatory" broker or lender may simply forge the borrower's signature. Another fraudulent practice is for the broker or lender to collude with a corrupt appraiser to deliver an appraisal that exceeds the true value of the property. The investor then purchases the loan on the basis of the inflated appraisal.

All of these practices have two things in common—

- They are illegal under current law; and
- The investor is a victim along with the borrower, since the loan will eventually default and the investor will lose most or all of its investment.

Although legitimate, mainstream lenders maintain extensive procedures to avoid being caught in scams of this type, they are sometimes victimized by fraud by "predatory lenders." We recognize that more can be done—CMC's plan for addressing predatory

lending includes the creation of a nationwide registry that would report on licensing status and disciplinary actions, so that brokers and companies who are caught engaging in fraud in one jurisdiction could not simply relocate to another area.

Incapacitated Homeowners

There have been allegations that predatory lenders make loans to homeowners who are mentally incapacitated. Since the homeowner does not understand the nature of the transaction, the end result is default and foreclosure.

Under long-standing contract law principles, a mortgage loan in which the borrower was incapacitated at the time of signing is unenforceable. Entering into such a transaction may also represent civil or criminal fraud.

As noted, subprime lenders are not in the business of making loans that are likely to default, and major lenders maintain procedures to avoid originating or purchasing loans in which the borrower lacks the legal capacity to enter into a contract.

Acceptable Practices That Are Subject to Abuse

The second type of alleged predatory lending consists of practices that are not illegal or unacceptable but may harm consumers when used in abusive ways.

Mortgage Broker's Fees and Kickbacks (Including Yield Spread Premiums)

A prominent target of critics of "predatory lending" has been the yield-spread premium —compensation paid to the broker through an increase in the interest rate. Yield spread premiums have been the subject of extensive class-action litigation in which plaintiffs have argued that this form of compensation is illegal under the prohibitions in RESPA against kickbacks and fee-splits.

Yield spread premiums can be helpful to consumers. Paying a yield spread premium allows a lender to reduce the cash required to close the loan by financing closing costs through a higher interest rate. A borrower who understands the cost of the loan can choose between paying more of these costs upfront or over the course of a loan.

The appropriate remedy for any abuses of yield spread premiums is not to prohibit a practice that often benefits consumers. It is to provide more effective disclosures and improve the competitive environment so that consumers can make informed choices that serve their interests. If consumers understand their closing costs, including the broker's fees they are to pay, before they commit themselves to a transaction and lenders are allowed to compete in providing ancillary settlement services, the broker's receipt of a yield spread premium is irrelevant to the consumer's shopping decision. Importantly, we note that the Mortgage Bankers Association of America and the National Association of Mortgage Brokers have encouraged the use of a form, developed jointly by those organizations, that explains the broker's role.

Prepayment Penalties

Another practice that is often criticized as "predatory" is the imposition of a prepayment penalty—a fee for paying off the loan before some specified time. In most instances, the penalty is reduced over time until it is finally phased out completely.

Legitimate lenders use prepayment penalties to protect themselves against the risk that the borrower will prepay the loan before the lender has recovered its origination costs. A prepayment penalty is one way for a lender to hedge against that risk as well as other financial risks that can occur from early prepayment of the loan. The benefit of reduced prepayment risk can be passed on to the borrower in the form of lower points or a lower interest rate. If a lender is not allowed to impose a prepayment penalty, then it may not be able to offer a zero- or low-closing-cost loan or it may have to increase its rates to be profitable.

On the other hand, an unscrupulous lender can use a prepayment penalty to lock a consumer into an undesirable loan. The CMC believes that the appropriate remedy for the "predatory" abuse of prepayment penalties is to ensure that borrowers understand that a loan with a prepayment penalty is an option that allows them to reduce their interest rate or upfront costs, not a requirement to obtain the loan. In addition, under the CMC's mortgage reform proposal, no prepayment penalty would be permitted after five years from the date of the loan. However, prepayment penalties would be authorized during this five-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of six months' interest on the original principal balance.

Making Unaffordable Loans (Asset-Based Lending)

Another common allegation is that predatory lenders make loans on the basis of the value of the property, disregarding the borrower's ability to pay and in fact anticipating that the borrower will default and the lender will foreclose.

CMC members and other responsible subprime lenders are not in the business of making loans that borrowers cannot repay. Foreclosing on a house is costly, time-consuming, and almost always results in significant losses to the lender. As discussed in greater detail under Tab 3, many subprime loans are now sold into the secondary market, and the rating agencies insist that such loans meet underwriting standards.

For those reasons, the CMC supports, in principle, the existing HOEPA rule against engaging in a pattern or practice of lending without regard to repayment ability. In practice, however, it is difficult to craft specific rules to prevent such "asset-based" lending that reliably apply to all situations. Attempts to specify static rules regarding each borrower's repayment ability are likely to be counterproductive and injure the very borrowers they are intended to protect. For example, one common proposal is to establish a presumption that a borrower with a debt-to-income ratio ("DTI") above a certain cutoff, such as 50%, lacks repayment ability. This rule seems to make sense until a lender encounters a borrower who currently is meeting her obligations with a DTI of 65% and wants a loan that would reduce her DTI to 55%. Moreover, a DTI that indicates

an excessive debt load in a rural area may reflect the average in areas such as New York City or San Francisco with very high housing costs.

In addition, setting a cutoff for DTI at any particular level ignores differences in borrowers' circumstances that affect the debt load they can carry. At one extreme, an individual with a very high income, $1 million/year for example, and few family obligations can easily afford to make high monthly payments and still have enough to meet other living expenses. At the other extreme, a borrower with a low level of income and many dependents may not be able to make mortgage payments that represent a high fraction of his or her income.

Another proposed remedy for asset-based lending is to institute "suitability" rules that create lender liability for making an individual loan if, in hindsight, the lender should have anticipated that the borrower would default. For a mainstream subprime lender that already makes every effort to avoid making loans that go into default, the effect of such a rule will be to increase the costs of foreclosure by requiring the lender to absorb both the losses on the loan itself and the cost of settling the claim that it made an unsuitable loan. These costs will ultimately be passed onto borrowers in the form of higher loan costs or reduced credit availability.

High Points and Fees: Padding Closing Costs; Inflated Appraisal Costs; Padded Recording Fees; Bogus Broker Fees; and Unbundling (Double-Charging for the Same Service)

One of the major sources of criticism of and litigation against the subprime lending industry has been fees paid to mortgage brokers and to other participants in the mortgage process such as appraisers. For example, critics allege that lenders overpay mortgage brokers in comparison to the services the brokers provide or require an expensive appraisal when a "drive-by" evaluation would suffice. Critics also note that the actual amount of these costs (as opposed to an estimate) is not disclosed in advance of settlement, when the borrower still has the opportunity to shop for a better deal or negotiate an improvement in the current one.

Although the CMC agrees that borrowers should not have to pay for services that are not needed or not provided, we believe that a focus on the specific components of the cost of the mortgage is misplaced. Ultimately, the borrower is concerned with total costs (closing costs and interest rate) and not with the relationship among the different providers of settlement servicers or the cost of each individual component of the loan.

The CMC also agrees that present disclosure requirements do not give borrowers accurate and understandable information about the costs of obtaining a loan when they are in a position to use it. In some instances, current requirements may actually have facilitated abuses—as when an unscrupulous lender allegedly misrepresented the TILA-required "amount financed" (which does not reflect loan fees deducted from the proceeds) as if it were the total amount of the loan.

But the CMC believes that it is ineffective to combat excessive loan fees through ever-increasing scrutiny of the practices of settlement service providers and the relationships among them. A more sensible approach—the one taken in the CMC's mortgage reform proposal—would be to eliminate the disincentives in current law that prevent mortgage originators from offering a single, guaranteed price for all settlement services, and then impose a requirement mortgage originators to honor that commitment. Borrowers have no way of knowing what a service such as an appraisal or flood certification "should" cost, yet current law has created an elaborate system of disclosure and monitoring of such costs that is of very little value to most consumers.

Credit Insurance

Consumer advocates often assert that credit insurance products are of little or no benefit to consumers. In fact, while credit insurance is clearly not a good choice for all consumers, lender-provided credit insurance meets a consumer demand that is not met elsewhere in the marketplace. Independent insurance agents are often not interested in providing insurance to subprime borrowers in the relatively small amounts characteristic of a second mortgage loan. In addition, the liberal eligibility standards and convenience of purchasing the insurance are attractive to some subprime customers.

An unscrupulous lender can abuse the credit insurance product by selling it to a consumer who does not want or need it, based on the misrepresentation that insurance is required to obtain a loan. But a recent report on subprime lending shows penetration rates for single-premium credit insurance ranging from 28.3% for first-mortgage loans to 47.9% to second mortgages.[10] These statistics do not support the common assertion that credit insurance is being foisted on unwilling consumers.

Moreover, abusive credit insurance practices are illegal under current law. TILA currently permits a creditor to exclude credit insurance from the finance charge and annual percentage rate only when the lender discloses in writing that it is voluntary and the consumer consents to the purchase by signing or initialing the disclosure form.[11] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address an unmet demand for life and disability insurance. About 25% of all U.S. households do not have life insurance coverage, and about 40% of single parent households and households with annual incomes below $35,000 are completely uninsured. About 50% of all households are uninsured. The Department of Housing and Urban Development estimates that 46% of all foreclosures on conventional mortgages are caused by borrower disability and that 33% of Americans will suffer a serious disability between ages 35 and 65.

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[10] *See* Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* at 12 (July 24, 2001).

[11] 12 C.F.R. § 226.4(d).

Single-premium credit insurance—in which the cost of the insurance is financed as part of the total cost of the loan—has been particularly controversial. The CMC members are no longer offering this product. Other large lenders, however, have modified their sales policies in response to concerns about the marketing of this product, by, for example, offering a monthly-premium product as an alternative and instituting a liberal cancellation policy. It should be noted, however, that the single-premium product has advantages for some consumers. For example, the consumer does not face cancellation of the policy if he or she misses a single payment—a consideration for some subprime borrowers.

The CMC's mortgage reform proposal, discussed above, includes a number of other protections related to credit insurance. There would be clear and conspicuous disclosure given to the consumer that the insurance is voluntary and that it may be cancelled at any time with a refund of unearned premiums. Monthly-pay insurance could also be sold at or before closing. In both situations, there would be a notice after closing that the borrower may cancel the insurance at any time. Refunds of unearned premiums would be based on the actuarial method, not the less favorable Rule of 78's.

Loan Flipping

Loan flipping is the practice of an unscrupulous broker or lender repeatedly convincing the borrower to refinance in order to get a small amount of cash back. The broker or lender then receives additional points and fees. Consumer advocates often argue that it would be better for the consumer to take out a second, junior loan than to refinance the entire obligation. While that may be true in many instances, there are other situations in which the rate and terms on a new first mortgage are more desirable than the combination of retaining the existing first mortgage and obtaining a new second mortgage.

Loan flipping is another example of a practice that is easy to condemn in theory but difficult to prevent through a single rule that can be applied to all situations. One approach, taken in several state anti-predatory laws, is to require a demonstrated "net benefit" to the borrower before the same lender can refinance a loan. The difficulty in this approach is its subjectivity, which could leave lenders exposed to litigation if they could not demonstrate an adequate net benefit.

The CMC's mortgage reform proposal would limit the financing of closing costs and points on HOEPA loans to 3% of the loan amount for refinancings or equity loans entered into within twelve months of a prior financing. The rationale for this approach is to reduce the lender's incentive to flip HOEPA loans. Borrowers who must bring cash to closing to pay costs over the 3% are less likely to be "flipped" numerous times. At the same time, the CMC believes that 3% should be sufficient to allow for refinances to take advantage of declining interest rates.

Arbitration Clauses

Many consumer credit contracts—including many subprime mortgages—include a provision requiring that disputes be resolved through arbitration rather than through the lengthy process of litigation in the courts. Consumer advocates have asserted that binding arbitration clauses are inherently unfair, and there is no question that such a clause could be abused by erecting insuperable obstacles to a consumer's obtaining relief. But the U.S. Supreme Court has upheld the use of such clauses even when the case involves "claims arising under a statute designed to further important social policies," so long as the consumer can vindicate the rights granted under the law before the arbitrator.[12]

The Supreme Court noted in another case that arbitration benefits consumers in many ways:

> "[A]rbitration's advantages often would seem helpful to individuals, say, complaining about a product, who need a less expensive alternative to litigation. See, *e.g.*, H.R. Rep. No. 97-542, p. 13 (1982) ('The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices . . .').."[13]

In place of long, drawn-out proceedings in which the attorneys' fees often dwarf any nominal amount received by consumers, an arbitration clause offers consumers speedy access to a neutral forum that can resolve their dispute with the damages being paid to the consumer, rather than attorneys. The one group that clearly does not benefit from reasonable arbitration clauses in consumer contracts is the class-action trial bar.

Dispute Resolution Process

Recently a number of investors, including Fannie Mae, have indicated their refusal or hesitancy to purchase loans having mandatory arbitration provisions. This certainly stems in part from certain state high cost loan laws that regard such provisions are potentially predatory. While we disagree with that premise, a potential alternative provision that would provide immediate relief to consumers and some protection against the frenzy of class actions for lenders is a dispute resolution provision, that would part of the loan contract, that would require the borrower to notify the lender (or servicer) of a compliance defect in a loan, such as an incorrect disclosure or impermissible term, prior to instituting any action, and giving the lender or servicer an opportunity to correct the

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[12] *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

[13] *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

error. For its part, the lender (or servicer) would be incented to review the loan file to correct defects on its own.

For example, the provision could provide for a 60-day cure period for disclosure defects, including inaccurate disclosures, missing disclosures or late disclosures. For inaccurate disclosures, there could be a minimum adjustment amount of $200 for an error less than $200, and an adjustment of the actual amount of the error plus $50 for an error of $200 or more. For missing disclosures that the lender provides within 60 days after the closing, the account would be adjusted by $250. If the disclosure is provided within one year after the closing, the lender would adjust the account by $500. For late disclosures, if discovered within 60 days after the closing, the lender must adjust the account by $25. If the late disclosure is discovered within one year after the closing, the lender must adjust the account by $50.

If the lender fails to cure a defect brought to its attention and the borrower prevails in an action against the lender, the lender would owe a minimum adjustment amount of $2,000 plus attorneys' fees. If the lender has failed to provide the notice of right of rescission, the right to rescind would be extended to one year from the closing date. If the defect is willful and knowing, the borrower may bring an action, and if successful, the lender would have to make a minimum adjustment of $5,000 plus attorneys' fees.

If adopted as part of the loan contract, these remedies would benefit both consumers and lenders. Consumers would receive immediate compensation for compliance defects, without having to pursue an action, and in most cases, would receive damages in amounts exceeding the actual amount of the error. In addition, because of the incentive to the lender of responding quickly to the consumer, the consumer will be made whole in a matter of months, rather than years.

The lender would benefit from these provisions by not having to undergo the great expense of defending class action lawsuits over relatively minor defects. Giving the consumers the incentive to bring errors directly to the attention of the lender also offers the lender an additional means to monitor its disclosure compliance procedures and improve the accuracy of the service it offers future borrowers.

Finally, both consumers and lenders would benefit ultimately from implementation of such a provision because the reduction in lawsuits would decrease overall costs to lenders and thus allow them to offer loans at lower rates.

Balloon payments and Negative Amortization

Consumer advocates often characterize two loan structures—*balloon payments* and *negative amortization*—as types of predatory lending. In a balloon payment loan, the monthly payments do not fully amortize the amount of the loan, resulting in a large final payment. In negative amortization, the monthly payments are insufficient to pay the interest that accrues on the loan, and the difference is added to the principal. Balloon payments are restricted and negative amortization is prohibited under HOEPA.

We recognize that both of these structures can be used in an abusive manner. If the broker or lender misleads the borrower about the nature of a balloon loan or the final payment is due in an unreasonably short time, the homeowner may not be able to afford the balloon payment and may either lose the home or be forced to refinance on unfavorable terms. A borrower who does not understand the nature of negative amortization may face similar negative consequences.

At the same time, both of these loan structures can be helpful to some consumers. Balloon payments can benefit borrowers by allowing them to obtain lower-cost credit than they would otherwise qualify for. A balloon note can be particularly helpful to a borrower who expects to move to a new location within the period of the balloon mortgage. Such a mortgage would be less expensive than a fixed-rate, long-term mortgage loan for the consumer.

Negative amortization, by definition, reduces the monthly payment and may make a loan more affordable to a borrower with significant equity but insufficient income to qualify for a standard loan. Congress has recognized the benefits of one form of negative-amortization loan—the reverse annuity mortgage—by exempting such loans from the general prohibition against negative amortization in HOEPA.

Thus, further blanket restrictions on these loan structures, while protecting some consumers, could prevent others from obtaining loans that fit their financial circumstances.

MORTGAGE LENDING AND SERVICING PROCESS

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, a real estate broker or home improvement contractor refers the borrower. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).

- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

  The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.

- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.

- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in

the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

Compensation to Brokers and Correspondent Lenders

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[14] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid

[14] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

by the lender reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[15] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[16] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will

[15] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[16] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

Compensation to Investors (Portfolio Lenders or Secondary Market Investors)

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

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