

Subcommittee on Financial Institutions and Consumer Credit  
Subcommittee on Housing and Community Opportunity  
Joint Hearing Entitled "Promoting Homeownership by Ensuring Liquidity in the Subprime  
Mortgage Market"

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**Prepared Testimony of Michael D. Calhoun,  
General Counsel  
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 issue of liquidity in 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 industry, along with the impact of these failures on homeowners and policy solutions that address these failures.

I'd like to emphasize three points.

- **Assignee liability provisions in state predatory lending laws focus on those loans at highest risk of abuse.** These provisions provide that families with high-cost loans who are injured by illegal acts have a remedy to protect their homes. Standard & Poor's adopts this view by requiring extra credit enhancement in states with predatory lending laws for high cost loans only, leaving the rest of the market unchanged.<sup>1</sup>
- **Provisions against flipping of loans have provided an essential borrower protection without disrupting the secondary market.** Prohibitions on flipping prevent repeated abusive refinancings of loans that do nothing more than generate fees for lenders and strip the homeowner's equity. North Carolina has had this provision for all home loans for four years, and it has not generated a single filed case, nor has it disrupted the secondary market.
- **State laws have not hampered subprime lending's growth; volume and liquidity in the subprime mortgage market are expanding rapidly.** In 2003, subprime lending and securitizations both increased by more than 50 percent. The first quarter of 2004 had 70% year-to-year growth. State laws to protect families from predatory lending are not stifling this exploding market.

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<sup>1</sup> S&P also required credit enhancement for New Jersey loans in the "covered loan" category, those that have between 4% and 5% in fees. While this category represents less than 2% of the market, legislation that deletes the covered loan category is pending in the New Jersey legislature and is likely to pass by the end of the month.

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.<sup>2</sup> And home equity comprises over 60 percent of the net worth of minority and low-income families.<sup>3</sup> 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. **Our overall loan loss rate is less than one-half of one percent per year, and our assets have grown to almost \$1 billion.**

Self-Help's Secondary Market Program is a major component of our home lending work. Through the program, Self-Help buys packages of nonconforming loans from banks in return for the banks' commitment to re-lend the money to an equivalent number of low-wealth home buyers in the future. This program, which has been in place for ten years, has been tremendously successful, and has grown at a rapid pace. We have financed over \$3.1 billion of loans to 36,500 families across the country through thirty lenders. Forty-one percent of the program's home loans had been made to minority families, 39% were made to female heads of household, and 21% of the loans were made to rural families. Additionally, these programs are reaching working-class families. The average income of the homebuyers is 64% of the relevant area median income. Losses have been well below one-half of one percent a year. Our program has also enabled us to develop a deeper understanding of the complexity of the secondary market and the issues that both lenders and borrowers face in today's home lending market.

Given our experience with mortgage lending, we have been surprised to hear concerns regarding liquidity and the availability of credit in the subprime market. Even while much of the economy has experienced bumps in recent years, the mortgage market has boomed, driven in part by the continued expansion of the subprime market. Unfortunately, the incredible growth of the subprime market has corresponded with an increase in abuse that has become a crisis for American families. The prevalence of abusive loan terms and lending practices in the subprime market have not only limited the equity-building potential for homeownership, but have led families to lose their homes and their accumulated life savings. The secondary market for subprime loans has encouraged such abuse, creating incentives for lenders to charge excessive

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<sup>2</sup> See, e.g., Joint Center for Housing Studies of Harvard University. State of the Nation's Housing 1997: p.18.

<sup>3</sup> "Net Worth and Asset Ownership of Households, 1998 and 2000," at 15 tbl. I (U.S. Census Bureau, p70-8, May 2003).

fees and take advantage of vulnerable borrowers, and failing to engage in basic due diligence that could prevent abuses from taking place.

Self-Help and others in North Carolina first became familiar with the dangers of the subprime market in the 1990s, when we began to see borrowers come through our doors in search of help in staving off foreclosure. To our dismay, abusive terms in their existing loans routinely prevented us from refinancing their loan because all of their equity had been stripped by these abusive terms. 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.

In response, Self-Help joined with a remarkable coalition of bankers, credit unions, mortgage brokers, mortgage bankers, consumer advocates, the NAACP, AARP, and other community organizations to develop a state law with strong standards that would preserve the important benefits of the subprime market while weeding out the worst abuses. The resulting anti-predatory lending law, enacted in North Carolina in 1999, was the first in the nation, and its success continues to be a model for efforts in other parts of the country.

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.

Based both on our experience as a lender and our research into the abuses that impact low-wealth families, I hope today to address your concerns about the availability of credit in the subprime market. I also wish to bring to your attention the serious harms that abuses in this market have created, and to explain how North Carolina and other states have successfully addressed these issues while maintaining a vibrant market. I applaud your concern about the impact of lending practices on subprime borrowers, but hope that you will conclude that Congress could best respond by supplementing the important work that is taking place at the state level and supporting strong standards that promote responsible lending throughout the mortgage market.

**I. The subprime market and the secondary market for subprime loans continue to grow at a rapid pace.**

*"The subprime mortgage business had one of its best years ever in 2003."*<sup>4</sup>

The "subprime" market is intended to serve those who do not qualify for "prime" loans, primarily due to impaired or limited credit histories. To account for less-than-stellar credit, responsible subprime lenders charge slightly higher interest rates to compensate for the increased risk associated with their lending activities. Subprime home loans are typically packaged and

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<sup>4</sup> *Subprime Mortgage Loans* 2004, p.5, SMR Research Corporation, January 2004.

sold to investors in the secondary market, which in turn provides subprime lenders with a source of capital with which to make additional loans.

There is no evidence that changes in mortgage laws at the state level have had a deleterious effect on the subprime market, which has continued to grow at an astonishing pace. **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 the issuance of subprime securities rose to \$203 billion from \$135 billion.<sup>5</sup> In 1994, by contrast, subprime lenders securitized just \$10 billion worth of home equity loans.<sup>6</sup>

Mortgage industry forecasts have concluded that subprime lending will continue to increase in 2004.<sup>7</sup> At a recent MBA Subprime Lending Conference, the chief economist of the Mortgage Bankers Association noted that subprime lending is “much less interest rate sensitive” than the prime market and predicted that the sector could see growth in 2004 even if other sectors of the mortgage market falter.<sup>8</sup> Similarly, one industry publication reported, “Subprime lenders should continue to see strong demand for their product in the secondary market this year, analysts predict.”<sup>9</sup> This prediction has proven true for the first quarter of 2004, with the market growing an additional 70.3 percent, on average, over the prior year’s first quarter.<sup>10</sup>

## **II. Predatory lending abuses have created a crisis for American families.**

The subprime market is largely a market for refinance loans -- approximately three-quarters of subprime originations in 2001 and 2002 were refinances<sup>11</sup> -- which present unscrupulous actors with opportunities to strip homeowners’ built-up equity. Unfortunately, the combination of tremendous growth in subprime lending, the lack of standards for this rapidly growing industry, and subprime borrowers’ frequent lack of financial sophistication has created an environment ripe for abuse. While by no means are all subprime loans predatory, almost all predatory loans are subprime. As a result of the growth of subprime lending, the pressing issue today is no longer the availability of credit in America’s communities. Rather, the debate has shifted to the terms on which credit is offered.

Predatory mortgage lending is now epidemic, costing U.S. families an estimated \$9.1 billion each year in lost homeowner equity, back-end penalties, and excess interest paid.<sup>12</sup> Abusive practices include stripping equity from homeowners through excessive fees; steering homeowners into unnecessarily expensive loans on the basis of race, ethnicity, age, and gender; and interfering with the ability of homeowners to protect their homes from foreclosure with

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<sup>5</sup> Inside B & C Lending. Jan. 12, 2004, p.3 and Feb.9, 2004, p.1.

<sup>6</sup> Cathy Lesser Mansfield, “The Road to Subprime ‘HEL’ was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,” S.C. Law Review, v51, n3 (2000), 473-587.

<sup>7</sup> *Subprime Mortgage Loans 2004*, p.15, SMR Research Corporation, January 2004; *Subprime Lenders Shatter Records in '03 and Get Set for More in '04*, Inside B&C Lending, February 9, 2004.

<sup>8</sup> Lew Sichelman, National Mortgage News, “Line Between Prime and Nonprime Gets Blurry,” May 24, 2004.

<sup>9</sup> Inside B & C Lending. Jan. 12, 2004, p.3.

<sup>10</sup> Inside B&C Lending, June 14, 2004, p.1-2.

<sup>11</sup> SMR Research Corp., Analysis of 2001 and 2002 Home Mortgage Disclosure Act data.

<sup>12</sup> Stein, Eric. “Quantifying the Economic Cost of Predatory Lending”, Coalition for Responsible Lending (2001) (available at <http://www.predatorylending.org/pdfs/Quant10-01.PDF>).

legitimate defenses. We know from experience that predatory lending robs families of the home equity wealth that could otherwise be used to send children to college, start small businesses, weather crises such as unanticipated medical expenses, and enjoy some measure of security in old age. Even worse, because predatory lending can lead to increased foreclosures across a neighborhood, abuses have a devastating impact on communities.

Examples of some of the worst abuses include:

1. **Excessive points and fees.** Points and fees are costs to borrowers that are not directly reflected in interest rates. Excessive points and fees are frequently the hallmark of a predatory loan, and they can disguise the real cost of credit when they are financed rather than paid outright at a loan closing. The problem for borrowers is that, while they may refinance out of a loan that has an interest rate that does not properly reflect their risk, they cannot recover fees, ever. Instead, those fees are financed into the loan amount and are repaid from the homeowners' equity when they refinance. Furthermore, in the subprime market, fees are not advertised in a consistent way, and homeowners may not learn the total fees they are being charged on a loan until the day of closing, if at all. Thus, comparing lenders' fees is more difficult than comparing interest rates; homeowners would have an easier time "shopping" for loans if lenders took their compensation in the form of interest rates rather than fees.

2. **Abusive broker kickbacks.** Research suggests that brokers originate approximately half of all subprime refinance loans,<sup>13</sup> and that these brokered loans are particularly expensive for African American and Latino homeowners.<sup>14</sup> Most borrowers do not understand that mortgage brokers generally do not have legal duties to find them the best loans available. Because borrowers are typically unaware of the best available interest rate for which they qualify, yield spread premiums<sup>15</sup> function as kickbacks that encourage mortgage brokers to steer consumers into particularly costly loans. As one study recently put it,

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

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<sup>13</sup> "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.4.

<sup>14</sup> See, e.g., Prepared Statement of Prof. Howell E. Jackson Finn M.W. Caspersen and Household International Professor of Law and Associate Dean for Research and Special Programs Harvard Law School, *Hearing Before the Senate Banking, Housing and Urban Affairs*, 107th Cong., January 8, 2002, available at [http://banking.senate.gov/02\\_01hrg/010802/jackson.htm](http://banking.senate.gov/02_01hrg/010802/jackson.htm) (finding that "mortgage brokers charged two racial groups - African-Americans and Hispanics - substantially more for settlement services than they did other borrowers. For African-Americans, the average additional charge was \$474 per loan, and for Hispanics, the average additional charge was \$580 per loan.")

<sup>15</sup> Brokers can be paid for their services directly by borrowers, frequently as a percentage of the total loan amount and through other direct fees, including application fees. Brokers are also frequently paid indirectly by the lender/investor through a "yield spread premium" based on the yield of the mortgage. This premium reflects the difference in price between what a lender is willing to pay the broker for a home loan made to the borrower at market rate and the value of a mortgage originated at a higher interest rate. For example, if the borrower should receive a 7% loan and instead receives a 7.75% loan with a prepayment penalty, the lender might pay the broker \$103,000 (rather than the typical \$100,000) for a \$100,000 loan.

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.<sup>16</sup>

Those looking to increase their own compensation at the expense of homeowners may choose their targets in a manner that takes advantage of more vulnerable borrowers. A recent study of older borrowers who obtained mortgage loans (both prime and subprime) concluded:

[B]orrowers with broker-originated loans were much more likely to report that they did not initiate the contact about the loan, and they relied more on the broker than the borrowers with lender-originated loans. In addition, borrowers with broker-originated loans were more likely to report having received loans with less favorable terms such as prepayment penalties and points paid upfront than borrowers with lender-originated loans.<sup>17</sup>

**3. Charging prepayment penalties on subprime loans.** Prepayment penalties on subprime loans trap borrowers in high-rate loans, often leading to foreclosure and bankruptcy. Prepayment penalties prevent borrowers from using the subprime market as a bridge to conventional financing as the borrowers' credit improves. While prepayment penalties are rare in the conventional market, a large majority of subprime loans contain these terms. Prepayment penalties may vary with respect to how large they are (usually calculated in terms of a number of months' interest) and how long they remain in effect. Some of the most pernicious penalties remain in effect for five full years and are calculated as six months' interest on any prepaid amount that exceeds 20% of the loan. In the context of a subprime loan with an interest rate of 12%, this means that the prepayment penalty amounts to approximately 5% of the loan balance. For a \$150,000 loan, this fee is \$7,500, or equal to the median net worth of African American households in 2000. This is a very steep penalty for simply paying off a loan "too quickly."

**4. Flipping borrowers through fee-loaded refinancings.** Abusive lenders refinance subprime loans over and over, each time charging fees that reduce home equity and each time leaving the borrower worse off than when he or she started. North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their interest-free first mortgages into high interest loans.<sup>18</sup> Some lenders set borrowers up by selling them bad loans packed with unexplained terms; when balloon payments come due or when interest rates on the loans rise, these borrowers have little choice but to

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<sup>16</sup> "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).

<sup>17</sup> Kellie M. Kim-Sung and Sharon Hermanson, "Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans," AARP Public Policy Institute (January 2003).

<sup>18</sup> See "Overview of Habitat for Humanities Refinances" (Coalition for Responsible Lending, Dec. 9, 1999), under Studies at <http://www.responsiblelending.org>. Since 1999, Habitat has instituted additional protections against flipping.

refinance. Loan flipping is this practice of refinancing a mortgage loan without benefit to the borrower, usually in order to extract additional origination fees, closing costs, points, prepayment penalties, or other charges.

For abusive lenders, loan flipping can be an alternative to making “high-cost” loans, or loans with high interest rates or points and fees. Fees are not packed into loans all at once, but rather accumulate over the course of multiple transactions. By flipping loans, unscrupulous lenders can avoid high-cost loan thresholds while still racking up exorbitant fees.

5. **Single-premium credit insurance.** Credit insurance (in the form of life, accident, health, or other forms of insurance) is paid by the borrower to repay the lender in the event the borrower dies. When paid for up-front, this insurance does nothing more than strip equity from homeowners. After North Carolina banned this practice, the industry largely eliminated single-premium credit insurance.

The stories of individuals who have been callously preyed upon by predatory lenders could fill volumes. In 1998, Self-Help learned about such abuses first-hand, when a middle-aged African American home loan borrower broke into tears in our CEO’s office. He told us that his wife had died three years before, leaving him to care for their six-year old daughter. He desperately wanted to hold onto his house, saying, “This house is more than a home. It is also the physical memory of my daughter’s mother.” For ten years, he said, he had tried to refinance a home loan he had taken at 14% interest; he insisted that the lender would not let him pay off the loan. The loan documents showed that this man’s loan of \$29,000 had been inflated with \$15,000 in fees, including credit insurance and other unnecessary costs. The lender would not tell him—or Self-Help -- the pay-off balance. We soon discovered that the problem was larger than one loan. This same lender was making 18,000 mortgage loans per year in North Carolina alone. The story is not an isolated example-- we have seen the dynamic play out time and time again, and the United States Departments of Treasury and Housing and Urban Development have documented these abuses in a joint report.<sup>19</sup>

Because predatory lenders are known to target certain neighborhoods, the odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant. For instance, according to the Mortgage Bankers Association, nearly 16 percent of Ohio’s subprime loans were in foreclosure last year at this time. This was thirteen times the rate of foreclosure in conventional loans.<sup>20</sup> New evidence from the Woodstock Institute in Chicago shows that recent increases in foreclosures have been fueled in large part by increases in subprime home lending in the last half of the 1990s. In addition to finding subprime lending “the dominant driver” of increases in foreclosures, the authors note that the impact of foreclosures is most keenly felt in “modest-income neighborhoods where foreclosures more often lead to abandonment and blight”

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<sup>19</sup> U.S. Department of Housing and Urban Development & U.S Department of the Treasury, “Curbing Predatory Lending” (June 2000) (available at: <http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf>).

<sup>20</sup> See, “Pace Quickens on Home Foreclosures in Ohio”, [The Columbus Dispatch](#) (March 25, 2003).

and that those costs are "borne by entire communities, not just by the lender or borrower."<sup>21</sup> Key findings from the report include the following:

- From 1995 to 2002, foreclosure starts in the Chicago area grew 238 percent.
- Increases in the number of subprime loans resulted in a 22 times larger growth in the number of foreclosures than identical increases in prime lending, controlling for unemployment, changes in population, home values, family income, and minority population concentration.
- Census tracts experiencing an increase of 100 subprime loans over this time period experienced 29 percent more foreclosures after controlling for "neighborhood demographics and economic conditions."

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."<sup>22</sup> 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.<sup>23</sup>

While we might expect some elevation of default rates in the subprime market, the statistics documenting Self-Help's experience with lending to borrowers with blemished credit and low incomes (including our loss rate of no more than 0.5 percent per year) suggest that foreclosures in the subprime market cannot be explained solely by borrower behavior. Rather, we must recognize that abusive lending pushes borrowers past their limits and imposes extensive costs in our communities.

### **III. The North Carolina anti-predatory lending law has protected the state's vibrant subprime lending market, while driving out bad loans.**

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--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.

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<sup>21</sup> Immergluck and Smith, *Risky Business -- An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute, March 2004.

<sup>22</sup> Steve C. Bourassa, "Predatory Lending in Jefferson County: A Report to the Louisville Urban League," 2 (Urban Studies Institute, University of Louisville Dec. 2003).

<sup>23</sup> *Id.*



Empirical research shows that the North Carolina successfully addressed abusive practices and simultaneously has allowed the subprime lending market to thrive.

**A. The North Carolina law has decreased the incidence of equity-stripping loan terms.**

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.<sup>24</sup> After analyzing the effects of North Carolina’s law on the home mortgage market, researchers from the University of North Carolina concluded that the law has had a particularly significant impact on abusive refinances. 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. **“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 was in predatory loans.”**<sup>25</sup>

In a separate finding, the UNC researchers also noted evidence that the North Carolina law resulted in a reduction in the “steering” of borrowers to loans with a higher price than that justified by their credit history. Subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—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.

**B. The North Carolina flipping provision successfully balances concerns of the market and borrowers.**

The UNC findings regarding a reduction in abusive refinances are particularly significant, because a crucial component of North Carolina’s landmark legislation is its prohibition against loan flipping. Specifically, the North Carolina forbids “knowingly or intentionally” refinancing a home loan that does not provide the borrower with a “reasonable, net tangible benefit,” considering “all of the circumstances.”<sup>26</sup> The NC standard is a compromise that favors both homeowners and lenders for three reasons:

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<sup>24</sup> 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>).

<sup>25</sup> 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>).

<sup>26</sup> “No lender may knowingly or intentionally engage in the unfair act or practice of ‘flipping’ a consumer home loan. ‘Flipping’ a consumer loan is the making of a consumer home loan to a borrower which refinances an existing

- The NC standard provides incentives for lenders to reduce the incidence of flipping by more closely monitoring the underwriting and origination of refinance.
- At the same time, the “knowing or intentional” scienter requirement discourages potential litigants from bringing frivolous claims.
- In addition, the requirement that the trier of fact specifically review “all of the circumstances,” including “the borrower’s circumstances,” makes it impossible for a claim to be asserted as a class action, since borrowers have differing circumstances.

The North Carolina provision also strikes the right balance by being neither over- nor under-inclusive. It allows lenders to use their knowledge of the market to develop standards for compliance, and avoids setting strict rules that would constrain the ability of lenders to make refinance loans that may be appropriate in one context, and of little value to the borrower in another. In reality, financial professionals are already accustomed to complying with broad and flexible standards of conduct in their business, such as unfair trade practice laws, the suitability standard governing investment advice<sup>27</sup>, and the standard of liability for “churning” in the securities industry.<sup>28</sup>

Significantly, while the North Carolina flipping provision has been successful at reducing flipping abuses, it has not led to frivolous litigation in connection with refinance transactions. In a recent review of relevant filings in North Carolina District and Superior Courts, Federal District Courts, and U.S. Bankruptcy Courts against the nation’s top 10 subprime lenders over the five-year period since the North Carolina law became effective (1999-2004), **the Center for Responsible Lending identified no instances in which a borrower has alleged flipping since the North Carolina anti-predatory lending law became effective.** Given the scope of the review performed, this suggests that exceedingly few, if any, flipping claims are being alleged against subprime lenders in NC. (See “Flipping” Prohibitions in N.C. Elicit No Substantial Litigation,” attached at Appendix A.).

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consumer home loan when the new loan does not have reasonable, tangible net benefit to the borrower considering all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances. . . .” N.C. Gen. Stat. § 24-10.2(c) (1999).

<sup>27</sup>For example, Rule 2310 of the NASD’s Rules of Fair Practice sets a broad “reasonable grounds” and “reasonable efforts” standard in determining the suitability of a broker’s recommendation to a customer and puts the obligation on the broker or company to evaluate the transaction. It provides that “[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situations and needs.” Further, brokers must make “reasonable efforts to obtain information concerning” the customer’s financial and tax status, investment objectives, and such other information.

<sup>28</sup> Churning occurs when a broker abuses his customer’s confidence by excessively trading the customer’s account in order to generate commissions. E.g., Deborah Travis, Comment, Broker Churning: Who is Punished? Vicariously Assessed Punitive Damages in the Context of Brokerage Houses And Their Agents, 30 Hous. L. Rev. 1775, 1778-79 (1993); Section 10 of the Securities Exchange Act of 1934 (the 1934 Act) prohibits churning as a form of broker-dealer fraud by making it unlawful for “any person . . . to employ . . . any manipulative or deceptive device or contrivance in contravention” of any rule “the Commission may prescribe as necessary or appropriate to the public interest or for the protection of investors.” 15 U.S.C. § 78j (1982). See also Rule 10b-5, promulgated under section 10(b) of the 1934 Act.

**C. The North Carolina law has improved the operation of risk-based pricing in the prime market and has allowed for the continued widespread availability of credit.**

Finally, it is clear that credit continues to be widely available in North Carolina in the nearly five years since the law went into effect. 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 functioned as a vulnerability tax on North Carolina families.

Additionally, 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. Although a reduction in steering led to a decrease in refinance loans to borrowers with higher credit scores, such loans to borrowers with credit scores below 580 increased by 18.5 percent in NC after the law. While 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.

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.<sup>29</sup> 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.<sup>30</sup> 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 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."<sup>31</sup>

In summary, the North Carolina law has been an unqualified success. 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**

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<sup>29</sup> Inside B&C Lending. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5, 2001.

<sup>30</sup> Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.

<sup>31</sup> 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>).

**subprime mortgage capital accessible to North Carolina borrowers with blemished credit records.”<sup>32</sup>**

#### **IV. Assignee liability is critical to successful efforts to address predatory lending.**

Since a majority of home loans are resold on the secondary market, assignee liability has proven a critical component of successful efforts to address predatory lending at the state level. Without liability for a person who has purchased the home loan (called an “assignee”), a family that has been the victim of a predatory loan cannot stop the foreclosure of their home even if the originator is solvent and well-capitalized. Instead, they end up losing their home, and then they must bring a separate action against the originator. This separate action can take years.

Assignee liability is even more important in light of the substantial involvement among mortgage brokers and other minimally capitalized originators who are frequently out-of-business before a homeowner recognizes a predatory loan.<sup>33</sup> Almost all mortgage loans are sold or otherwise assigned after closing, so the party collecting and enforcing the note is not the one that the borrower dealt with and who originated the loan. In fact, while very few home loans were brokered ten years ago, an estimated 65 percent are broker-originated today.<sup>34</sup>

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. Without assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. The lack of assignee liability provides little incentive to purchasers of such loans to determine if the loans were originated illegally or are so out of line with market norms that they present a substantial likelihood of abuse.

Indeed, rather than critique these loans, too often loan purchasers reward unscrupulous lenders by paying more. This practice becomes problematic for assignees, however, as borrowers eventually succumb to pressures inherent in an abusive loan and foreclosures and value-reducing, unexpected prepayments resulting from refinancing grow. Evidence abounds

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<sup>32</sup> 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 significant 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.

<sup>33</sup> Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. See Wholesale Access, “New Research About Mortgage Brokers Published,” (August 6, 2003) (available at: <http://www.wholesaleaccess.com/8.6.03.mb.shtml>) and Eggert, Kurt, “Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,” *Creighton Law Review*, v35, n3 (April 2002), 507-640.

<sup>34</sup> See <http://www.wholesaleaccess.com>.

that the market has been caught unaware in recent years by these trends, most notably in the large foreclosures that drove Conseco and other subprime lenders into bankruptcy.<sup>35</sup>

#### **A. Investors have continued to do business under assignee liability rules in other contexts.**

Hardly a new development, assignee liability exists in several other contexts related to lending. Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws.

Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For instance, an assignee may not be considered a holder-in-due-course (and thus be entitled to enforce a promissory note without regard to a consumer's claim) if the assignee purchased a delinquent loan.<sup>36</sup> Furthermore, even a holder-in-due-course is subject to certain claims, including defenses based on duress, lack of legal capacity, illegality of the transaction, or fraud."<sup>37</sup>

HOEPA itself provides for assignee liability in two instances. First, in instances where a homeowner did not receive the material disclosures required by HOEPA, the homeowner may rescind the loan (tender the principal owed on the loan and receive in return all interest and fees paid on the loan), even after it has been assigned.

Second, and more relevant to the issue at hand, HOEPA provides that assignees of HOEPA high-cost home loans are subject to "... all claims and defenses ... that the consumer could assert against the original creditor..."<sup>38</sup> In instances where assignees are held liable pursuant to this provision, damages are capped at "the greater of (1) the applicable TILA damages or (2) elimination of the loan and recovery of all payment made."<sup>39</sup> In other words, without time limits apart from those governing the underlying cause of action, an assignee may be liable for damages equal to amounts owed plus all amounts paid on the loan, including amounts paid before it took assignment of the loan. The only exception to this strict liability lies in instances where an "assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine ... [that the loan was a HOEPA high-cost home loan]."<sup>40</sup>

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<sup>35</sup> Berenson, Alex, "A Boom Built Upon Sand, Gone Bust", N.Y. Times at B-1 (November 25, 2001); *See also*, Smith, Joseph A., "The Federal Banking Agencies Guidance on Subprime Lending: Regulation with a Divided Mind", North Carolina Banking Institute, v6, 73, 100 (2002) (discussing over-valuation resulting from gain-on-sale accounting related to securitization).

<sup>36</sup> *See e.g.*, NCGS 25-3-302 (detailing this and other prerequisites to holder-in-due-course status).

<sup>37</sup> *See e.g.*, NCGS 25-3-305(a)(1).

<sup>38</sup> 15 U.S.C. 1641(d).

<sup>39</sup> *See e.g.*, In re Murray, 239 B.R. 728, 733 (Bkrctcy. E.D. Pa. 1999) (applying damages cap from 15 U.S.C. 1641(d)(2) and 15 U.S.C. 1641(d)(3)).

<sup>40</sup> 15 U.S.C. 1641(d)(1).

HOEPA's legislative history provides the following helpful explanation of the motivation for and desired effect of this provision:

By imposing assignee liability, the Committee seeks to ensure that the High Cost Mortgage market polices itself. Unscrupulous lenders were limited in the past by their own capital resources. Today, however, with loans sold on a regular basis, one unscrupulous player can create havoc in a community by selling loans as fast as they are originated. Providing assignee liability will halt the flow of capital to such lenders.<sup>41</sup>

As one would expect, when faced with potential liability, assignees have developed techniques that limit their exposure. For example, in virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Investors also conduct due diligence, such as loan sampling, to verify the integrity of the loans they are buying. Moreover, individual investors in securities backed by subprime home loans retain confidence since they have no individual liability under any assignee liability schemes designed in the states since they are not "holders" or "assignees" of the loans and consequently may not be sued.

**B. Assignee liability in state anti-predatory lending laws encourage due diligence and provide limited recourse for victims of abusive practices.**

Building on HOEPA's initial statement of assignee liability for high-cost home loans, states such as North Carolina, New Jersey, New Mexico, New York, and Illinois have developed and begun to implement new provisions that (1) provide a clear incentive for the secondary market to conduct due diligence to prevent the purchase of high-cost home loans, (2) ensure that homeowners being foreclosed on or otherwise suffering harm arising from a predatory loan can defend their home, and (3) cap liability at the amount of the loan plus costs and prohibit class action lawsuits against good faith secondary market participants that unintentionally purchase a high-cost home loan.

As the states have sought to address predatory lending by building on HOEPA's substantive rights, they have also typically refined the concept of assignee liability in a two-step approach. First, a company that refuses to exercise due diligence to prevent the purchase of high-cost home loans is subject to all the liability of the original creditor to preserve the claims of homeowners who otherwise would be left defenseless when the original creditor has sold the loan and subsequently gone out of business.

Second, for companies that accidentally purchase a high-cost home loan after engaging in due diligence (a rare occurrence), homeowners are given the right to defend their home against foreclosure or continuing harm, subject to several restrictions. The New Jersey Home Ownership Security Act of 2002, as well as laws in New Mexico and Illinois, provide examples of this two-step framework.

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<sup>41</sup> S.Rep. No. 103-169, at 28 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1912.

**C. Impact of assignee liability on the secondary market is negligible.**

Under the New Jersey approach, the bottom-line exposure of assignees under the legislation is negligible. In fact, the following chart provides a rough but conservative estimate of total exposure to show that good-faith loan assignees should find their total exposure amounting to less than 0.0001% of total loan purchases (or 0.01 basis points).

Occurrence necessary for exposure	Estimated Likelihood
High-cost home loan is purchased despite due diligence procedures to avoid it.	1 in 1,000
Loan contains a violation of high-cost protections.	1 in 10
Borrower identifies violation, retains individual lawyer (no class action claims allowed), and successfully prosecutes claim.	1 in 10
Seller who made promises not to sell high-cost home loans is insolvent and therefore can't indemnify secondary market actor.	1 in 10
All four factors met (0.001*0.1*0.1*0.1)	1 in 1,000,000

On May 13, 2004, Standard & Poor's published an explanation of its expanded credit enhancement criteria for loans originated in states with anti-predatory lending laws that include assignee liability provisions. The S&P announcement will have very little, if any, effect on the overall secondary market for mortgage-backed securities. As intended by the state laws they address, the ratings agency's credit enhancement requirements apply almost exclusively to high-cost loans—a very small subset of subprime loans.

In fact, S&P observes that, “the additional credit enhancement requirement will be applied primarily to high-cost loans that have historically not been a large component of Standard & Poor's rated transactions.” The credit enhancement requirement may well mean that lenders will be forced to hold high-cost loans in their portfolios. This should discourage lenders from making unnecessary high-cost loans while allowing those loans that truly merit high-cost pricing to be made by lenders with sufficient financial strength to stand behind their loans—exactly the outcome desired by those who have supported strong state anti-predatory lending laws.

This prediction has already been borne out in North Carolina, which incorporates assignee liability by making a violation of the anti-predatory lending law a violation of state usury law. North Carolina case law has held assignees liable for usury violations and yet, since passage of its anti-predatory lending law, North Carolina subprime home loans have continued to be widely available and sold on the secondary market.<sup>42</sup>

<sup>42</sup> See, e.g., North Carolina Anti-Predatory Lending Law Reviewed by Standard & Poor's, February 13, 2004, available at [http://www.securitization.net/pdf/sp/NCarolina-Anti-Predatory\\_19Feb04.pdf](http://www.securitization.net/pdf/sp/NCarolina-Anti-Predatory_19Feb04.pdf).

**V. Federal preemption of state anti-predatory lending laws would be misguided, as any federal standards should supplement, not replace, existing state efforts.**

While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular context.<sup>43</sup> States have served as “laboratories of democracy” with respect to predatory lending by helping to refine solutions for important issues. States that passed laws after North Carolina have developed new definitions of points and fees that expand on the North Carolina definition by including back-end payments to brokers for placing borrowers in loans with higher interest rates than those for which they qualify (yield spread premiums); expanded the scope of loans provided with new protections by ensuring that open-end loans, including home equity lines of credit, are covered (North Carolina later adopted this point); clarified available remedies with more explicit provisions; and taken other steps, such as imposing fiduciary duties on mortgage brokers. Each of these steps represent meaningful advances in the evolving debate over how best to solve the predatory lending problem.

The experiences in New Jersey, Georgia, and other states show that concerns about the operation of specific legislative provisions can readily be resolved at the state level. After rating agencies raised questions about the Georgia law, a resolution was quickly reached that capped the liability of loan purchasers (to the amount of the loan) and provided additional protections for loan purchasers who engaged in due diligence (by protecting them against class actions). Georgia eventually chose not to enact this provision, and instead adopted a provision that cut off almost all assignee liability, far more than the rating agencies require. In New Jersey, the Department of Banking and Insurance has taken the lead in addressing concerns with the Garden State’s assignee liability provisions through regulatory guidance. New Mexico deleted a provision of its legislation in response to legitimate concerns raised about the application of a component of the law. The point is not that these states adopted the perfect solution for predatory lending, but rather that each proved capable of quickly adjusting its standard to market needs, and in doing so may help define which policies protect and which fail to protect homeowners and lenders alike.<sup>44</sup>

Federal preemption of state anti-predatory lending laws would be misguided—and harmful to homeowners. When the federal government first legislated against predatory home lending through the HOEPA floor, states were free to go further. This dynamic has served the nation well, allowing for a “cooperative federalism” in which state-developed solutions and federal regulatory efforts inform and support each other.

**A. Federal agencies have learned from state-based efforts to address predatory lending.**

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<sup>43</sup> Perhaps the most notable states in this regard include New Mexico, New York, and New Jersey; however, Illinois, Massachusetts, California, South Carolina, Arkansas, and Georgia have all made contributions to the pioneering efforts of states to identify solutions that protect homeowners and promote a thriving market.

<sup>44</sup> For a discussion of preemption, see e.g., Michael Greve, Subprime, but not Half-Bad: Mortgage Regulation as a Case Study in Preemption, *FEDERALIST OUTLOOK*, October 6, 2003, *available at* [http://www.aei.org/publications/pubID.19271,filter./pub\\_detail.asp](http://www.aei.org/publications/pubID.19271,filter./pub_detail.asp).



In at least two cases, federal agencies have learned from and acted upon lessons developed at the state level. In adopting changes to their regulatory framework, the Federal Reserve Board and the Office of Thrift Supervision each exemplified the best ideals of federalism.

The Federal Reserve Board took important action in 2001 when it moved to incorporate single premium credit insurance within the scope of charges evaluated as a point or fee under HOEPA. But, the Federal Reserve did not arrive at this conclusion in a vacuum. Indeed, the first jurisdiction to reach such a conclusion was the state of North Carolina, which adopted a similar provision in its 1999 law. Even as North Carolina reached the conclusion that such products were harming consumers, it recognized that legitimate forms of credit insurance, calculated and paid on a monthly basis, did not have harmful equity stripping effects and should not be subject to the same scrutiny. Following the law's effective date, Freddie Mac and Fannie Mae and then many lenders publicly disclaimed such products and the market appears to have successfully transitioned to the monthly product. Consequently, the Federal Reserve acted responsibly when it saw that similar benefits could be extended through the federal HOEPA floor to borrowers in all states.

Similarly, some 35 states currently have statutory provisions relating to prepayment penalties on home loans. Yet, federal law had been interpreted to preclude these states from enforcing those laws against state-chartered finance companies and mortgage brokers in adjustable rate mortgages (ARMs) and other alternative mortgage transactions. Increasingly, subprime prepayment penalties in home loans have come under scrutiny and a number of states have moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision took commendable action when it revised federal regulations in a way that promoted cooperative federalism by restoring the states' rights to apply their laws to these state-chartered institutions.

**B. States are best equipped to respond to abuses in their particular markets.**

I urge you today to continue in this vein and partner with states to provide protections for the nation's homeowners. In addition to losing the opportunity for synergy with state efforts, federal preemption of state law is not a practical response to predatory lending because states are in the best position to respond to many of the challenges presented by predatory lending, for at least three reasons: (1) many of the bad actors involved in predatory lending are state-chartered entities with minimal capitalization, (2) regional variations in real estate markets require different solutions to predatory lending, and (3) irresponsible lenders can invent new abusive practices virtually overnight, and the federal government is ill-equipped to react quickly to these changes.

First, federal enforcement of financial services laws depends largely on periodic examinations of the practices of large institutions. The broker who just hung a shingle from his door, however, can originate abusive loans without much fear of federal oversight—as can a state-chartered affiliate of a bank that is not likely to affect its larger parent's overall safety and soundness. State attorneys general and bank regulators have been instrumental in investigating abusive practices and in demanding redress for their citizens. They are also the primary

regulators of non-depository finance companies, which dominate the subprime market. The federal government simply cannot be everywhere at once to monitor local real estate transactions.

Second, predatory lending laws should address the special characteristics of each state's underlying real estate regime and market. For example, the mechanism for ensuring that a borrower can raise defenses to foreclosure on predatory home loans may depend on whether a state has judicial or non-judicial foreclosure procedures. The appropriate loan-size threshold for when to prohibit prepayment penalties may depend on the real estate values in a given state. North Carolina prohibits prepayment penalties in first-lien home loans of less than \$150,000. In California, the most reasonable threshold would perhaps be considerably higher.

Third, new financial services products are developed every day, frequently to exploit loopholes in laws against abuse. If HOEPA preempted state laws back in 1994, North Carolina never could have outlawed single premium credit insurance, and the abusive practice would still be widespread today. In North Carolina, the legislature prohibited the sale of financed credit insurance. Within two years, the similar "but-not-insurance" product of "debt cancellation agreements" was born, and many states have moved to cover such products as they address single premium credit insurance through legislation. State legislatures are better suited than Congress for responding quickly to such changes.

**C. Lenders have experience complying with a variety of state laws that affect their business practices, and complying with state-based homeowner protection laws presents no heavier a burden.**

Given the evidence of success at the state level, Congress would do harm to homeowners by imposing a uniform standard in lieu of state protections. Every day, lenders deal with tremendous variety in state real estate laws and practices, including consumer protection laws.<sup>45</sup> The laws concerning who may act as a settlement agent differ from state to state. Foreclosure law differs from state to state. States have their own fraud and deceptive practices acts, interpreted by state court judges in accordance with state-specific common law. Just as lenders find tools for complying with these and other variations, we believe that they are capable of complying with state-based homeowner protection statutes as well. The market has responded by producing computer products that claim to assist lenders in their compliance obligations across state borders.<sup>46</sup> In fact, the variation in these statutes is actually quite small, and we can expect states to move even closer to a consensus approach as regulation of predatory lending improves in its ability to curb abuses. With the incredible recent growth in subprime lending that has occurred, it is simply not credible to claim that variations in state laws have hamstrung this industry.

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<sup>45</sup> Significantly, federal laws such as the Fair Housing Act and the Equal Credit Opportunity Act regulate the real estate finance market without broadly preempting comparable state regulations.

<sup>46</sup> See Bergquist, Eric, "Some Lenders Turning to Compliance Software", *American Banker*, v168, n62 (April 1, 2003).

## Conclusion

Both subprime lending and the securitization of subprime loans increased by over 50 percent in 2003 over 2002, and lenders continue to be optimistic about the growth of the subprime market. A recent news report on the Mortgage Bankers' Association Subprime Lending Conference found that industry predicted further growth in 2004. "The times have never been better for subprime," stated David Farrell, a senior vice president at Countrywide Financial Corp., West Hills, Calif., and chairman of the MBA's Nonconforming Credit Lending Committee. "I don't see much beyond blue skies ahead," he said, noting that Countrywide alone did \$3 billion in alternative loans in April.<sup>47</sup>

Unfortunately, borrowers continue to face the danger of abusive lending practices that threaten to strip their hard-earned equity. States have been at the forefront of fighting these abuses, both through the important efforts of state officials and through legislation that provides meaningful protections that deter lenders from even making predatory loans. I encourage you to look carefully at the success of the state efforts and urge you to support the important work that has already been done to preserve the wealth of American families.

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<sup>47</sup> Lew Sichelman, National Mortgage News, "Line Between Prime and Nonprime Gets Blurry," May 24, 2004.

## APPENDIX A

### “Flipping” Prohibitions in N.C. Elicit No Substantial Litigation

Center for Responsible Lending

May 7, 2004

#### Background

Responding to widespread instances of predatory lending in the late 1990s, North Carolina enacted landmark anti-predatory lending legislation. As part of that law, policymakers included a prohibition against loan flipping—an abuse that occurs when lenders make loans primarily for the purpose of generating additional fee income without providing borrowers with any offsetting benefit. For a borrower to prevail under the North Carolina standard, he or she must show that the refinancing of a home loan provided no “reasonable, tangible net benefit” in light of “all of the circumstances” and that the lender “knowingly or intentionally” made the offending loan.<sup>48</sup>

This standard provides incentives for lenders to reduce the incidence of flipping by more closely monitoring the underwriting and origination of refinance. At the same time, potential litigants are discouraged because of the standard’s scienter requirement. In addition, a requirement that the trier of fact to specifically review “all of circumstances”, including “the borrower’s circumstances”, makes it impossible for a claim to be asserted on behalf of a class of borrowers, each of whom would have differing circumstances.

#### Identification of Likely Defendants

While it is not possible to measure directly the incidence of flipping, it is possible to analyze whether borrowers are pursuing flipping claims in any substantial numbers. To do so, one must identify a set of potential defendants. Since predatory lending practices, including loan flipping, most commonly occur in the subprime sector, our analysis focused on that sector. We identified the nation’s top 10 subprime lenders based on total origination volume over the five-year period since the North Carolina law became effective (1999-2004). These lenders, identified in Figure 1, were responsible for an estimated 58.5% of all subprime originations since the North Carolina flipping standard became effective.

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<sup>48</sup> The standard is codified in North Carolina General Statutes, Chapter 24, Section 10.2.

**Figure 1:** Top 10 U.S. Subprime Home Lenders (10/1999-12/2003)

<b>Lender</b>	<b>Volume (millions)</b>
Citifinancial / Associates	\$81,647
Household / Beneficial	\$79,063
Ameriquist Mortgage	\$61,844
Washington Mutual / Long Beach	\$57,006
New Century Financial	\$53,070
Option One Mortgage	\$48,427
Countrywide Financial	\$41,949
First Franklin Financial	\$41,525
Homecomings (GMAC-RFC)	\$36,258
Wells Fargo Home Mortgage	\$26,865
<b>A. Total of Top 10</b>	<b>\$527,654</b>
Total Estimated Subprime Home Loans	\$901,950
Share of Top 10	58.5%

Sources: *The 2004 Mortgage Market Statistical Annual*, *The 2003 Mortgage Market Statistical Annual*.

### **Identification of Relevant Lawsuits**

Next, we used fee-based electronic services (Westlaw, Pacer) supplemented by a direct review of courthouse records by attorneys to measure the extent to which the top subprime lenders had been sued in North Carolina during the relevant period. While a large percentage of cases we identified were in North Carolina District Court, where damages are limited to \$10,000, rather than state Superior Court, we nonetheless chose to examine cases from both courts to ensure maximum inclusion. In addition, borrowers could conceivably bring actions in federal court or adversary proceedings in bankruptcy court based on a flipping claim. Our analysis focused on court data that includes each of these possibilities.

We first found the total number of lawsuits filed against the identified lenders in state and federal court. Of these, we eliminated those cases where records clearly indicated that the subject matter could not involve a flipping claim. For example, some records indicated that the claim was employment-related. Others involved lawsuits brought by plaintiffs ineligible to assert a flipping claim, such as commercial entities. We identified 41 lawsuits in state court and 27 lawsuits in federal court (see Figure 2) where one might find an allegation of flipping. These data tend to over-count the possibility of a flipping claim since they may include claims based on non-home loans and, even in the class of home loans, loans made for purchase that by definition could not support a claim of improper refinancing.

**Figure 2:** Total NC State Court and Federal District Court Litigation Against Top 10 Subprime Lenders (10/1999-5/2004)

Year	Lawsuits with Possible Flipping Allegations	Lawsuits Reviewed	Flipping Claims
1999	0	0	0
2000	4	2	0
2001	20	15	0
2002	17	17	0
2003	22	21	0
2004	5	5	0
Total	68	60	0

Sources: *Westlaw, Pacer.*

While the data in Figure 2 reflect every suit filed against the identified lenders in North Carolina in federal district court, due to limitations in the Westlaw source, it represents cases filed in state court only in the counties of Mecklenburg, Guilford, Forsyth, Wake, Buncombe, Cumberland, and Durham. However, we believe these seven counties provide more than an adequate basis for assessing the incidence of potentially relevant litigation in North Carolina state courts generally since, according to an analysis of Loan Performance Inc.’s ABS database, they accounted for 48.4% of all subprime originations in the state during 2003.

#### **Results of State Lawsuit Review**

Once the total relevant state lawsuits were identified, we directly reviewed all of the complaints filed in those lawsuits in Guilford, Durham, and Wake counties to estimate the incidence of flipping allegations. These counties were chosen because they had the largest number of relevant filings (93% of the identified lawsuits were in those counties). Using Loan Performance Inc.’s ABS database once again, we calculate that these counties alone accounted for 20.7% of North Carolina’s 2003 subprime market production. In our review of the 38 lawsuits filed in these state courts, we found no allegations of flipping.

#### **Results of Federal District Lawsuit Review**

To evaluate possible litigation claims in Federal District Court in North Carolina, we reviewed complaints available on the Internet through Pacer. Of the 27 federal lawsuits identified as potentially containing an allegation of flipping, 22 complaints (81%) were manually reviewed.<sup>49</sup> We identified no allegations of flipping in any of the federal district court cases.

#### **Results of Bankruptcy Review**

Finally, we evaluated whether borrowers were bringing flipping claims in the context of a bankruptcy proceeding. To do so, we used Pacer to access U.S. Bankruptcy Court filings from 1999 to present in both the Middle District and the Western Districts of North Carolina, while filings for the Eastern District were not available. In each instance, we identified the number of bankruptcy claims in which a borrower named one of the top 10 subprime lenders as a creditor, which occurred 12,941 times. We then pulled a random sample of 126 files for further review to determine whether the borrower had challenged the validity of the debt and/or sought discharge

<sup>49</sup> In the remaining 5 instances the complaints were not electronically available.

of the lien securing the debt in an adversary proceeding in the bankruptcy context while alleging flipping. Within our sample of filings in U.S. Bankruptcy Courts in North Carolina, we identified no instances of flipping allegations.<sup>50</sup>

**Figure 3:** Debtors Listing Top 10 Subprime Lenders as Creditors in U.S. Bankruptcy Court – Middle and Western District (1999 to present)

<b>Lender</b>	<b>Bankruptcy Filings</b>	<b>Files Reviewed</b>	<b>Flipping Claims</b>
Citifinancial / Associates	3,116	29	0
Household / Beneficial	1,858	19	0
Ameritrust Mortgage	226	4	0
Washington Mutual / Long Beach	2,579	25	0
New Century Financial	42	1	0
Option One Mortgage	449	8	0
Countrywide Financial	1,791	15	0
First Franklin Financial	0	0	0
Homecomings (GMAC-RFC)	586	15	0
Wells Fargo Home Mortgage	2,294	10	0
Total	12,941	126	0

Source: *Pacer*

## Conclusion

A review of relevant filings in North Carolina District and Superior Courts, Federal District Courts, and U.S. Bankruptcy Courts identified no instances in which a borrower has alleged flipping since the North Carolina anti-predatory lending law became effective. Given the scope of the review performed we believe this to be compelling evidence that exceedingly few, if any, flipping claims are being alleged against subprime lenders.

<sup>50</sup> Since zero instances of flipping were identified, the sample error is not readily calculated. However, had one instance of flipping been identified in the 126 files reviewed (0.79%), the sample error would have been 1.5% at a 95% confidence level. Accordingly, even if we had found one flipping claim, we would be confident in predicting that fewer than 2.3% of debtors filing in these courts would allege flipping in the course of a bankruptcy proceeding.