Testimony before the

HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM SUBCOMMITTEE ON DOMESTIC POLICY

"Foreclosure, Predatory Mortgage and Payday Lending in America's Cities"

March 21, 2007

Jim McCarthy
President/CEO
Miami Valley Fair Housing Center, Inc.
21-23 East Babbitt Street
Dayton, OH 45405
(937) 223-6035
jim.mccarthy@mvfairhousing.com

Testimony before the House Committee on Oversight and Government Reform
Subcommittee on Domestic Policy
"Foreclosure, Predatory Mortgage and Payday Lending in America's Cities"
March 21, 2007

I. Introduction

Good afternoon. Mr. Chairman and Members of the Subcommittee, thank you very much for this opportunity to discuss the subprime lending problem faced by borrowers and the ways in which cities are affected by the rise in foreclosures. My name is Jim McCarthy, and I am the President and CEO of the Miami Valley Fair Housing Center in Dayton, Ohio. I also currently serve as the Chair of the Board of Directors of the National Fair Housing Alliance.

The Miami Valley Fair Housing Center (MVFHC) is the only private, non-profit fair housing organization in the Dayton, Montgomery County, Ohio area, and an operating member of the National Fair Housing Alliance. Our mission is to eliminate housing discrimination and ensure equal housing opportunity for all people in our region. MVFHC works to educate the public and local housing professionals about their rights and obligations under fair housing laws and it conducts investigations into discriminatory rental, real estate sales, mortgage lending and homeowners insurance practices.

Founded in 1988 and headquartered in Washington, DC, the National Fair Housing Alliance is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Through comprehensive education, advocacy and enforcement programs, NFHA protects and promotes residential integration and equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

Since January 2001, the Miami Valley Fair Housing Center has been implementing the Predatory Lending Solutions (PLS) project in Montgomery County, Ohio. PLS project is a multi-component project developed by the Fair Housing Center and its collaborative partners and has been used by other communities as a model in creating a program to address the problem of predatory lending. Through the PLS project, we assist residents of Montgomery County by providing outreach and education on the dangers of predatory mortgage lending, and providing intervention and rescue services to those residents who have been victims of predatory mortgage lending.

II. Fair Housing

The federal Fair Housing Act prohibits discrimination in the provision of housing and housing-related services on the basis of race, color, national origin, familial status, sex, religion or disability. Examples of discriminatory behavior include refusing to sell, rent or negotiate for housing; setting different terms, conditions or privileges for sale or rental of a dwelling, for a loan or for homeowner's insurance; and making housing or housing-related services unavailable, including mortgage loans, appraisals and homeowner's insurance. The National Fair Housing Alliance estimates that nearly four million violations occur annually against African-Americans, Latinos, Native Americans and Asian Pacific Islanders alone. Millions more violations are committed against people in all of the seven protected classes.

Fair housing enforcement is the most important fair housing issue facing our nation. However, there is no strong commitment by the federal government to enforce fair housing laws. In the past four years, the number of cases that the US Department of Justice's Housing and Civil Enforcement Division has filed overall has precipitously decreased by 29 percent. One major drop off in case handling has been with race cases; in the past four years, the number of race cases the section has filed has fallen drastically, by 43 percent. There is also a lack of commitment on the funding side. The US Department of Housing and Urban Development's Fair Housing Initiatives Program (FHIP), the primary avenue for federal funding of non-profit fair housing work, has not received its authorized level of $26 million in funding since 1995. Even the authorized amount will not come close to tackling the problem of housing discrimination in our country today.

III. Fair Lending

Fair lending, covered by the Fair Housing Act, is a key part of ensuring equal housing opportunity in our communities. Examples of lending discrimination include denying loans to African-American and Latino applicants who are similarly qualified as – or better qualified than – their White counterparts, offering less favorable loan terms and conditions, as well as higher points, to minority loan applicants and women; and engaging in disproportionate marketing efforts in minority and White communities. Research has found that African-Americans and Latinos encounter discrimination in their efforts to secure home loans.[1]

NFHA conducted its own fair lending investigation that revealed discrimination based on race or national origin in two-thirds of almost 600 tests conducted. The testing was conducted from 1993 to 1995 in eight cities: Boston, Chicago, Oakland, Atlanta, Dallas, Denver, Detroit, and Richmond. In two-thirds of the tests, Whites were favored over African Americans and Latinos; in only 3 percent of the tests, minority testers were favored over White testers. In all cases, the minority testers were better qualified for the loans than their White counterparts.

The testing revealed that:

- Whites were steered to superior loan products while African-Americans and Latinos were steered to FHA loans, even when their loan amounts exceeded the FHA loan limit.

- African-American and Latinos were told that the qualification standards were more stringent than those quoted to White borrowers.

- Closing costs were typically higher for minority testers.

[1] Turner, M., et.al., *All Other Things Being Equal.* April, 2002. Retrieved at www.huduser.org.

- Whites were given significant assistance in qualifying for loans while their minority counterparts were not and Whites received more information in writing than their counterparts.

Private lawsuits have historically been important to the effort to eliminate lending discrimination. Currently, most fair lending cases are brought by private fair housing organizations and individual attorneys. While these private efforts are very important, the full engagement of the responsible federal government agencies is an essential component of any serious effort to combat lending discrimination in all of its many, evolving forms.

Private organizations do not have the resources needed to undertake investigation, analysis and litigation of fair lending violations on a routine basis. This requires review and analysis of a wide range of documents related to marketing practices, underwriting and loan servicing policies, confidential personal data from actual loan files, and a variety of other information that lenders deem proprietary. While fair housing organizations provide a vital service in conducting testing and research activities to uncover fair lending violations, for both policy and practical reasons, the federal government must also be an integral partner the effort to enforce fair lending laws.

If the government fails to pursue such cases or does not engage in a competent effort to uncover lending discrimination by the lenders under its authority, then most lending discrimination will go unchecked. Indeed for the entire history of our country, it has. Lack of forceful federal enforcement actually provides a form of safe harbor for those in the industry engaging in discriminatory practices.

IV. How Fair Housing and Fair Lending Are Related to Predatory Lending

While predatory lending practices can occur in both the prime and subprime markets, the overwhelming number of predatory practices uncovered by fair housing organizations exist in the subprime market. While the subprime lending market offers credit to high-risk borrowers at higher interest rates and fees, some lenders have capitalized on this extension of credit by steering vulnerable individuals, often on the basis of the borrowers' race, ethnicity, age or gender, to take loans whose terms they cannot possibly repay.

This practice of predatory lending is a serious fair housing concern. Fannie Mae estimates that between 35% and 50% of subprime borrowers could have qualified for lower-cost market loans, but were instead targeted with sub-prime loans.[2] In a recent multi-state analysis of higher cost mortgage lending, researchers found that African-Americans in six metropolitan areas were 3.8 times more likely to obtain a higher cost loan than their White counterparts. The same study found that Latinos are 3.6 times more likely than their White counterparts to receive a higher cost loan[3].

---

[2] Carr, J., et al., *Financial Services in Distressed Communities: Issues and Answers*. Fannie Mae Foundation. August 2001.

[3] Campen, Nafici, rust, Smith, Stein, Kerkhove; Paying More for the American Dream: A Multi-State Analysis of Higher Cost Home Purchase Lending, March, 2007. A Joint Report By: California Reinvestment Coalition,

Characteristics of predatory lending involve aggressive or targeted marketing to financially vulnerable households with unreasonable and unjustifiable loan terms and excessive fees; basing loan values on inflated appraisals; mandatory arbitration clauses that restrict the borrower's private right of action; pre-payment penalties offer no benefit to the borrower; and repeated refinancing that does not benefit the borrower and often jeopardizes his or her property.

Although predatory lending has become shorthand term for a variety of practices that include car title lending, payday lending and check cashing businesses, my work and thus my testimony is focused on residential real-estate transactions that involve financing a home or refinancing home-equity. Common abuses seen at my local agency include taking advantage of a homeowner's inexperience and lack of financial sophistication, manipulating a borrower into a loan that he or she cannot afford, inflating the appraisal value of a home to maximize broker/lender profit, steering prime borrowers to subprime lenders and charging points and fees, interest rates and prepayment penalties that are in excess of the borrower's actual risk to the lender.

Predatory lending becomes a fair housing and fair lending issue when lenders and/or mortgage brokers target specific populations, such as elderly, minority and low to moderate-income homeowners, particularly those with substantial equity in their homes; and/or aggressively market loan products that are not suitable to the borrower.

Predatory Lending in Montgomery County, Ohio

The pattern of predatory mortgage lending in the Dayton/Montgomery County area certainly bears this out. When we first began dealing with the issue at my agency, the majority of our clients were elderly individuals residing in inner-city minority neighborhoods. Many of them had owned their homes free of debt for a number of years, until they became involved with a subprime lender. Our work suggests that these homeowners were targeted by subprime lenders because they had significant equity in their homes, and their credit needs had been historically ignored by depository lending institutions. So the very same neighborhoods that have been subjected to years of homeowner insurance and mortgage lending redlining, have now also been targeted as vineyards ripe for harvesting of hard-earned equity. At my agency, we define a predatory loan simply as: any loan that is inappropriate for the borrower.

Attorneys working on the Predatory Lending Solutions (PLS) project use these guidelines to identify loans that could be predatory:

- If the borrower is in foreclosure or has missed a payment or is struggling to make payments because of how inappropriately high the payments are, that is a predatory loan;

- Unless there was an unforeseen life event, like a job loss, major health problem, divorce or death of a spouse, borrowers should always be able to afford the loan they are given. If they can't, that loan was inappropriate for them;

---

community Reinvestment Association of North Carolina, Empire Justice Center, Massachusetts Affordable Housing Alliance, Neighborhood Economic Development Advocacy Project, Woodstock Institute.

- If the borrower has a 2/28 Adjustable Rate Mortgage (ARM), and that borrower is not reasonably expecting to have a significant increase in income within the next 2 years, or planning on moving, that loan is inappropriate for the borrower and is a predatory loan;.

- If the borrower was lied to about any material (i.e. important) term of the loan, that is a predatory loan. (*Examples: interest rate, monthly payment amount, payment amount including amounts for taxes and insurance, fixed vs. adjustable rate, they would be refinanced in a year*);

- If the borrower was loaned more money than their house is worth, that is a predatory loan. This traps the borrower in that loan, because they will be unable to refinance or sell and they will not have equity;

- If the borrower was charged excessive closing costs, that is a predatory loan. Unfortunately, there is no maximum amount set in this regard. If a loan has points and fees that are 8.0% or more of the total loan amount, then it is a high cost loan and subject to the Home Ownership and Equal Protection Act (HOEPA), but just being a HOEPA-covered loan is not a violation.

Most predatory mortgage loans are made by subprime lenders, those lenders that specialize in loans to borrowers with less than perfect credit. While some subprime lenders represent a viable source of capital and credit to those who legitimately do not have access to the prime market, others have used unfair and deceptive tactics to harvest equity out of our neighborhoods for enormous profits.

The Devastating Effects on Our Cities

Predatory mortgage lending and its subsequent foreclosures result in a myriad of devastating and extremely costly consequences to our cities. Vacant, boarded-up homes lead to neighborhood destabilization, increased criminal activity, urban sprawl, declining property values and thus an eroding tax base. This dynamic diminishes the local government's capacity to provide basic services, such as education and police and fire protection, to its citizens.

Early in the PLS project, we commissioned a study of subprime lending in the Miami Valley area and the subsequent foreclosures. The study found that mortgage foreclosure filings in Montgomery County, Ohio increased from 1,022 to 2,451 over the period from 1994 to 2000, and that subprime lenders were responsible for a disproportionately high share of that increase. A substantial number of the subprime foreclosures sampled showed signs of predatory lending, including high interest rates, pre-payment penalties and balloon payments.

In addition, as the volume of loan foreclosure filings increased throughout the County, the relative share of filings in suburban jurisdictions increased. The City of Dayton's share decreased from 48 percent to 40 percent. This clearly identified the problem as more widespread than originally thought.[4] In the years since the study was completed, mortgage foreclosure filings in Montgomery County, Ohio have continued to skyrocket. In 2006, there were in excess of 5,075 mortgage foreclosure filings in Montgomery County alone, accounting for approximately 50 percent of all civil actions filed in Montgomery County Common Pleas Court. This huge influx of foreclosures is taxing the staffing and budgets of Ohio's court systems, county sheriff's offices, which are responsible for conducting foreclosure sales in Ohio, as well as the vacant and abandoned property maintenance departments of all of Ohio's 88 counties, cities, townships, and villages.

V. Ohio's Foreclosure Problem

Fair housing and consumer advocates have been sounding warnings regarding Ohio's subprime lending and foreclosure problem for years. Ohio has been and is experiencing unprecedented levels of residential foreclosures that are having devastating effects not only on the individuals and families losing their homes to foreclosure but also for their neighbors and the cities they live in. For more than two years now, the Mortgage Bankers Association (MBA) has said that Ohio has the highest foreclosure rate in the country. The MBA found that the percentage of loans in Ohio that were somewhere in the process of foreclosure in the third quarter of 2006 was 3.3 percent. That gave Ohio the highest foreclosure rate, which was about three times the national average. The bankers group based its rankings on a sample of 43 million loans serviced nationally by banks and other financial institutions. The sample represented about 80 percent of all loans serviced nationally.[5]

The Cleveland/Lorain/Elyria/Mentor area had one foreclosure for every 40 households. Akron ranked 16th with one for every 43 households. Other Ohio cities in the top 100 were Dayton, which ranked 15th with one foreclosure for every 43 households and Columbus, which ranked 19th with one foreclosure for every 45 households. Cincinnati ranked 49th and had one foreclosure for every 87 households.[6]

In Ohio, foreclosed upon homes often sit vacant for months, sometimes years, once abandoned by their former homeowners. The societal costs of abandonment are enormous. Even one or two abandoned buildings force neighbors to tolerate eyesores that attract crime, arson, vermin, and dumping. Derelict buildings present safety and fire hazards, reduce property values, and degrade community quality of life.[7]

Because of the foreclosure crisis in Ohio, a task force consisting of the Cuyahoga County Foreclosure Prevention Office, Fannie Mae, the Federal Reserve, Freddie Mac, Miami Valley Fair Housing Center, National City Bank, NeighborWorks, Option One, and led by the Toledo

---

[4] *Predation in the Subprime Lending Market,* by: Richard D. Stock, Ph.D., Director, Center for Business and Economic Research, University of Dayton, with assistance from Marvin F. Hatsfield, Patrick S. Rooney, Ryan A. Cook (October 2001), available at http://mvfairhousing.com/cber/.
[5] Ibid.
[6] Ibid.
[7] *Reinventing Dayton and the Miami Valley through Vacant Property Revitalization and Reclamation*, A National Vacant Properties Campaign Assessment Report by Joseph Schilling, John Kromer, and Jessica Millman (May 2005), *available at* http://www.vacantproperties.org/latestreports/ReinventingDayton_Final.pdf

Fair Housing Center worked throughout 2006 gathering information on foreclosures in the state and in November 2006, hosted the Ohio Foreclosure Summit in Toledo, Ohio. The purposes of the Summit were to: a) effect a reverse-catalyst to reverse the trend of increasing foreclosure filings in the state of Ohio; b) address some of the major issues effecting foreclosure rates by providing substantive takeaways for Summit participants; and c) continue efforts begun by the Federal Reserve in its ground-breaking Foreclosure Conference. The Summit was also followed by a two-day foreclosure counseling workshop.

Prior to the Foreclosure Summit, a series of Foreclosure Workshops were held throughout the state in six locations: Youngstown, Cleveland, Bowling Green, Columbus, Dayton and Athens. We have a matrix that we would be happy to share with the committee that gives a breakdown of the responses to a series of questions that were posed at each location. The responses provided the four major themes addressed at the Summit: Predatory Lending; Policy and Legislation; Education for Counselors; and Improved Communications between the Borrower and Lender.

VI. The Predatory Lending Solutions (PLS) Project in Dayton and Montgomery County, Ohio

The Predatory Lending Solutions (PLS) Project was designed to offer prevention and intervention services to Miami Valley individuals and families who are current or potential victims of predatory mortgage lending practices. The project is a collaborative effort of multiple non-profit community organizations and has been supported by our local Montgomery County, Ohio government, our local affordable housing trust, as well as the U.S. Department of Housing and Urban Development, Fannie Mae, and Freddie Mac. We also had some private banking institutions that contributed to the project during its first years. During the initial implementation of the PLS project, the Miami Valley Fair Housing Center was designated as the lead agency.

The Predatory Lending Solutions Project's design, as originally conceived, included the following four components: Community Education & Outreach; Intervention & Rescue Services; Community Impact Research; and Legislative Support. The project has been successful in reaching extraordinary numbers of consumers through education and outreach activities over the life of the project

Since the launch of the project, the need for our services has far exceeded our capacity to provide services with the limited resources available. Despite our success, blatant abuses continue to occur to Dayton and Montgomery County, Ohio residents. Following is a story that was related to me by an attorney in private practice in Dayton, Ohio just last week.

> "Jim, I want to share this with you. Even though I'm not a stranger to the practice of predatory lending, I found it disturbing. A week or so ago I was contacted by a title company in Chula Vista, CA. They said they needed an attorney to notarize a document in connection with a real estate transaction. It turned out I was to conduct a complete mortgage closing with an enormous stack of documents to be initialed, signed, witnessed, etc."

> "Finally the would-be borrower, a woman of 78, and her daughter came in to my office. The facts of the transaction amazed me. The woman is supposedly borrowing $290,000 to keep her deceased daughter's home in Atlanta, GA. Another daughter, who lives in CA, is to be a co-borrower. It turns out that the woman's only source of income is Social Security, and less than $600 per month. She owns her home in Dayton, together with a son & daughter-in-law who live in North Carolina. The three of them borrowed about $37,000 on the Dayton property a few years ago. Her monthly expenses for the Dayton house are more than she receives from Social Security, but the daughter who came to the closing lives there, too, and helps with bills."
>
> "The mortgage deal: She is to borrow $290,000 in two separate loans, one for $232,000, a second for $58,000. Payments on the first loan are $1,522 per month, INTEREST ONLY, for the first 10 years, the payments then go up about $500 more for the remaining 20 years. I can't remember amount of payments on the $58,000 part of the loan. Some of the facts of her financial situation were included in the loan documents, but there was also a form which was like a "don't ask, don't tell" disclaimer, saying she asserts she has the resources to make these payments and doesn't have to disclose all the information. I didn't let her sign that – I just couldn't."

Ultimately, the attorney who shared this story with me decided that she couldn't be part of this sham any more, notified the title company and sent the documents back un-initialed, and unsigned. But this story is not unique.

PLS Project Success Stories

For those clients we are able to assist, given our limited resources, we have been exceedingly successful in keeping them in their homes, and getting them into appropriate loan products. Below are some brief summaries of successful case resolutions accomplished by the PLS project to date.

Caucasian American married couple, with adult children who live independently.
Original loan amount $144,500
Home value = $97,470
Original loan Interest rate = 10.0%

PLS project negotiated a short-pay off of $89,600 to the lender, and secured refinancing for the clients on a loan amount of $92,600, with a 6.375% interest rate, fixed for 30 years.

Staff time required to resolve this case = 113.5 hours

African-American male, no children.
Original loan amount $35,000
Adjustable rate mortgage, for which he paid nearly $5,700, or more than 16% in closing costs.
Client was in foreclosure when he came to the PLS project, but he did have quite a bit of untapped equity.

PLS project negotiated a loan modification that waived all past-due payments, interest, late fees and litigation costs and received a fixed-rate loan that he could afford.

Staff time required to resolve this case = 53.0 hours

African-American male, 2 children
Client had two mortgages, one for $74,000 with a 10.15% interest rate and monthly payment of $657.62, which was 50% of his income. Second mortgage for $8,039 with a 17.99% interest rate and monthly payment of $184.72. The house was over-appraised.

PLS project negotiated loan modifications on both loans. First loan balance was reduced to $72,482.08, with a 6.50% fixed interest rate for 30 years and monthly payment of $458.14. Second loan balanced was reduced to zero and lien released on property.

Staff time required to resolve this case = 102.5 hours

African-American married couple, 2 children
Original loan amount = $48,000 with a 12.079% interest rate and monthly payment of $523.11, with no escrow for taxes and insurance

PLS project negotiated a loan modification down to the actual value of the house, $30,000.00, with a 9.0% interest rate fixed for 30 years, and monthly payment of $324.79, including escrow for taxes and insurance

Staff time required to resolve this case = 201.25 hours

African-American single female, 3 children
Original loan amount = $80,992.80 with a 11.051% interest rate and monthly payment of $796.84, with no escrow for taxes and insurance

PLS project negotiated a short payoff to the lender, and secured refinancing for the client on a loan amount of $53,300.00, with a 6.5% interest rate fixed for 30 years, and monthly payment of $336.89, including escrow for taxes and insurance

Staff time required to resolve this case = 124.50 hours

As the work of the PLS project clearly demonstrates, when consumers have effective advocates armed with the appropriate time and resources, intervention that keeps the homeowners in their homes, and puts them in appropriate mortgage loan products, is possible.

Our clients ***are not deadbeat mortgage borrowers***. They are hardworking individuals and families chasing the "American Dream" of homeownership as marketed by some of the largest and most wealthy residential mortgage lenders and mortgage brokers in the United States. No matter what regulatory or legislative steps are taken to address the problem of predatory mortgage lending and its subsequent foreclosures, there absolutely must be resources designated to provide for legal and advocacy assistance to those individuals and families whom have already fallen victim to some of the most pernicious practices ever seen in the residential mortgage lending business.

VII. Federal Regulators Must Improve Fair Lending and Predatory Lending Oversight

The federal agencies that regulate insured depository institutions, particularly the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Federal Reserve Board (Fed), have the authority to conduct an effective process for fair lending examinations; however, their record of enforcement falls short of the mark and has not been effective at eliminating discrimination in the mortgage market. Disclosure is a valuable tool for the evaluation of lending practices, but it cannot replace forceful and effective enforcement activities undertaken by federal agencies. Financial regulatory agencies have referred some lending discrimination cases to the Department of Justice for enforcement actions; however, they are few in number.

We applaud the regulators for their recent proposed guidance that would extend their joint guidance on non-traditional mortgages to hybrid adjustable-rate loans, including 2/28s. This is an important move. However, regulators must become more aggressive about conducting systemic analysis of lenders' portfolios to ferret out fair lending violations. For example, regulators must conduct regression analyses of lender files that are inclusive of the lenders' subprime and prime books of business. More specifically, regulators need to perform regression analyses to specifically look at the occurrence of yield-spread premiums stratified by various protected class characteristics.

Foreclosures disproportionately affect minority communities that have traditionally not had access to main stream and prime lenders. From a fair lending perspective, when examining a lending institution that makes both prime and subprime loans, it is critical to review the institution's marketing and application procedures to ensure that all applicants have equal access to all reasonable products for which they qualify. It is also critical to look at the lenders distribution system. Does the lender have retail brick and mortar operations in predominately White, suburban communities while not having brick and mortar retail operations in predominately African-American and Latino neighborhoods? Does the lender, when considering its entire books of business, rely on mortgage brokers as its primary originators in predominately African-American and Latino neighborhoods?

While looking at these areas, it is also important to not forget more traditional analyses. For example, it is still important to look at origination and declination rates for Latinos and African-Americans versus Whites.

In addition, federal regulators are only looking at potential discrimination in loans through underwriting procedures, rather than more general fair lending and safety and soundness issues. The lending industry has convinced regulators that underwriting systems are completely objective and free of discrimination; however, that is not the case. For example, credit scoring, which is a key factor in underwriting programs, has been shown to have a disparate impact on people of color, women, and others.

Credit scoring systems are based upon data primarily culled from credit repositories. It is important to note that a significant number of African-Americans and Latinos currently and have historically obtained loans outside of the financial mainstream from lenders who do not report credit information to the repositories. This means that millions of bits of important information about the way African-Americans and Latinos obtain and maintain credit is not included in the data sets that are used to help build credit scoring systems.

This is a significant problem that the National Fair Housing Alliance has been addressing with lenders, regulators, rating agencies and the GSEs. To date, there is no fix. The reality is that current credit scoring systems may be good at assessing risk for consumers who operate within the financial mainstream. However, they are probably not as adept at assessing risk for consumers who operate outside of the financial mainstream.

Case Study in Lending Discrimination: Flagstar Bank, FSB

Because there are no public documents about the results of fair lending exams, it is difficult to assess the quality of the fair lending examination process. Community Reinvestment Act (CRA) evaluations are supposed to contain comments on whether the regulator found any evidence of discriminatory lending practices. However, statements in these public disclosures do not always contain accurate information of the findings of the fair lending exams.

The recent case of Flagstar Bank, FSB, represents that rare exception where we actually have proof of fair lending violations that we can compare to the public comments of the institution's regulator and to the CRA ratings given to the bank before and after the violations occurred. This case illustrates the disconnect between some lending institution behavior and the fair lending examination process by the federal financial institution regulatory agencies.

- Between February of 1994 and November of 2005, during which time the OTS gave Flagstar Bank "Satisfactory" and "Outstanding" CRA ratings, this lender was sued numerous times in federal court for issues related to discrimination in lending. Most lending cases are either dismissed by the courts or settled. Flagstar, in contrast, was found liable for discrimination at trial or by the court in at least two of these cases.

- In 1999, a jury in Detroit found Flagstar liable for discrimination against minority borrowers, and plaintiffs were awarded damages. In 2003, in a national class action suit, a federal court in Indianapolis found a written pricing policy developed by Flagstar management in 2001 so overtly discriminatory that the court ruled against Flagstar on summary judgment. The policy explicitly stated that pricing would be different for minority and non-minority borrowers. It appears that <u>the discriminatory pricing policy was developed and implemented by Flagstar *while* the OTS was conducting its consumer compliance examination.</u>

- The OTS conducted five CRA examinations and never found Flagstar in violation of discrimination laws. During this time period, Flagstar was given a "Satisfactory" CRA rating four times and was elevated to an "Outstanding" rating <u>after</u> the summary judgment finding in 2003.

This took place despite the seemingly extensive fair lending examination procedures (see the Interagency Fair Lending Examination Procedures). These procedures call for the review of "lending policies, marketing plans, underwriting, appraisal and pricing guidelines" (page 6) and for the review of "complaints alleging discrimination in residential loan pricing" (page 8). The procedures call for the review of possible indicators of overt discrimination, "including explicit prohibited basis identifiers in underwriting or pricing" (page 7). Clearly, these core examination factors were either ignored or the examiners for the OTS who were assigned to review one of the largest mortgage lenders in the nation did not understand the most basic tenants of fair lending.

Flagstar was one of the nation's twenty largest mortgage lenders during the period covered by this litigation. It sold loans to both Fannie Mae and Freddie Mac and was one of the largest underwriters of FHA loans through certification granted by HUD. After the judicial findings of lending discrimination, <u>no sanctions were applied by the OTS, HUD, Fannie Mae, or Freddie Mac.</u>

In fact, Flagstar was allowed to expand significantly during this time period by opening numerous branches, expanding into a new state and to additional metropolitan areas. The approval of its applications to expand was based, in part, on its CRA ratings. As a result, during the period from 1994 through 2005, Flagstar grew from just over $500 million in assets to nearly $13 billion in assets.

The Flagstar case raises serious concerns about the adequacy and effectiveness of the regulatory agencies' fair lending enforcement efforts.[8]

No Agency Regulates Independent Mortgage Companies for Fair Lending Compliance

To help alleviate the problems in the subprime market, the Federal Reserve should exercise its discretion as the agency with rule-making authority under the Home Ownership and Equity Protection Act (HOEPA) to limit the use of subprime exploding ARM mortgages.[9] HOEPA provides broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices on all mortgage loans, not only high-cost loans; however, the Federal Reserve has never exercised this authority. By issuing a regulation under HOEPA, the Federal Reserve would ensure that all subprime mortgage loans in the country were subject to the same rules.

Although there are a few notable cases of state attorneys general who have used consumer protection statutes effectively to eliminate unfair and deceptive lending practices, on the whole, state regulation has not proven adequate to the task of fair lending enforcement. This is a gap that must be filled.

HUD has the authority as the lead agency in fair housing enforcement to initiate investigations and enforcement activities in this area, but, aside from some minimal cases of closing cost violations of the Real Estate Settlement Procedures Act (RESPA), it has not brought any fair lending enforcement actions against independent mortgage companies.

VIII. Federal Agencies Must Increase Their Fair Lending and Anti-Predatory Lending Enforcement Efforts

HUD, as the lead enforcement agency under the Fair Housing Act and the administrator of the Federal Housing Administration, has a critical role to play in fair lending enforcement. However, it has undertaken very little fair lending enforcement activity. Aside from the recent settlement between HUD and Fifth Third Bank, the level of fair lending enforcement activity by HUD has been negligible. Assistant Secretary Kim Kendrick has made a commitment to improving enforcement efforts at HUD and to reinvigorating the Secretary-initiated complaint process.

---

8 The section regarding Flagstar is from testimony by Calvin Bradford, Ph.D. before the House Financial Services Committee on Financial Institutions and Consumer Credit, "Home Mortgage Disclosure Act: Newly Collected Data and What It Means", June 13, 2006.

9 (l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--

> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower." 15 USC Section 1639(l)(2).

During the 1990s, the Department of Justice was a leader among government agencies in fair lending enforcement. These DOJ investigations set in operation a process by which both HUD and the financial regulatory agencies could refer pattern and practice cases to DOJ for investigation and litigation. These cases have set out legal strategies and formats for investigation and litigation in a wide range of lending issues from redlining to retail and wholesale pricing. Historically, the decade of the 1990s can be seen as the high point in federal enforcement efforts. As listed on its website, DOJ has filed twenty-three lending discrimination cases since the early 1990s, two of which are in the form of amicus briefs. Three of those cases allege discrimination in non-mortgage consumer credit transactions. Of the remaining eighteen cases, three have been filed since 2000. About half the DOJ cases have been referrals from OTS, OCC, or the Fed. DOJ cases filed since 2000 appear to be based on analysis of HMDA data from the late 1990s and early 2000s.

The Federal Trade Commission has authority over non-regulated lenders under the Equal Credit Opportunity Act (ECOA), but it has pursued almost no lending discrimination cases, although the FTC had an enforcement plan as far back as 1978 (See Discrimination in Real Estate Finance: The Role of the FTC Enforcement – A Report to the Federal Trade Commission, Pottinger and Company, 1978).

IX. Recommendations for Anti-Predatory Lending Legislation and Fair Housing Legislation

Congress, the Administration, and federal agencies must use their authority to undertake much stronger anti-predatory lending and fair lending activities, including investigations and enforcement. The following are recommendations that Congress should implement and/or oversee.

Fair Housing: Increased Appropriations and New Legislation

- Congress should allocate at least $26 million to HUD’s Fair Housing Initiatives Program in order to facilitate increased education and enforcement efforts on the part of local fair housing organizations. A special component should be set aside for qualified fair housing organizations (QFHOs) to conduct activities to specifically address fair lending issues.

- Congress should support and pass fair housing legislation that contains the following provisions: an increased authorization level for HUD’s Fair Housing Initiatives Program; a commitment of at least $20 million annually for fair lending and fair housing enforcement testing and actions; a commitment of at least $5 million annually to fund studies of the effects of housing segregation on our nation’s communities. Draft legislation is currently circulating in both Houses.

Anti-Predatory Lending: New Legislation

- Congress should support and pass anti-predatory lending legislation that contains the following provisions: effective rights and remedies; prohibitions against steering; a suitability standard; designating "high-cost" as including all loan fees; no federal preemption; advance disclosure of costs and fees. (A detailed discussion of these provisions is in an attachment to this testimony entitled, "Leadership Conference on Civil Rights Position Paper on Predatory Lending Legislation.")

- Congress needs to create a rescue fund to help people who have received discriminatory loans, predatory loans or loans that were not suitable for their situations to convert those problematic loans into appropriate loans.

Aggressive Fair Lending and Anti-Predatory Lending Oversight and Enforcement

- Congress should require federal government agencies, including HUD, DOJ, and the FTC, to undertake more aggressive, effective and expansive fair lending enforcement activities. These agencies should consult with experts in fair lending enforcement organizations so that the federal examination and enforcement programs reflect best practices and state of the art investigation techniques and litigation strategies.

- Congress should require that HUD improve the quality of its training programs to increase the capacity of its investigators and Fair Housing Assistance Program (FHAP) investigators to investigate lending complaints.

- Congress should require that federal agencies that regulate insured depository institutions, particularly the OCC, the FDIC, the OTS, and the Fed, use their authority to undertake stronger oversight and enforcement activities to eliminate discrimination from the mortgage market. Any cases that regulators resolve with lenders on behalf of a few consumers should also be referred to DOJ for a pattern and practice investigation.

- Congress should ask the Fed for a status report on the 270 institutions that it flagged in 2005 and 2006 for additional investigation because of their pricing data and other issues.

- Congress should move to regulate all financial institutions active in lending. To fill the vacuum of fair lending enforcement activity for non-depository institutions, the Fed should use its authority to ensure that these institutions are in compliance with the fair lending laws. If this authority is lacking, Congress should grant the needed authority.

Changes Regulators Must Implement

- Regulators need to examine lenders in a holistic fashion reviewing data from retail and wholesale divisions as well as prime and subprime divisions together.

- Regulators should contract with private, qualified fair housing organizations to conduct comprehensive testing programs.

- Regulators need to run regression analyses on lender portfolios looking at origination, pricing, point of origination, costs, pre-payment penalty, and yield spread premium issues stratified by key protected class characteristics. Regulators are in a unique position to do this as they have access to full records and data.

<u>Changes Investors Must Implement</u>

- The securities industry and investors need to develop and implement effective screening programs and procedures to filter out predatory and discriminatory loans. Loans identified as having excessive fees, inflated appraisal issues, yield spread premiums, pre-payment penalties and other problematic provisions should be tagged for additional review.

- Investors need to be more flexible in offering work-out solutions for troubled consumers. They also need to make these solutions more accessible and transparent to consumers and counseling agencies.

<u>Changes Lenders Must Implement</u>

- Lenders need to change their platforms to make all of their loan products and services available to all consumers. Lenders need to concentrate efforts on making prime loan products accessible to consumers who qualify who come to the lender through the subprime door.

- Lenders need to expand their retail prime operations into historically under-served communities.

- Lenders should increase their efforts to partner with fair housing organizations and counseling agencies to expand counseling and loan education activities to consumers.

<u>Changes Loan Servicers Must Implement</u>

- Servicers need to abdicate a “dialing for dollars” and “collections” mentality for a “homeownership preservation” mentality.

- Servicers should base workout decisions leading to a long-term resolution of the consumer’s delinquency on factual information, the availability of different options, and borrower qualifications.

- Servicers should provide superior consumer accessibility to information and assistance by using multiple methods of communication and by promoting financial literacy through partnerships with consumer groups, housing counseling agencies, government agencies and regulators.

- Servicers should provide a toll-free number, answered by loss mitigation specialists, for all counseling agency calls.

Thank you once again for the opportunity to testify before this Committee. I am available to answer any questions and assist in any way that we can to assure that this Committee, Congress and the government as a whole fulfill their duties to enforce fair lending nationwide.

Attachment to this testimony:

- *Leadership Conference on Civil Rights Position Paper on Predatory Lending Legislation*

Leadership Conference on Civil Rights

1629 K Street, NW
Suite 1010
Washington, D.C. 20006

Phone: 202-466-3311
Fax: 202-466-3435
www.civilrights.org

LCCR POSITION PAPER
ON PREDATORY LENDING LEGISLATION
October 2006

Threats to the Homeownership and Financial Security of Diverse Populations

Today, too many individuals and families are targeted for abusive home loans that strip away their hard-earned home equity and put their homes at a high risk of foreclosure. People of color are at greater risk of losing hard-earned wealth—and even their homes—as a result of high-cost, risky lending and abusive servicing. These predatory practices also disproportionately impact the disabled, seniors and female headed-households.

Many people of color could qualify for more affordable and fair loans that would enable them to maintain and build additional wealth. Unfortunately, many prime lending institutions continue to underserve people of color. Although some in the subprime lending industry have claimed that factors such as income and credit histories account for racial disparities, credible reports and studies which control for these factors refute these claims. As early as 2000, HUD found that African-American families living in upper-income neighborhoods were more likely to receive subprime loans than White families living in low-income neighborhoods.[i] Fannie Mae and Freddie Mac report that as many as a third of the families who receive subprime loans actually qualify for prime loans.[ii] Two reports issued in May this year have shown that African-American and Latino individuals and families are much more likely to receive high interest rate loans than White individuals and families, even with the same credit profile.[iii]

While clearly not all subprime lending is predatory, a significant share of predatory lending takes place in the subprime market. Although there are predatory lenders in the prime market as well, predatory lending in the subprime market is particularly destructive to minority and other vulnerable communities. Subprime loans not only cost more over time, but can strip away wealth that has already been earned. Large fees and prepayment penalties, which are rare in the prime mortgage market, are much more common on subprime loans. Many subprime homeowners are put into loans they cannot possibly afford to repay by lenders and mortgage brokers.[iv] This happens in part because both have strong market incentives to push such loans. For example, mortgage brokers receive large bonuses—called yield spread premiums—for putting families in loans with higher interest rates when they qualify for lower-cost loans.

All of these onerous terms and abusive practices dramatically increase the risk of foreclosure. According to a study by the University of North Carolina, one in five families that received a subprime refinance home loan in 1999 had entered foreclosure at least once by 2004. In jurisdictions where lenders are permitted to begin foreclose without judicial review (roughly half the states[v]) borrowers have little to no recourse to protect themselves other than to delay the foreclosure process by declaring bankruptcy.

Essential Elements of Predatory Lending Legislation

Any predatory lending law should include these essential provisions:

Effective rights and remedies: These include: (1) the availability of a private right of action and class actions, which are often the only effective way to gain appropriate remedies to these abusive practices and deter bad actors; (2) strong remedies and penalties for abusive acts; (3) effective assignee liability so that borrowers can bring their claims against those who buy, service, securitize or collect (including foreclose) on their loans; and (4) prohibitions on mandatory arbitration clauses that weaken victims' legal rights and prevent them from bringing claims to a court of law. Without these fundamental procedural protections, any substantive consumer protection rules are unenforceable. There needs to be greater accountability for all players in the mortgage industry.

Prohibitions against steering: Steering borrowers to loans with interest rates far higher than they qualify for is very costly for people of color, and must be prohibited for all home loans.

A suitability standard: Many borrowers are being placed in loans they cannot possibly afford to repay. Lenders and mortgage brokers should ensure that a loan is suitable for the borrower's objectives and circumstances.[vi]

"High-cost" must include all loan fees: Predatory lending laws typically define high-cost loans and provide protections for those loans that are the most likely to be subject to abuse. To provide effective protections for these loans, the definition of a high-cost loan must include all of the different loan fees that lenders and brokers charge, including prepayment penalties and yield spread premiums.

No federal preemption: The majority of states have passed laws to address predatory lending. Many of these laws have been highly effective in reducing abusive lending without impeding access to credit. In order to protect states from increasing claims of preemption, any federal law must permit states to enforce their own laws. State protections have a proven track record, such as requiring counseling before borrowers are sold a high-cost loan and curbing prepayment penalties on subprime loans. Historically, federal laws have set floors for protections, and states have been able to build on these federal protections.[vii] In this area of mortgage lending it is especially important that state authority be preserved, as abusive lenders rapidly develop new abusive tactics that will not be addressed by any federal law.

Advance disclosure of costs and fees: Too often borrowers discover at the closing table that the terms and conditions of their loan have changed. At this point, it is often difficult for the borrower to negotiate a return to the original deal or to postpone the closing to allow for further discussions with the lender. All lenders should be required to provide at least seven (7) days prior to closing, the final terms, conditions and costs of the loan to the borrower. This disclosure should also include any costs and fees associated with servicing.

[i] For example, one study by HUD in 2000 found that as much as one-half of refinance loans made in predominately black neighborhoods are subprime. U.S. Department of Housing and Urban Development and U.S. Treasury Department. 2000. *Curbing Predatory Home Mortgage Lending.* Washington, DC: U.S. Department of Housing and Urban Development.

[ii] See, e.g. Freddie Mac. 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 African American borrower receiving subprime loan increased by 1/3 compared with white borrower, controlling for risk).

[iii] Debbie G. Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006); Allen J. Fishbein, Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, Consumer Federation of America (May 2006)

[iv]The most common subprime loan, known as a "2/28," has a low rate for the first two years and then monthly payments increase by 40-50%, even if market interest rates do not go up. Most families cannot absorb this large payment shock, and their homes are put at risk of loss.

[v] NCLC Repossessions and Foreclosures Manual, Appendix (5th ed. 2002 and Supp. 2004).

[vi] Many professions require practitioners to serve their clients best interests. For example, investment advisors are required to sell only suitable products to their clients. Similarly, state-licensed real estate agents work explicitly for the seller or buyer.

[vii] For example, the Fair Housing Act states that "nothing in the Act will be construed to invalidate or limit any law of a State or political subdivision of a State." 42 U.S.C. § 3615.