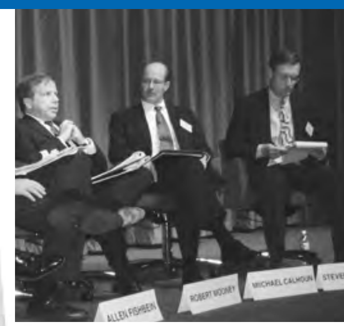
Together We Can—Again

A Symposium on the Remaining Challenges to Abusive Lending Practices



conducted by the

National Association of Affordable Housing Lenders and The Center for Community Lending

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"Together We Can" — Again

Dear Friend:

The National Association of Affordable Housing Lenders (NAAHL), the only association devoted to supporting private investment in low-and moderate-income communities, is committed to finding practical solutions to predatory lending. This is our second report in five years to highlight industry progress and to identify what still needs to be accomplished. Since our first "Together We Can" symposium and report on this issue, we have made great strides in understanding what predatory lending is, who engages in it, how it is financed, and how to fix it. But there is much more to do. The startling, extreme increase in subprime lending, up 500 percent in five years, should signal greater urgency in identifying any predatory loans, and mitigating their impacts on borrowers and their neighbors.

In 1999, a wonderful and visionary leader in Chicago, Gale Cincotta, alerted us that people were being victimized by unscrupulous lending practices, neighborhoods were being harmed, and 20 years of private capital investment in these communities was at risk. Since then, NAAHL and our companion foundation, the Center for Community Lending, have insisted that if we are not part of the solution, then we are part of the problem. Just as we have been, and remain, committed to increasing the flow of capital into underserved communities, now we must be equally concerned that the capital is available on fair terms that do not strip wealth and equity from those who can least afford the loss.

The report from our first symposium was widely appreciated. State and federal officials and many others used it as a learning document. We hope the current report will be just as useful. **It reflects the perspectives of practitioners, regulators, consumer advocates, and researchers regarding the challenges we face with subprime lending and predatory abuse. It documents the novel mitigation efforts of communities struggling with the recent experiences of victimized neighborhoods. Finally, it presents the assessments of key policymakers on the status of legislative efforts to solve the problem, and where we go from here.**

Among the highlights:

- Understanding how comprehensive examination of banks acts as a deterrent to predatory practices among federally insured and regulated banks and thrifts
- Clarifying how we define and identify predatory and abusive practices
- Describing the adverse consequences for unsuspecting borrowers
- Identifying the extent of subprime versus prime lending, and comparing outcomes in different communities and markets
- Discussing the role of brokers and other non-bank lenders, and such practices as "push marketing" which encourage borrowers to take on more debt than they can afford or need
- Learning about collaborative and creative partnerships to deal with this multi-faceted challenge, and the role of counseling and financial education
- Viewing the role of states as "laboratories of democracy", and the issues involved in state versus federal legislative approaches.

We hope that our report suggests the positive ways that the public and private sectors can work together in partnership to ensure fair and ethical lending practices in all our communities, while continuing to bring much needed capital to those communities that have traditionally been underserved. Together, we really can!

Sincerely yours,

Judith Kennedy

JUDITH A. KENNEDY

President
NAAHL

Panel Discussions

“...our legacy is not just making private capital available to all persons, including low-income persons, but that private capital is available on fair terms.”

MS. JUDITH KENNEDY: Good morning. I am Judy Kennedy, the president of the National Association of Affordable Housing Lenders (NAAHL) and a member of the board of the Center for Community Lending (CCL). NAAHL represents America's leaders in moving private capital to those in need. Started in 1990, NAAHL encompasses 200 organizations committed to increasing private lending and investing in low- and moderate-income communities. Members are the “who's who” of private sector lenders and investors in affordable housing and community economic development: banks, thrifts, insurance companies, community development corporations, mortgage companies, loan consortia, financial intermediaries, pension funds, foundations, local and national nonprofits, and public agencies. The Center is a foundation of nonprofit executives banding together to work in the public's interest.

We are delighted to have you all here. I have been thinking a lot lately about the title of a book of one of my favorite authors, Doris Goodwin, called “No Ordinary Times.” These are no ordinary times. We have confronted the most significant attack on the Community Reinvestment Act (CRA), certainly since 1999, and perhaps in history. HUD's budget has been under assault, and all of the programs that we know and love are at risk. Federal funding for these programs, apart from Section 8 voucher renewals, totals the amount of just one Department of Defense contract.

Despite these challenges, we have held our ground. We have held our own in appropriations, where the HUD budget competes with high priority programs such as national services, veterans' benefits, and especially the National Aeronautics and Space Administration.

Your participation today demonstrates how committed you are to making sure that our legacy is not just making private capital available to all persons, including low-income persons, but that private capital is available on fair terms.

We have decided that finding practical solutions to predatory lending is an important part of our mission. NAAHL tries to be an honest broker between opposing viewpoints about what is practical, what is possible, and what is positive for victimized communities, and borrowers. Today's event is another such effort to advance the ball.

We conducted our first symposium on this issue, “Together We Can,” in 2001. And much has happened since then. So many responsible lenders have adopted best practices, many of them publicly announced.

Today's program will highlight changes in the market and in public policy in recent years, as well as what remains to be accomplished.

Our first panel will define our knowledge, experience, and understanding of the challenges we face with subprime lending and predatory abuse. We will hear from the perspectives of practitioners, regulators, consumer advocates, and researchers. The second panel will provide a useful blueprint for communities struggling with the recent experiences of victimized neighborhoods. Finally, our last panel features key policymakers who will provide their assessment of where we go from here, understanding our accomplishments and remaining challenges.

We would not be here today without the support of our major donors. As we carry out our civic responsibility, we need the help of our sponsors. So thank you to Robin Coffey and Harris Bank for sharing this beautiful facility. Thank you, too, Phyllis Rosenblum and HSBC North America, for enlightening and supporting us. Thank you to Wells Fargo and Company, La Salle Bank Corporation, and Washington Mutual Bank, organizations very involved in best practices in mortgage lending. New Century Financial Corporation, Merrill Lynch CDC, and the Federal Home Loan Bank of Chicago also supported this meeting.

With that, I turn the program over to Gary Washington, who will moderate the first panel.

Panel 1–Current Context for the Mortgage Market

Gary Washington

MR. GARY WASHINGTON: I also extend a warm welcome to all of you and thank you for coming this morning. Our first panel this morning talks about the current mortgage market context, addressing the challenges and opportunities facing the subprime and the prime markets. How can we assess progress in mainstreaming responsible lending practices? How do responsible lenders and advocates view the market in light of recent business and public policy developments? What might facilitate an increase in responsible lenders in the subprime market?

We are fortunate to have with us this morning four individuals who have been at the forefront of thinking about these issues. They will help set the stage for understanding the current market, and will offer some ideas on where we may be heading.

Let me first introduce Bob Mooney of the Federal Deposit Insurance Corporation. Bob was named chief of CRA in 2002, responsible for fair lending policy development and examination support. Bob has served as FDIC's senior fair lending specialist and worked on the interagency CRA and compliance initiatives and authored a side-by-side guide to fair lending. Before joining the FDIC, Bob had more than ten years of experience in retail banking.

In addition, we are joined by Michael Calhoun, the general counsel of Self Help and representing the Center for Responsible Lending. Self Help is a community development lender dedicated to helping farm laborers and other low-income families help themselves that has financed more than $3.5 billion of loans to first-time homebuyers and small businesses. The Center for Responsible Lending is a research and policy affiliate of Self Help. Mike has conducted research and provided technical assistance on many consumer finance issues, including North Carolina's landmark predatory mortgage lending act.

We also have with us Allen Fishbein, the director of housing and credit policy for the Consumer Federation of America (CFA). CFA is a national nonprofit association of 300 consumer organizations with a combined membership exceeding 30 million, founded in 1968 to advance consumer interest through education, research, and advocacy. Allen was previously general counsel of the Center for Community Change. There, he led the organization's work on the Community Reinvestment Act, as well as on the expansion of responsible lending and banking services to low-income households and underserved communities. Allen also served at the U.S. Department of Housing and Urban Development where he coordinated activities of the National Predatory Lending Task Force, a joint federal body established by HUD and the U.S. Department of Treasury to investigate predatory mortgage lending.

Last, but not least, we have Steven Hornburg joining us this morning. Steve is the principal of Emerging Community Markets. A national strategist with over 20 years of experience in national housing policy and mortgage finance, Steve analyzes affordable housing, housing finance, homeownership education and counseling, community development, fair lending, smart growth and various HUD programs.

I would like to ask Bob Mooney to talk about how the CRA review process identifies and addresses abusive lending practices.

MR. ROBERT MOONEY: Thank you, Gary. We all agree that predatory loans harm individuals in communities, and also raise compliance concerns and safety and soundness concerns for insured depository institutions. Some practices may violate the fair lending laws and other consumer protection laws, resulting in lower CRA ratings and legal or regulatory actions. Questionable loan underwriting and a risk of litigation also pose safety and soundness concerns.

The federal banking agencies examine banks and thrifts for compliance with all of these safety and soundness, as well as consumer protection laws, and many predatory practices fall under that panoply of laws and regulations. We have talked about where and how we treat predatory lending and practices under CRA.

> "I will briefly lay out how we examine for those under three conditions during three types of examinations: the safety and soundness examination, the compliance examination, and then the CRA examination."

I will briefly lay out how we examine for those under three conditions during three types of examinations: the safety and soundness examination, the compliance examination, and then the CRA examination. When I do that, it will become clear how this level of consistent, intensive, and comprehensive examination of banks acts as a proper deterrent. In addition, it may help to explain why predatory practices generally do not exist among

> **"...it may help to explain why predatory practices generally do not exist among federally insured and regulated banks and thrifts directly."**

Gary Washington, Allen Fishbein, Robert Mooney, Michael Calhoun, Steven Hornburg

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While other non-bank lenders are covered by many of these same rules and regulations, the review of these non-banks, whether licensed by states or not, is sporadic and may often vary. Predatory practices have been found more often among some, but not all, of these non-bank lenders.

First, let me turn to safety and soundness examinations. If safe and sound, well-managed, appropriately capitalized, and fairly priced, subprime lending programs provide an important source of credit to disadvantaged borrowers. These borrowers are individuals whose credit histories may not permit them to qualify for prime loans. It is almost an axiom that not all low- and moderate-income disadvantaged borrowers have poor credit. However, the economic situation of many of these borrowers almost dictates poor credit ratings that drive and limit loans for which they can qualify.

Appropriately underwritten subprime lending has helped many of these individuals achieve financial independence through homeownership. Unfortunately, some subprime lenders have engaged in abusive or predatory practices. Expanded guidance on subprime lending programs, issued jointly by the banking agencies in January 2001, provides a good description of predatory lending. Let me share that guidance with you.

This approach encompasses practices targeted by many definitions currently in use. We do not have one definition of predatory lending. I like this approach because three categories capture the whole range of predatory practices. They are:

1. making unaffordable loans based on the value of collateral without regard to the borrower's ability to repay, and with no expectation that the borrower can repay;

2. inducing a borrower to repeatedly refinance, charging higher points and fees with each transaction—so-called equity stripping—thereby stripping out a borrower's stake in their home; and

3. the most comprehensive category, engaging in fraud, deception, and/or unfair practices to conceal the true nature of the loan and included ancillary products from an unsuspecting or unsophisticated borrower.

Loans to borrowers not demonstrating the capacity to repay, other than through the value of the collateral and liquidation, are considered unsafe and unsound. Such loans would be criticized in a safety and soundness examination. The agencies have powers under the Federal Deposit Insurance Act when any institution engages in unsafe and unsound practices. For instance, the agencies may issue a notice of charges or other proceedings that may lead to a cease-and-desist order. The agencies may require an institution to correct any such conditions through reimbursement and indemnification and to guarantee against loss under certain circumstances. The agencies may also impose civil money penalties for violating any law or regulation, including compliance laws and regulations.

Let me now turn to the compliance examination process to explain how we identify predatory practices that may be present. Predatory and abusive practices can be identified when we examine an institution for evidence of discriminatory or other illegal credit practices.

Now, what do I mean by discriminatory or other illegal credit practices? An institution engages in discriminatory credit practices if it discourages or discriminates against credit applicants or borrowers on a prohibited basis. Under the Equal Credit Opportunity Act, prohibited bases are race and color, religion, national origin, sex, marital status and age, and exercise of consumer rights under the Consumer Protection Act. Prohibited bases under the Fair Housing Act are race and color, national origin, religion, sex, disability, and familial status, which largely focuses on families with children under the age of 18 and pregnant women.

Other illegal credit practices inconsistent with helping to meet community credit needs result in more than just violations in the compliance examination and enforcement action. Such actions could result in lower CRA ratings and trigger a rescission of certain equity mortgage transactions—the so-called three-day right of rescission—under the Truth in Lending Act.

Back in the late 1970's, home improvement dealers often preyed on unsuspecting borrowers. The right of rescission was an effective and controversial form of protection to combat this problem. We would look for compliance with Truth in Lending Act requirements where proper disclosure of fees, rates and other costs help protect against predatory lending.

Certain other terms associated with high-cost loans are regulated under the Home Ownership and Equity Protection Act, or HOEPA. HOEPA actually does several things. It shines a spotlight on practices that could be considered predatory or abusive. It also has some prohibitions. For example, it bans balloon payments in the first five years of a high-cost loan, an important protection for vulnerable borrowers. It prohibits prepayment penalties generally after five years—a timeframe some think should be three years—so someone could refinance a high- cost loan within a fair, reasonable time.

HOEPA also makes the purchaser of a mortgage loan liable for any violations or misrepresentations made at the time the loan was made, a provision known as assignee liability. This liability may make some reluctant to buy these high-cost loans. Others may conduct more stringent due diligence steps to ensure that either subprime loans they purchase are not high-cost loans as defined by HOEPA, or high-cost HOEPA loans they do purchase do not entail predatory practices.

"...any loan with total points and fees exceeding the greater of $400 or 8 percent of the loan amount is defined as a high-cost or HOEPA loan."

Recent changes to HOEPA include a lower interest rate triggering classification as a HOEPA loan. Under the lower threshold, any loan with total points and fees exceeding the greater of $400 or 8 percent of the loan amount is defined as a high-cost or HOEPA loan. The rate threshold is adjusted annually, and the 2003 number for points and fees was $488, or an APR of 8 percent for first-lien loans, and 10 percent for second-lien loans. The Federal Reserve could set that anywhere between 8 and 12 percentage points above Treasury rates on debt with a similar maturity. Any loan that meets that definition is automatically a HOEPA loan. In addition, any loan including single premium credit insurance is now automatically defined as a HOEPA loan.

"...any loan including single premium credit insurance is now automatically defined as a HOEPA loan."

Banks are not required to report publicly loan information on pricing, lien status, and rate spreads either equal to or greater than 3 percent on a first loan, or greater than 5 percent for a second loan. While not publicly reported, that information can be used by federal banking agencies to control predatory lending practices.

These agencies examine banks closely for compliance with these requirements, evaluating information from examinations to determine whether they represent legal credit practices.

Examiners also review compliance with the Real Estate Settlement Procedures Act, or RESPA, to determine whether or not referral fees are given and accepted, and if there are any unearned fees or kickbacks in connection with certain mortgage transactions. You might find these when there is collusion among several parties in the lending process.

Finally, the Federal Trade Commission Act addresses unfair deceptive acts or practices. We would look for three things to determine if a practice is unfair. One, is it likely to cause substantial injury, meaning monetary damage, to a consumer? Two, is it a practice that a consumer could not reasonably avoid by themselves without help? Finally, are the costs of a practice not outweighed by benefits to a large number of consumers?

Deceptive practices involve three characteristics. First, a representation, omission, or practice must be likely to mislead a consumer. Second, we look at how the consumer responds to the practice, and determine whether their reaction is reasonable. Third, we look to see if the representation, omission, or practice was material, meaning it would affect the decision of the consumer. Regarding omissions about which the institution knew, we look to see whether the institution knew or should have known that the consumer needed more information to make the right decision. These tests sound as if written by a lawyer, but in practice, this approach works pretty well.

In sum, some predatory practices generally are covered by safety and soundness underwriting requirements. Disclosure regulations also address predatory practices, and include requirements under Truth in Lending, HOEPA, RESPA, and Fair Housing. This umbrella is large, and coverage is good.

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However, these laws may not address other predatory practices, and potential abusive practices are often better addressed under FTC Act provisions on unfair or deceptive practices. Let me give you a couple of examples. Some practices considered predatory or abusive such as loan flipping, refinancing of special subsidized mortgage loans, and fee packing probably involve some type of unfair or deceptive practice.

The banking agency examines banks and thrifts for compliance with these laws. How does this count under CRA? Under existing CRA regulations in effect since 1995, as well as prior regulations, only illegal credit practices can have a negative effect on evaluation. We have never taken away from a CRA rating because certain practices may abuse or harm communities. We have only given positive consideration for those activities that help low- and moderate-income areas.

The regulations, however, do not limit consideration of illegal practices to assessment areas. Some banking agencies—OTS, FDIC, and, I believe, the Federal Reserve—have in fact lowered CRA ratings for institutions where they engaged in illegal credit practices. In most cases, the illegal practice involved discrimination outside of their assessment areas. We also have lower ratings where the bank subsidiary engaged in illegal credit practices outside of assessment areas.

In February 2004 the 4 banking regulators issued a joint proposal to clarify that authority and incorporate some of that approach in the regulations. We have had CRA guidance available on illegal credit practices, which covers what I have just presented. The proposed rule moves that guidance into the regulations itself. We did that to respond to public comments that the guidance should be part of the regulations to make expectations clear.

“For the first time, this interagency proposal mentions violation of applicable state and consumer protection laws, although only in the preamble. All CRA-eligible loans would be covered...”

For the first time, this interagency proposal mentions violation of applicable state and consumer protection laws, although only in the preamble. All CRA-eligible loans would be covered, including small business, small farm and mortgage lending, and consumer loans, whether elected or not. If a bank elects consideration of affiliate loans in the bank’s assessment area, any illegal practices would be considered. The proposal also added equity stripping as a new predatory lending feature. It further explains that we would use the FTC Act to review unfair and deceptive practices.

What does all of this mean? The key point is banking agencies do a rather stringent review of banks, thrifts and on credit unions looking for these practices. **What we are concerned about is the large number of non-bank entities not regularly reviewed in this manner.** Governor Gramlich cited a rough estimate in a speech a year ago indicating the Federal Reserve Board assumed 75,000 lenders in the country. Given 10,000 banks and thrifts, and about 15,000 credit unions, the number of non-bank lenders is very significant.

By no means do I suggest all are involved in predatory practices, but we have seen predatory lenders mainly from this group. Again, these non-banks do not undergo stringent and rigorous examination reviews. Mortgage companies fall under the purview of HUD and the FTC, and they do an excellent job of investigating complaints. Nevertheless, they are not set up to do regular on-site examinations as the banking agencies are.

Some states do a good job of looking at those they license, but others may not. I look forward to a discussion today on how we can approach this class of lenders in a similar way to deter predatory lending.

MR. MICHAEL CALHOUN: Let me comment on where we from Self Help and the Center for Responsible Lending see the subprime market now and what we view as the key issues. For background, Self Help and the Center for Responsible Lending were very active with the Mortgage Bankers Association and other parties in North Carolina in enacting the Predatory Mortgage Lending Law there in 1999, and in enacting a mortgage broker and lender regulation law in 2001.

First, when you look at the current subprime market, perhaps the most startling fact is the astonishing growth rate. We are seeing 50 percent annual growth rates in volume. In 2004, subprime lending was expected to exceed $400 billion in originations. Only a few years back, we were looking at $100 billion of subprime originations.

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Securitization is increasing at a comparable rate, with about two-thirds of these loans securitized. The subprime market remains concentrated in refinance and, in particular, cash-out refinance loans. There are purchase loans, but those form a minority share of the market. The subprime market has improved, but distinct differences still exist between the subprime and prime markets.

Upfront fees in the subprime market remain considerably higher. Whereas you would expect to pay one to two points on a prime loan, best practices for subprime loans fees are 3 points, and most people regard five points as an outside cap. In addition, mandatory arbitration clauses are prevalent in the subprime market. We believe that practice will go away, particularly with Fannie Mae and Freddie Mac's announcements that they will not buy subprime loans that have mandatory arbitration clauses. **Finally, you can see a very stark difference between the prime and subprime market on prepayment penalties.** Perhaps three to five percent of prime loans have them, while they are the norm in the subprime market. General industry estimates suggest that 80 percent or more of subprime loans have prepayment penalties.

Prepayment penalties are important in the context of what we just heard about HOEPA. One of the lessons from the North Carolina law was the importance of including all the fees in the definition of a high-cost loan. Otherwise, while, under some circumstances, charging a high upfront fee or prepayment penalty might be reasonable, combining all of these charges makes the loan abusive. That was the approach of the North Carolina law.

“One of the unfortunate aspects of HOEPA is that it currently rewards lenders for charging high prepayment penalties, a problem stemming from legislation and not regulation.”

One of the unfortunate aspects of HOEPA is that it currently rewards lenders for charging high prepayment penalties, a problem stemming from legislation and not regulation. Subprime lenders have been able to avoid having their loans defined as high-cost under both the HOEPA and state law definitions.

Under HOEPA, you can charge unlimited prepayment penalties that are not considered in determining if the loan is a high-cost loan, which triggers the additional consumer protections. Under HOEPA, a lender can charge 7.99 upfront points and a 10 percent prepayment penalty on a loan. Current federal law does not regard that loan as high-cost.

In many ways, prepayment penalties have come to substitute for the single premium credit insurance we saw in the 1990's. With single premium credit insurance, the borrower got an additional form in the Truth in Lending packet of closing materials. This form required the borrower to sign indicating, “I want to pay for this very expensive and overpriced insurance rather than buy it on a more affordable monthly basis.” You now see the same form out there for prepayment penalties, only now the borrower's signature indicates, “I've been offered a loan without a prepayment penalty, but I'd rather have this loan with a large prepayment penalty.”

In both the prime and subprime market, we are also seeing that loans are increasingly monthly payment driven, as evidenced by the prevalence of ARM's in both markets. I know Allen Fishbein will comment on this, but the Consumer Federation of America did a very important study of how, ironically, subprime borrowers least suited to handle an ARM's fluctuating payments are ending up in these mortgages. We see the same problem with interest-only mortgages.

These mortgages can increase the chance of paying prepayment penalties. The industry justifies prepayment penalties in part by saying that as many as 25 percent of borrowers would not qualify unless their loan had a prepayment penalty. An example would be useful to show what that means for an individual borrower.

Take a buyer of a $150,000 home with $10,000 of equity in the house. They are going to borrow around $150,000. They pay three to five percent in fees up front, adding to the cost of the loan. Typically, their loan will also include a prepayment penalty, set by many lenders in an amount equal to six months of interest. If the interest rate is nine or ten percent, such a prepayment penalty adds about four more points to the cost of the loan.

Furthermore, subprime loans have an extremely high prepayment speed. Annually, around 25 percent of these loans prepay, so the typical life of these loans is about three to four years. Such prepayment speeds mean that more than half of borrowers with subprime loans featuring prepayment penalties will probably pay those penalties. This, and the fact that early mortgage payments are almost exclusively interest, place borrowers in a de facto negative amortization mortgage. Thus, in the early years, if our borrower sells their home or refinances into a less costly mortgage, they will probably lose $10,000 of equity in their home, and may owe more.

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"The foreclosure rate for subprime loans is ten times the rate for prime loans."

Looking at the broader context, these loans roll over every three to four years, with terms that, taken together, erode or even erase the borrower's net worth. Self Help focuses on increasing the wealth of minority households. The median net worth of minority households right now is around $10,000. With that one refinancing, that loan has stripped away the equity equal to the total net worth of the median African-American household.

The other concern we see really hitting now—and your own Woodstock Institute here in Chicago has led the research on this issue—is increasing numbers of foreclosures resulting from these loans. The foreclosure rate for subprime loans is ten times the rate for prime loans. The Woodstock Institute did a study here in Chicago, finding that the overall foreclosure rate had increased in Chicago by more than 200 percent over the last five years. The study identified subprime loans as the dominant driver of that increased rate of foreclosure.

On a final note, there has been a landmark development in the subprime lending market, namely the announcement by the rating agencies of how they will treat subprime loans under the various state predatory lending laws. Essentially, a lot of the dust has settled. Standard and Poors has announced that loans that are not high-cost generally will be accepted into the secondary market with no additional credit enhancement or additional responsibilities for the purchaser. This announcement included states such as North Carolina, New Jersey, and New Mexico.

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We have reached a milestone on how to resolve regulations of these loans, particularly on how assignee liability is treated, a critical issue for policing the market. I look forward to your questions and comments.

MR. GARY WASHINGTON: Thanks. Allen?

MR. ALLEN FISHBEIN: It is a pleasure to be here. As a consumer advocate, the Consumer Federation of America is concerned about two issues in mortgage lending, the same two issues we are concerned about in all aspects of financial services. One, we want consumers to be able to make good choices in the marketplace, and we help them have the tools and abilities to do that. In addition, we want to make sure the law adequately protects them from abusive and predatory practices. That is how we approached the issue of predatory lending.

As we talked about the current context of the mortgage market, I thought I would discuss five points relevant to the intent of today's conversation. Some of my points track what Mike said earlier.

• First, we have to recognize that the trend of mortgage industry restructuring and consolidation is continuing. There is a very profound change going on dramatically altering the landscape. Consolidation means the top 25 prime mortgage lenders made 78 percent of all the loan originations in 2002, up from 28 percent in the early 1990's. The top 10 made over 50 percent of those recent originations.

In the subprime market, even more consolidation is occurring. In 2002, the top 25 subprime lenders made 88 percent of all subprime originations through retail and other channels, up from about 47 percent less than 10 years ago. The top five subprime lenders accounted for about 40 percent of all subprime lending, up from about 20 percent a decade ago.

• Second, contrary to this trend of consolidation mortgage broker firms have proliferated, increasing the dominance of this origination channel. The number of mortgage brokers has more than doubled in the past 10 years, up from 7,000 in the 1980's to 44,000 mortgage brokers currently. Particularly in the subprime market, mortgage brokers are originating close to 60 percent of all of the loans. This is a profound change with significant implications. On top of that, as Mike said, the subprime market has significantly expanded. Since 1994, the market volume has increased ten-fold, and about two-thirds of all subprime loans are securitized.

The press is reporting that this market is becoming much more competitive, a good thing for consumers. Prime lenders are trying to get into the subprime market. Subprime lenders are trying to become prime lenders. The distinction between prime and subprime lending is blurring, and the continuum of risk-based pricing many have predicted is becoming more of a reality, potentially a useful thing for consumers.

“A common thread is turning up that could be labeled the smoking gun of predatory lending: subprime loans foreclosing much more quickly than prime loans.”

It is amazing to me that, based on the first half of this year, indications are that subprime originations now represent 20 percent of the home refinance market, more than double last year’s share.

“...subprime originations now represent 20 percent of the home refinance market, more than double last year’s share.”

• Third, while mortgage lending has continued to expand into underserved markets and homeownership rates continue to increase, questions are starting to emerge, as we see more zero down payment and high loan-to-value (LTV) mortgages. While availability of credit has increased, are we potentially unleashing dangerous forces destructive to neighborhoods? In addition, a different set of lenders are serving low-income and minority markets, with a different product mix, giving rise to concerns about a so-called dual market. Subprime and government-insured loans are a predominant part of this increase in credit that has occurred in these communities. These loans are largely broker-led. Many involve so-called “push marketing”, which encourages borrowers to take on more debt than they can afford or even need.

This tactic pushes some borrowers into higher cost mortgages, when they are qualified, based on their credit scores, for lower-cost mortgages.The result, as Mike said, is increased foreclosures, particularly in subprime loans, harming not only the individual household but also the neighborhoods where subprime lending is concentrated. We know from research that indeed it is concentrated. It is heavily concentrated in African-American and Hispanic markets and lower-income markets. So higher levels of foreclosure affect not just families, the victims who lose their homes, but people living next door and in the neighborhood. This could reverse a lot of positive neighborhood revitalization that occurred over the last decade.

Not surprisingly, subprime foreclosures run ten times higher than prime, according to research by the Woodstock Institute and Neighborhood Housing Services here in Chicago. Subprime foreclosure rates can be 20 times higher or more than prime foreclosure rates. For instance, subprime foreclosure rates in Ohio and other places are running at 15 percent.

Not only are these rates comparatively higher, the nature of some of the subprime market foreclosure activity is troubling. We are in the process of analyzing the research studies done around the country. A common thread is turning up that could be labeled the smoking gun of predatory lending: subprime loans foreclosing much more quickly than prime loans.

These findings suggest that perhaps these loans were not truly above water when they were first underwritten, and the results are disproportionate in their impact. Even though subprime lending has been increasing, foreclosures have been skyrocketing even more than one might expect just from more lending. This raises important concerns for all of us.

“One-half of all outstanding existing mortgages were originated in 2003.”

Early in 2004 we saw a dip in foreclosure activity. While hopeful, one interesting statistic I saw should temper our interpretation of this dip. One-half of all outstanding existing mortgages were originated in 2003. Two-thirds of all existing mortgages were originated in 2002 and 2003. These statistics mean a lot of new paper is out there seasoning, and we may not see the real peak of foreclosure activity for years, in fact, loans were poorly underwritten or excessive risk was taken.

The Consumer Federation of America has been particularly interested in this subject. **There was an adjustable rate mortgage boom, particularly in 2004 as interest rates moved upward.** Somewhere around 65 percent of all of the mortgages being written in the first six months of the year were adjustable rate, the highest percentage in a decade. Some are written as interest-only loans and some with zero down payment requirements.

This creates new uncertainty for the consumer, and, if nothing else, the opportunity for new forms of predatory lending and abusive practices that perhaps we have not seen yet. We did a survey of consumers and found that most consumers favored a traditional fixed rate mortgage. Based on our survey, people who were less wealthy or less educated and minority respondents were more inclined to find adjustable rate mortgages attractive. At the same time, these peoples’ response to our survey questions indicated they probably understood the risks with these mortgages less than the overall population.

Just as we think the industry has been cleaning up some of the abuse, we may see a completely new category of borrower targeted by new predatory practices aimed at these ARM borrowers. So sustaining homeownership becomes a key issue. We have to be concerned not just

“Many involve so-called “push marketing”, which encourages borrowers to take on more debt than they can afford or even need.”

“We have to be concerned not just about getting people into homes, but keeping them in their homes.”

about getting people into homes, but keeping them in their homes. Going forward, we need to make sure that we have the infrastructure in place to do that.

• Fourth the **“buyer beware” condition of the present market makes existing consumer protections still inadequate.** The reality is that many consumers have not made the transition from viewing lenders and brokers as gatekeepers of credit. Some consumers still believe you have to convince them to give you a loan. Many also believe that lenders and brokers are obligated to offer them the best deal, which they are not.

This misperception is not limited to mortgage lending. At CFA, we see this with credit card and other installment debt, as well as in payday lending and many other forms of finance. Many consumers also do not shop. Instead, they rely on brokers. The complexity of the products makes it difficult for them to make choices even when they do shop. Thus, many consumers are not up to the challenge of protecting their own interests in the marketplace.

Since brokers are compensated based on upfront fees and not on loan performance, mortgage brokers’ incentives do not align well with consumers and funders of the mortgage.”

Therefore, the market falls short of the competitive ideal. Fueling this is the increased dominance of the mortgage broker channel and the resulting tremendous changes in mortgage lending. Since brokers are compensated based on upfront fees and not on loan performance, mortgage brokers’ incentives do not align well with consumers and funders of the mortgage. Wall Street’s securitization of subprime loans can price for that additional risk, unfortunately reducing the incentive to police the mortgage brokerage networks adequately.

• Fifth is a question: what should be done? I worked on the HUD-Treasury National Predatory Lending Task Force, which issued a report on curbing predatory lending. That report envisioned a comprehensive solution to predatory lending focusing on ridding the subprime market of these practices. Our recommendations outlined roles for federal government, states and localities, the industry, and community organizations and nonprofits. In fact, this comprehensive approach has not been pursued. Progress has been piecemeal. We have had positive developments on all these fronts, but without a more comprehensive approach, the problem continues.

“More needs to be done. Over the past couple of years, a consensus has emerged that predatory lending must be curbed, and that additional legislation and consumer protections probably are needed. From our standpoint, the state level is where the most exciting activity is happening. A number of states have enacted innovative laws going beyond federal law. Legislation was introduced in the U.S. Congress this session. Congress did not act, in large part, because a national consensus is lacking on what needs to be done. As much as some in the lending industry would like to see federal standards, no consensus exists yet on key points.

An outline for action is being hammered out state by state, and a consensus may develop, if we give it time. Greater uniformity in state laws may reduce the need for federal law. We have to be careful about whether the federal law will be the panacea some would like to think. There is no assurance that federal law will be workable or effective: workable from the industry standpoint or effective in addressing the need for new consumer protections.

As much as we would like stronger regulations and consumer protections, **our view at CFA is that we should continue experimenting at the state level, letting those laboratories of democracy serve their purpose.** Their experience will help us learn how to fine-tune the sharper edges of consumer protection laws so that the secondary market can properly price for these requirements and not require additional credit enhancement. Perhaps in the future, a consensus will emerge on outstanding key issues, and we can all work towards a tougher federal law. A lot more work remains before then.

MR. GARY WASHINGTON: As always, Allen is provocative. Steve?

MR. STEVEN HORNBURG: I am going to give you an overview from 35,000 feet on the state of the industry. I am neither an economist nor a lawyer, but rather an educated consumer of this research. In my work, I have focused on expanding market access, so I have been involved with some of the research on subprime lending and predatory practice. Allen is right. A great body of literature is emerging on this topic. CRL and the Mortgage Bankers Association of America both have good web sites for those interested in exploring this research further.

The context for the growth of subprime lending is a familiar narrative. The last decade saw a great economy; expansion of the secondary markets; business innovation in products, underwriting, and technology; regulatory pushes to expand the markets; consolidation in both the prime and subprime markets, in the origination and the servicing area; and finally, the rising dominance of the mortgage brokerage channel.

Everyone is familiar with the narrative. The national homeownership rate went from 64 to 68 percent, producing nine million new homeowners, including 4.7 million minority households. Nevertheless, **a stubborn, persistent homeownership gap remains between non-Hispanic whites and minorities, both troubling and still a challenge.** Moreover, although subprime lending was a major contributor to reducing that gap, rising concern over predatory abuse has accompanied this market's growth.

What do we know from the research on subprime lending and predatory practices? First, massive growth has been documented, in both the number and volume of subprime loans. The home purchase loan share of the subprime market has been increasing, although refinance and equity take-out loans still dominate. Subprime loans are smaller than prime loans, affecting the base against which an industry charging a percentage of the transaction can recover fixed costs. Origination costs, therefore, are spread over a smaller base.

"Subprime rates seem to reflect the higher risk of lending to borrowers with lower FICO scores and the resulting default experience. Given the higher risk, it is not surprising there are higher foreclosure rates for subprime loans."

Subprime rates seem to reflect the higher risk of lending to borrowers with lower FICO scores and the resulting default experience. Given the higher risk, it is not surprising there are higher foreclosure rates for subprime loans. Allen is exactly right that the majority of the subprime portfolio is very recent vintage. Since loan defaults do not necessarily occur immediately but peak after a few years, we may be facing some issues down the road.

Subprime loans have a different and higher cost structure, reflecting the greater magnitude and kind of risks that they represent. Contributing to this difference is a lack of standardization, a need for high touch handling to originate a loan, and more aggressive servicing required to manage higher risk loans. For instance, from their Cost of Servicing study, MBA has shown lower productivity for the subprime industry compared to prime lenders, both on the loan origination and on servicing sides. This reflects these challenges and the need to work these loans more.

We also have seen a shift in the industry in 1998 from more thinly capitalized firms to firms that have deeper capital. These new players have more volume and capacity, are in the subprime market for a longer-term play, and have access to cheaper capital. This development alone has led to a hope for more competition in this market. As an aside, this shift makes me discount pre-1998 research simply because of the changeover in the industry's structure and players.

Allen Fishbein

Pricing differences for the various grades of subprime do appear mostly in line with the increased cost of servicing and risk. While unexplained residuals in pricing remain, overall pricing appears not out of line. This observation is true whether you consider absolute costs, building the cost structure up from the bottom, or subprime funding costs, compared to comparable debt instruments, such as corporate junk bonds. Therefore, analyses suggest that pricing is not out of line with costs or comparable funding. However, we need a greater understanding of what goes into pricing decisions, and what is included in the price being measured.

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There are signs that the market is maturing and becoming more competitive. Some of the spreads have been coming down over the years. The main share of the subprime market is still in the A range, including alt-A and A-, where FICO scores are typically between 580 and 640. The B, C, and D grades still form a much smaller part of the market.

As Allen said, there is evidence of disproportionately more subprime lending in minority and low-income communities. There is also evidence that the knowledge and attitudes toward finance of consumers and the

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"...most mortgage terms and conditions are not by definition abusive. Most of the time, the abusive practice is found in the construction of the terms and conditions, how they are used in combination, and how they are applied and enforced."

"Predatory abuses do appear to be more prevalent among non-bank lenders, but banks and their subsidiaries have a potential major influence through their broker channel and purchases they make."

shopping behavior may play a role in explaining why some borrowers end up in subprime. Nevertheless, clear and extensive anecdotal evidence exists documenting abusive lending practices. The empirical evidence of the magnitude of this problem is still lacking, but anecdotal evidence is clearly convincing and overpowering.

Past work I have done convinced me that, much as Bob said earlier, the abuses are violations of existing law. Whether or not existing law can be adequately enforced is a separate question. Some evidence suggests that litigation and self-interest are moving the industry toward an evolving a set of best practices. This development highlights the fact that most mortgage terms and conditions are not by definition abusive. Most of the time, the abusive practice is found in the construction of the terms and conditions, how they are used in combination, and how they are applied and enforced. It was heartening to me to find some movement towards sculpting out some bounds on acceptable use of mortgage terms and conditions.

There is evidence that anti-predatory and consumer protection laws affect lending. The evidence is subject to vigorous debate as to whether or not these laws are effective in clearly targeting predatory abuses, or whether they are also constraining legitimate lending. My read of the evidence to date is that the question is not settled. Neither side has conclusively proven their case; I can point to evidence and criticisms on both sides of the question. Predatory abuses do appear to be more prevalent among non-bank lenders, but banks and their subsidiaries have a potential major influence through their broker channel and purchases they make.

What are the challenges? To me, the state of the research sets up exactly like the debate over research on lending disparities. Imperfect information is available, and research using that data finds different outcomes for borrowers who appear similar based on available information. Full information is simply not there to come to a conclusive explanation for why these differences occur. That fact will not stop a lot of smoke surrounding the pending release of new HMDA pricing data. Therefore, one challenge is clearer definition of the magnitude and nature of the problem to get to more bright line definitions. That clarity is still lacking, although there is movement in the right direction.

In addition, the industry definition is seriously lacking. HUD has done their best job in trying to identify the industry. I suspect most lenders in this room that do subprime lending are not on that list, but HUD's definition is still the benchmark used for researching this issue.

A lack of transparency and standardization in the subprime market still hinders competition. This opaqueness also engenders deep suspicion among consumer advocates and housing activists very similar to past concerns with automated underwriting and credit scores. Lending is a knowledge-based industry, with proprietary ownership of specific approaches. While a competitive concern, if people do not understand what is going on inside of that black box, they will be suspicious.

I understand the policy and political concerns over national preemption, but am very concerned about the balkanization of lending oversight when you rely on state and local regulatory regimes.

"I have never bought into the state's rights and "laboratories of democracy" arguments. Where you have national or international markets in business operations, balkanized state and local regulatory regimes could lead potentially to credit rationing not seen in the past 20 years."

I have never bought into the state's rights and "laboratories of democracy" arguments. Where you have national or international markets in business operations, balkanized state and local regulatory regimes could lead potentially to credit rationing not seen in the past 20 years.

Existing law enforcement is clearly inadequate. There are significant challenges to enforcing existing law. Mortgage brokers move in and out of the market quite frequently. With a lag time of sometimes two or three years before violations of existing law may become known, catching up with predatory brokers can be difficult. Logistical difficulties, inadequate funding, and insufficient emphasis challenge law enforcement.

"We also need wider adoption of best practices by the industry."

We also need wider adoption of best practices by the industry. I hope that we can do a better job of enforcing the existing laws and that best practices are more widely adopted. If not, it will lead to blunt policy instruments and responses being enacted. Continuing evidence of abuse and lack of progress will make simplistic responses attractive, which will not serve either the industry or the

“The Chicago NHS has done some fantastic work in partnership with industry to help victims of predatory abuse, getting them into a better situation.”

consumer well. **Finally, heavy reliance on the broker channel should keep every lender awake at night.** You should be losing sleep over this because policing the broker channel is a huge challenge.

The new HMDA pricing data coming out next year will cut both ways. I hope it will force greater attention to practice and set a few more understandable boundaries for acceptable practice. While it may establish a floor, this reporting is a blunt instrument. There will be analyses producing far more smoke than fire. Unexplained differences will be found, but important information such as credit history, credit quality, and loan terms will be missing. This goes right back to the whole Boston Fed study debate, still ongoing, about whether or not these statistics and studies measure something meaningful, or are these differences explainable by missing information.

Lenders had better know what is going on with their business ahead of the release of the new HMDA data. If you have problems, or something that looks like a problem, you had better deal with it because these kinds of studies are going to dominate the media coverage and the policy debate, driving them in ways that may or may not be right. The bottom line is that lenders have to evolve their best practices and show more transparency. GSE involvement and litigation are starting to shape those best practices, but lenders can take more of a lead.

With rising and seemingly disproportionate foreclosures, it is not clear if servicing of subprime loans is at the same state as in the prime market. The prime market has evolved more loss mitigation strategies that are more consumer-friendly and smart business practice. Subprime servicing may need similar advances. With higher risk borrowers, it is not clear that the incentives are as aligned as much as they are in the prime market. Clearly, subprime servicers need to work on loss mitigation strategies that fall short of foreclosure because of the problems that Allen and Mike have identified.

“Lenders also need to figure out how to go after the bad players, whether they are brokers or other colleagues in the industry. If you are a legitimate player, the bad players are going to give you a bad rap.”

Lenders also need to figure out how to go after the bad players, whether they are brokers or other colleagues in the industry. If you are a legitimate player, the bad players are going to give you a bad rap. You need to get out ahead of the HMDA data, but prepare to be hammered. Figure out how you are going to engage in a positive way while being hammered.

Finally, **reach out and work with non- profits on education, counseling, and workouts.** I see my friend Ken Wade of NeighborWorks® America here. They do good work, and are figuring out solutions for the backside of predatory loans. The Chicago NHS has done some fantastic work in partnership with industry to help victims of predatory abuse, getting them into a better situation. A lot of work remains to develop and use these models more widely. The non-profit and advocacy community is a willing, ready, and necessary partner.

For advocates, keep on doing what you are doing. You need to ferret out the bad players. You need to expose them and put them out of business. The other side is you need to get over having problems with the profit motive and risk-based pricing. The profit motive will help subprime lending mature into a more competitive market and open up more opportunities for people. Risk-based pricing is not on the horizon. It is here, and not only in subprime market. I have been utterly amazed in talking with many folks working these communities about the lack of understanding that we do not have a bifurcated, yes-or-no market anymore. Risk-based pricing is the norm in both the subprime and prime markets, and you need to come to grips with that development. I have talked a lot with the nonprofit community about the need to recognize and embrace legitimate subprime lending. You cannot teach abstinence exclusively in counseling programs anymore. Emerging evidence suggests some people are oriented toward getting to yes, and will shop around for a mortgage now. If you counsel them to clean up their credit and wait for a year, they will walk out and maybe hit a legitimate subprime lender, or maybe they will be abused. The non-profit community needs to come to grips with different consumer profiles, and retool their counseling strategies for borrowers who will not wait.

Nonprofits also need to continue leading with the models and with the education and counseling that they do so well. They do fantastic work, and continue to lead the way on responsibly extending housing opportunity.

Nevertheless, please be careful with the hardball. Legitimate players have reputational and regulatory risk. You should encourage them to act responsibly, and not bash them unless they are clearly doing something wrong.

For both communities, you need to understand the consumer. Economists dominate the research that is out

“You cannot teach abstinence exclusively in counseling programs anymore. Emerging evidence suggests some people are oriented toward getting to yes, and will shop around for a mortgage now.”

“...the mortgage market knows less about why and how people shop for a mortgage than Taco Bell knows about why people pick a burrito versus a taco.”

there, and they offer significant insight. However, I have been saying for the past seven or eight years that the mortgage market knows less about why and how people shop for a mortgage than Taco Bell knows about why people pick a burrito versus a taco.

I will quickly mention three other issues.

• How deep can you go with risk-based pricing, when default rates reach 20 percent for some grades of subprime loans? I believe in the market and its ability to price risk, but at some point, what is doable becomes a legitimate public policy issue.

• In addition, there are equity concerns emerging with risk-based pricing. You lose the cross-subsidization that used to be inherent in the system, producing winners and losers. That is a challenge increasingly on some people’s minds.

• Finally, homes represent and define access to opportunity and life. You cannot just leave housing choice and the means to buy a home to caveat emptor. We have to get it right.

MR. GARY WASHINGTON: We have time for just a few questions. I have enough to fill the next three hours, but let me throw it open if anyone has a burning question that they want to raise from the floor.

AUDIENCE MEMBER: Mike, you listed three things that were different in the prime and subprime market. What about escrow accounts for subprime compared to prime? Is that something you have come across as an issue?

MR. MICHAEL CALHOUN: Just to repeat your question, “Is there a problem in the subprime market with escrow accounts?” I think you mean that the funds are not being escrowed, another device to lower monthly payments artificially. We do see that as a problem with the subprime market. The folks have been used to paying escrow. They go in for a loan. They do not ask for any change. They find out they owe taxes and insurance at the end of the year.

AUDIENCE MEMBER: Allen, you talked about the subprime market becoming more competitive. Could you talk a little bit about that? I want to understand what you mean by that.

MR. ALLEN FISHBEIN: I was alluding to the concentration and consolidation of the industry, where major national players are involved in the market. We hope that will lead to competition resulting in lower prices for consumers. I do not know whether there is evidence of that other than references to the spreads falling. However, that does not address issues of fees, points, and other differences in the market. I was not trying to say that this has been a positive outcome, but certainly increased competition has led to a fallout and reduction in the number of subprime lending specialists, so we have fewer and larger institutions. We hope that will result in a good outcome.

MR. STEVEN HORNBURG: The Mortgage Bankers Association is reviewing the cost structure of subprime versus comparable prime lenders, looking at return on investment for each. They are looking to see if subprime lenders are achieving a comparable return on investment. Those returns should indicate if, in fact, these markets are becoming more competitive. That research is under way.

MR. ALLEN FISHBEIN: One thing that tells me money is there to be made is when formerly prime lenders quickly go into the subprime market and become among the nation’s leading subprime lenders. We hope they bring their good practices from the prime into the subprime market, not the other way around. That is really where the question of the channels for these originations comes into play and who is actually responsible for that intake.

MR. MICHAEL CALHOUN: The point about the rate and the margin between prime and subprime raises two important things. First, we have not talked about how the Truth in Lending requirements from the early 1970’s really have not kept up with this new market, particularly for the subprime loans with a lot of the revenue fee based on both front-end and back-end fees. Effectively, Truth in Lending ignores those and provides misinformation to the consumer. The front end fees are amortized over the projected scheduled life of that 30-year loan, when we know the average life of those loans is four or five years. That greatly understates the APR because those fees, in fact, are earned over a four-year period, having a far greater impact on the true cost to the borrower.

Prepayment penalties, now a very significant part of the fee revenue flow for subprime lenders, have an even bigger impact. Those penalties are excluded completely from the annual percentage rate calculation. Indeed, the Truth in Lending regulation just tells people you may have a prepayment penalty without even going into the magnitude of it. If you look only at note rates, you are not accounting for these fees.

AUDIENCE MEMBER: The explosion in subprime loans occurred back in 2002 and 2003. I would like to hear what your comments are on the push from prime markets, especially the effect of risk-based pricing, use of secondary market automated underwriting techniques, and the mortgage insurance companies going to risk-based pricing where individuals who could be approved for prime loans cannot afford the mortgage insurance. How much of an effect have these developments had on growth in the subprime market?

> "...the latest subprime numbers reported that more than one-third of these loans are from California. A lot can be alternative-A loans, a near-prime product, now almost a necessity in California..."

MR. MICHAEL CALHOUN: First, let me talk about the numbers, where a lot of research needs to be done. One statistic jumps out at you. As you hear these numbers, note that the California market contributes heavily to these statistics; the latest subprime numbers reported that more than one-third of these loans are from California. A lot can be alternative-A loans, a near-prime product, now almost a necessity in California to get most people into a house just because of the crazy housing prices out there. One of the challenges here is to start to slice this aggregate subprime data, because there is a huge difference between a near-prime and a C or D loan. We see a lot more of the problems once you get past all those loans to B, C, and D grades.

The same thing is driving the prime market. All the data showed that consumers are turning to their homes for equity to meet current consumption needs. One of our concerns is that lower-income borrowers have the least capacity to survive that model of spending. They have the least cushion in their budget to be able to continue this practice, one of the main reasons for high foreclosure rate with these constant refinancings.

This is not exclusively a problem of the subprime market, but a concern with adjustable rate mortgage lending. This is why we have started looking at this question. Our sense was that adjustables are a good choice for certain consumers, but some consumers were locking themselves into adjustable rate mortgages, where the interest rate increases considerably over the life of the loan. It is not out of choice, but rather their only opportunity to qualify for homeownership. They are hoping that market conditions would take care of these problems later on. They assume that increases in housing values will bail them out of these loans, should the interest rates go up. Of course, that is speculative. What struck us was that this category of borrowers-those most at risk with the least income flexibility-was most likely to gravitate to that type of loan.

AUDIENCE MEMBER: Allen, a quick question. You mentioned several key factors on which there was lack of consensus at the federal level for regulating subprime lending. Can you tell us what those key factors are?

MR. ALLEN FISHBEIN: Probably a good starting point would be to look at the bill that former Congressman Bob Ney introduced in 2004. We have dubbed it the "Lender Protection Act," compared to the bill introduced by Congressmen Miller and Watt of North Carolina.

If you lay those bills side by side to see not what they purport to do, but what they actually do, you could get a sense of what some of the major differences are. Some issues in play are:

- strong limitations on the financing of points and fees
- the restrictions on prepayment penalties
- whether the scope of the legislation ought to be expanded
- mandatory arbitration bans
- assignee liability
- the lack of federal preemption

Some of the different issues are being played out, as I suggested, at the state level. Consensus is emerging in a number of states. This process has to work. Let the results bubble up to the federal level rather than imposing a top-down solution.

AUDIENCE MEMBER: Have there been any studies comparing the compensation structure of mortgage brokers in the prime and subprime area to see how much influence that might have in the steering of consumer subprime markets?

MR. STEVEN HORNBURG: I have not seen any literature on that topic. The whole compensation structure of the lending industry and real estate industry has some biases embedded in it.

MR. ROBERT MOONEY: During our lending examinations, we have looked at that issue and, as a result, have cited fair lending violations.

MR. MICHAEL CALHOUN: A Harvard study cited on our web site looked at yield spread premiums paid by borrowers and found they were correlated with the susceptibility of the borrower. Borrowers with yield spread premiums tend to have higher upfront fees. With the subprime market, we looked at data from Loan Performance's database, specifically examining prepayment penalties. We found that prepayment penalties are associated with loans with higher, not lower upfront fees.

MS. JUDITH KENNEDY: You say that CEOs are staying up at night because they are worrying about brokers. Well, what are they worrying about and why?

MR. STEVEN HORNBURG: How you exercise due diligence on a broker's channel is a huge vulnerability because somebody who is not working in your employ is sending you product. Asymmetric information on mortgages sent by brokers to lenders disadvantages the lenders. I defer to a lender about how you police that.

MR. GARY WASHINGTON: One of the biggest risks involved in managing the broker channel is the fact that, despite the lender's instruction in the period between receiving the proposed transaction and when you get it to the closing table, all kinds of things can happen. It can be the broker itself or the settlement agent. They can both take liberty with the transaction that finally ends up on the table in front of a borrower. One of the few ways to monitor changes is after the closing, where you review the transaction. You have approval of its detail. Then when the loan comes back from the closing table and you look at the final documents, they may not look like what you approved. Modifications to the approved transaction is a major issue and represents the biggest risk inherent in this broker channel. That is what keeps the CEOs and others awake at night.

MR. ROBERT MOONEY: There is a real risk with brokers that has surfaced in fair lending examinations where we have cited violations and made referrals to the Department of Justice. In some cases where a mortgage subsidiary of a bank was using brokers, brokers were treating individuals wanting loans in certain areas differently than other areas. That is a reason to lie awake at night wondering what is going on. Just as bank presidents wonder what is going on in all of those branches, the FDIC wonders what is going on when I am sitting up here.

MR. GARY WASHINGTON: I would like to thank all of our panelists. I will make three quick points in closing. What we are hearing is that **one of the most important priorities is to manage reputation risk.** That is something to which we all need to pay attention. When we have the opportunity, we need to come to a consensus—consumer advocates and lenders alike—on what makes sense for the marketplace and what is, as Allen mentioned, sustainable as a business model over the longer haul. We need to look at best practices and, if possible, develop them not in isolation, but in concert with our community development partners. After all, we are all in the same business of giving fair and equitable access to credit for the communities we serve and the individual borrowers.

> "When we have the opportunity, we need to come to a consensus—consumer advocates and lenders alike—on what makes sense for the marketplace and what is, as Allen mentioned, sustainable as a business model over the longer haul. We need to look at best practices and, if possible, develop them not in isolation, but in concert with our community development partners. After all, we are all in the same business of giving fair and equitable access to credit for the communities we serve and the individual borrowers."

Panel 2–What's Working Now? Fixing Lending Abuses

MS. ROBIN COFFEY: My name is Robin Coffey and I am with Harris Bank. With me today is Jim Wheaton, of Chicago's Neighborhood Housing Services (NHS) and Allan Kingston, the President and CEO of Century Housing, located in Los Angeles. NHS works with neighborhoods. Allan has defined himself as the affordability regulator for Los Angeles, working with about 1,000 units of housing. He makes sure low- to moderate-income families occupy them.

We are going to talk about what has happened in the neighborhoods most affected by the subprime lending market. These neighborhoods experienced the predatory lending first brought to everyone's attention by Gale Cincotta, who saw this happening through her work with NHS of Chicago.

The NHS offices in Chicago were spending more time not on lending, but on foreclosure counseling. They started to see that the increase in foreclosure was not due to the FHA market, historically a major source of foreclosures here in Chicago. Their experience will demonstrate the complexity of the mortgage market in the past, but more importantly as it exists today.

> "Both NHS and Century have cut through this complexity to find solutions to stabilize neighborhoods and help their residents."

It used to be that when you had a home going into foreclosure, you could do a real estate search to find out who the lender was, go to that lender and try to work out a solution. This is not the case anymore. The many layers of the current mortgage market and loan servicing practice mean that finding someone who can make a decision on a particular property takes a lot of time and effort. Both NHS and Century have cut through this complexity to find solutions to stabilize neighborhoods and help their residents.

> "Part of successfully resolving the consequences of predatory abuse involves making sure that the home remains as an asset to the community."

Part of successfully resolving the consequences of predatory abuse involves making sure that the home remains as an asset to the community. **Sometimes that means helping the owner stay in their home. Other times, the solution is helping the homeowner sell that home.** They can retain somewhat decent credit, but also retain the remaining equity left in that home.

We also count it as a win if the home does not become a boarded or unboarded vacant blight on the neighborhood. The neighborhood is better off if we can arrange for rehab by a nonprofit, and then sell the home to a qualified homeowner who will actually live there as opposed to absentee investors.

I found it interesting that 40 percent of the homeowners going through foreclosure never have any contact with their lenders during that process. Many end up selecting bankruptcy, which then prohibits the lender from having any contact with that borrower. A nonprofit faces an incredibly difficult task helping these homeowners. Just trying to identify who owns the mortgage note means sorting through a complicated web of servicers, sellers, and investors. For non-prime loans in particular, I do not think anyone understood how difficult a task these resolutions would be until they started to work through actual cases.

Chicagoland, as we like to refer to our town, has a high degree of cooperation among lenders, the nonprofits—especially Neighborhood Housing Services—and public and government agencies here. That level of cooperation, we are finding, is unique to Chicago. Such an environment fosters a lot of collaboration, and a lot of talking and sharing about what the different issues are. Most importantly, this cooperation helped people come to a consensus and move forward with solutions. Unfortunately, this cooperative spirit does not exist in many municipalities having these problems.

I will stop there, and ask Jim and Allan to talk about what they have seen, what the different issues are, and how they hope to move forward with solutions that keep their neighborhoods healthy. Jim?

MR. JAMES WHEATON: Much of what I say today might seem like stating the obvious, but these lessons learned bear repeating. As Robin mentioned, over the last several years our efforts have focused on foreclosures resulting from deceptive lending practices and improvident loans, as well as the impact of these foreclosures on neighborhoods and communities.

This broad civic engagement has been a learning process for all involved. We are realizing more and more **that the only way to solve this problem is to work together,** not coincidentally the theme of this conference. In Chicago, we have pulled together a multifaceted partnership to deal with a multifaceted problem. From our partnership, a multi-tiered response emerged we call

In Chicago, we have pulled together a multifaceted partnership to deal with a multifaceted problem.

the Homeownership Preservation Initiative. Our approach involves about 20 prime and subprime lenders and servicers working together to find solutions. Through our efforts and partnership, we are creating an environment where responsible lending can occur for borrowers and neighborhoods in Chicago.

Over the years, NHS has been in the business of revitalizing neighborhoods and helping people become homeowners in neighborhoods. In the last few years, we have seen foreclosures resulting from subprime lending and predatory abuse in the neighborhoods. Therefore, our focus has shifted from creating opportunities for homeownership and reinvestment, to looking very closely at opportunities to sustain homeownership. We have to provide both services and products that help individuals sustain homeownership and improve a neighborhood's ability to revitalize without the burden and blight of foreclosed and vacant properties.

Our multi-tiered approach looks at the whole continuum of what happens when a buyer or borrower gets interested in a home. Obviously, we have a need for education. We need well-informed consumers who are aware of their choices and their options and are aware of what goes into the home-buying process. Knowing how to shop for a mortgage and understanding the terms of a mortgage offered by prime and subprime lenders is very important. So NHS is very focused on providing home-buyer education early on to families preparing for homeownership, moving them to loan pre-approval and readiness to buy.

Part of the ongoing education that we offer to homeowners and consumers is that they have multiple loan options. Certainly they should be aware of those options when considering financing and refinancing their home. An increasing number of families are taking equity out of their home to cover their daily living expenses or for lifestyle choices, a dangerous trend that does not bode well for individuals or their neighborhoods.

"The City of Chicago's 311 information number provides counseling for people at risk of foreclosure."

However, education is not the only answer. In my more cynical moments, when people talk about home-buyer education I say, "Look at driver's education. How does that impact driving patterns in the country?" Obviously, telling people what is right and helping them understand their options is not the only solution, because bad things still happen. Through our Homeownership Preservation Initiative, we have developed relationships with the private and public sectors to touch people when they get into those situations. The City of Chicago's 311 information number provides counseling for people at risk of foreclosure. We commend the City and the Department of Housing for their involvement in this effort.

Homeowners at risk of foreclosure are encouraged to call the 311 hotline, staffed by a real person 24 hours a day, 7 days a week. The hotline connects them with a counseling agency that can provide an on-the-phone counseling session lasting 45 minutes to an hour. In some cases, their loan servicer gets on the phone to talk about mitigation measures or a plan to keep them out of foreclosure.

Beyond that, people can visit local agencies, NHS being one, for that kind of assistance. Through this new partnership of nearly 20 lenders, we now have contact with servicers and people who can make decisions about payment plans and mitigation measures, a connection we did not have a few years ago. As part of this initiative, servicers also are learning from one another about practices others have developed that they can use.

"The chances of successfully keeping a family in a home and solving a problem go up immeasurably with contact between borrower and servicer."

Our partnership also provides an opportunity for lenders to contact borrowers in default where previously they might nothave been able to reach that customer. We regularly hear from servicers that they never have contact with the majority of their customers going into default and foreclosure. They do not call or return phone calls. They do not respond to mailings. The chances of successfully keeping a family in a home and solving a problem go up immeasurably with contact between borrower and servicer. The 311 line and our partnership with lenders and servicers have increased the chances of that kind of contact occurring dramatically.

A mechanism for solutions also must be available, beyond just providing counseling and intervening with borrowers who are in trouble. In some cases, we can work out a loan modification with the lender or servicer. We also can come up with a payment plan that will work for the borrower. For some, the only solution is making alternative financing available, including refinancing the existing loan or what we call a foreclosure intervention loan. This loan is for a borrower with a temporary interruption of income or some kind of personal family catastrophe preventing them from making mortgage payments. They could get back on track with mortgage payments if they had a small amount of help to reinstate their mortgage and bring it current.

We have loans for that situation. We also are looking at refinances, whether with an existing lender which we have been able to work out in some cases; with another lender; or through our own resources.

In addition to our partners in the Homeownership Preservation Initiative, NHS is fortunate to have another partnership involving 30 lenders who made a three-year commitment totaling $100 million that NHS loans to low- and moderate-income families and neighborhoods across the city. Through that $100 million commitment, NHS can originate loans to refinance borrowers out of improvident and unsustainable situations. People who have gotten into trouble with their mortgages are not going to present the best credit profile. We can work with them, providing counseling. In some cases, we can negotiate a reduced payoff with the existing lender, and then refinance their debt under more affordable and sustainable terms. That ability helps us address some situations we previously could not address.

Beyond counseling and these tools to help people stay in place, we inevitably face the result of foreclosures: vacant properties. Years ago, the majority of foreclosed and vacant properties in Chicago's neighborhoods were the result of FHA-insured loans. Now, we see more and more of these vacant and foreclosed properties resulting from loans that were perhaps improvident or fraudulent, or perhaps resulting from very generous underwriting attempting to push homeownership further. Often, the family loses their home, leaving their house vacant. These vacant properties exert a deteriorating influence in the neighborhood, creating a focal point for drugs and crime. This blight undermines the confidence and the sense of belonging for people on the block.

Through the Homeownership Preservation Initiative and our partnerships with other lenders, the City, and HUD developed over the years, NHS is focusing on acquiring and taking control of those vacant properties and rehabbing them for resale. Through our development corporation, we acquire, rehab, and resell vacant single-family homes in neighborhoods around the city. We primarily focus on eight neighborhoods where we have neighborhood offices, but we also have a presence in the City's other low- and moderate-income neighborhoods.

We have found that feedback to lenders and communication between lenders and servicers is vitally important to this process. Through our neighborhood operations, we run into instances of mortgage fraud. Our feedback to the lenders lets them know they have acquired a loan that was fraudulent from the beginning. In our meetings with initiative partners, people talk about what they do as a common practice to develop a watch list of brokers, appraisers, and title companies that are problems. Others sit around the table saying, "You mean you could do that? You could actually identify the bad players and refuse to do business with them?" So facilitating communications between lenders and feedback to lenders from community-based organizations is essential to this approach.

Robin Coffey, James Wheaton, Allan Kingston

Going forward, we want to standardize that feedback and make sure it is more broadly available within the industry, among our partners, and to other key neighborhood partners. We want to make them aware that they have alternatives to just sitting back and seeing this happen, and then dealing with the aftermath.

MS. ROBIN COFFEY: Thanks Jim. Allan?

MR. ALLAN KINGSTON: Thank you, Robin. Good morning. When she introduced Jim, Robin said he would report on Chicagoland. Now, I have the ultimate satisfaction of reporting on LA-LA-land, an unfortunate moniker Los Angeles has acquired along the way.

Los Angeles presents a slightly different circumstance than Chicago. Although I will talk about what admittedly are some anecdotes, they give insight and understanding on what is happening in the real world. I will give you a report of what is actually happening from my experience on the ground. I could have easily titled my talk,"Predatory lending is alive and working well where we work."

So you can understand the community in which we work, I have to tell you about Century, a non-profit that is primarily a lender. We make loans on a smaller community basis and on a regional or intermediary basis. We are a social lender with a very strong commitment to a double bottom line. We link our financial programs with several social programs such as after school tutoring for at-risk youth, job training for men and women to enter the construction trades, senior wellness programs, child development services, and homeownership counseling. Century's programs have helped more than 20,000 families and individuals over the last several years, and we put them all together in an approach we call "more than shelter."

"Century's programs have helped more than 20,000 families and individuals over the last several years, and we put them all together in an approach we call 'more than shelter.'"

Our primary business remains lending. We are on both sides of lending, both creating and sustaining affordable housing. We helped to finance more than

11,000 affordable homes throughout the Los Angeles metropolitan area. About 20 percent of these homes have been single family. Our nonprofit lender has no deposit insurance, and we therefore do not have four or five tests to go through every year. However, the state of California does check up on us.

Our experience with homeownership dates back to our earliest days when we were a part of the state government system in California, before we were privatized as a non-profit organization in 1995. Originally, we provided replacement housing, but not always the financing, for families being displaced by construction of a major freeway across some of the poorest low-income minority neighborhoods in the LA metropolitan area. You may be familiar with South Central Los Angeles areas such as Watts, Willowbrook, the City of Compton, the City of Englewood, and Hawthorne. Ninety-five percent or more of the homeowners in these communities are minority households.

Many lenders became involved in thousands of loans made across a wide swath of South Central LA. Century itself financed and sold more than 2,000 detached single-family homes and condominiums to displaced residents during this period. We remain responsible for keeping those homes available and affordable to low-income families for a period of 30 years, although recently this was changed to 15 years. Our experience from this program taught us a great deal about the need to educate both residents and lenders: residents about the responsibilities and costs of homeownership, and lenders on dealing with the residents in an area like this.

The single most important factor in our ability to work with the community and these thousands of homeowners has been establishing a resident ownership services division in our own organization. This division became the counselor to people who had purchased homes through our program, or were experiencing difficulties refinancing their homes or with finances generally. One of the major trends we are seeing in this work is the impact of lending practices on low-income homeowners with homes appreciating faster than their incomes can support. Many of these families have an immediate and strong need to meet medical, educational, and other typical household expenses, such as a car breaking down. Because of these needs many families—mostly working families, but also in particular seniors—turn to lenders who, whether classified as subprime or predatory, take advantage of these folks.

After almost 20 years of experience with these lending practices and in these communities, we find that often, some mortgage lenders offer interest rates to low-income families and seniors at very high rates, making it almost impossible to pay back the loans. More and more, we are dealing with borrowers who, based on their income, cannot even demonstrate an ability to repay a loan. They are receiving loans so unrealistically underwritten that they end up losing their home. Unfortunately, we do not know about many of these cases until after the damage is done, so we cannot address them by early intervention. We are even finding growing rates of foreclosure in cases where we tried to do something early on.

The applicants do not fully understand the terms and conditions of their loans, and the true impact such loans might have on the property they own. The panel just before us did a great job of talking about many of these community issues, including prepayment penalties and fees, interest-only mortgages, and loans that are actually ARMs when people think they are getting a fixed rate mortgage.

The mortgage broker channel has been mentioned in prior discussion. Previous panelists mentioned how homeowners and homebuyers often feel brokers work in their best interests, and the most important message to these people is: "That is not the case; that simply does not happen." Education is the only way people will understand what is happening and the tremendous economic risk they face when they start with small amounts of equity.

The mantra of "education, education, education" sounds simple, but actually doing it is much harder in practice. Pre-purchase counseling never really seems to get to a key underlying issue that causes problems. Somebody with the desire to become a homeowner will go through any pre-purchase counseling program you want to give them, whether a two-hour session or 20 days of training. It does not matter. They will go through what program is required, but the bottom line is they just want to become a homeowner.

"Post-purchase counseling is really needed. This approach helps people know they have a real person that they can turn to..."

Post-purchase counseling is really needed. This approach helps people know they have a real person that they can turn to, that they can go to somebody and say "I have an issue." For people who are very close to the edge with a problem, we have a program providing default counseling. These people are likely to lose their home if they do not do something very quickly. To be successful, this program has to be widely known in the community. We go out to meetings held by community groups, churches, public officials, and meetings of all kinds to tell people about our programs. We spread the word about how we can help them understand the responsibilities of homeownership and what can happen if those responsibilities are not met.

I served as the chair of the National Housing Conference, the oldest advocacy organization for affordable housing in the United States. One of the great things we advocate for is homeownership, a great thing for many people. However, more than 20 years of working with many people in many situations, I have found that homeownership may not be for everybody. At some point, somebody needs to say, "Maybe it would be better if you wait a little longer and save some more money."

Lenders also need education. We need to make them aware that many loans are made with some kind of regulatory agreement attached to them. In our case, we have a "right to purchase" agreement allowing us to buy back any home at any time. We do exercise that right and buy back both condominiums and single-family homes. However, some of the lenders do not understand our right to purchase agreement. Many public agencies provide low-cost soft loans to homeowners, usually with 30-to-50-year terms, that eventually have to be paid. However, most of the communities and cities that do this do not have the ability to monitor these loans. Many times, when foreclosing on a particular borrower, the lender will ignore whatever is in the existing regulatory agreement.

We work diligently to make sure that lenders in the LA area are aware of the existence of our particular regulatory agreement giving us this right to purchase where we have such a loan. We have gone to court on at least 15 occasions to establish with lenders that we had a right to step in to stop a foreclosure. Our goal is simply to protect the affordability of these units. We have won every single case we have pursued, using our right established by the federal court consent decree under which we operate. On an industry-wide basis, better monitoring coupled with increased recognition and exercise of these rights would help avoid unnecessary foreclosures and their devastating impact.

An alarming trend we have seen recently is the use of credit card debt as a way to refinance. Using an equity loan to refinance a home can help where someone faces an emergency and needs to pull out cash to deal with their situation. However, the entire lending industry has not paid a lot of attention to the prevalent use of credit card debt. I doubt if the loan officers working down on the ground ever talk to the people who are marketing the credit cards for the same institution. Again, this is what we have seen in our work with low-income minority communities in LA.

Thank you for this opportunity to share our LA story, Robin.

MS. ROBIN COFFEY: One common theme we have heard is that additional help is available for those homeowners and homebuyers who need assistance. The challenge is trying to get those people needing help and counseling to listen and participate in the programs available to them. That is a difficult issue.

In some ways, Chicago's 311 campaign that Jim talked about is a success. However, the campaign is only reaching those people who, whether standing in a bus or on the "L" car, are thinking about their particular problem, see the sign posted, and make that call. Something has to trigger them to make that call. When we talk about general financial literacy, everyone agrees on the need. The challenge is integrating financial literacy within our education system and getting people to adopt a financially literate mindset.

Now, we will throw open this session for some questions.

MS. JUDITH KENNEDY: I want to comment on something you said. In other parts of the country, there is not the community infrastructure that exists in Chicago. Three or four years ago when we were talking about predatory lending, it was largely an urban issue. My advice to members of Congress and others was, "Find a local NHS." As wonderful as NHS is, they are not everywhere. Furthermore, I increasingly am seeing a rural problem.

I put this question more to Jim than to Allan, because rising house prices are not an issue here. I have been playing "Dear Abby" for this type of question, and I could use some help. Here is a typical question:

"Judy, if you can solve this mess, we'll erect a monument in your honor. Any idea how to keep a family of five with an annual household income of $15,000 in a house that they paid $154,000 for at 11 percent interest that is now appraised for $80,000? Rural County has had 6,000 foreclosures since 1995, one out of every five mortgages in the county. Predatory lending is a shorthand of misleading names for a whole mish-mash of problems, some of which should be prosecuted by the Attorney General. We would welcome any advice or suggestions you might offer, and we are serious about the monument."

So, Jim, here is your chance.

MR. JAMES WHEATON: In a situation like that, my first question would be whether the original transaction was completely legitimate. While not knowing the circumstances of this county, seeing a decline of 50 percent in the collateral value does not sound completely on the up and up to me. So I would start by asking what the original transaction was like, who was involved in it, and what recourse is available to get those particular actors and players back into the mix to sort out what actually transpired.

Robin alluded to how difficult it is to track back through the transaction and identify the broker and appraiser. What we had to do here in Chicago is literally go to the court when a foreclosure is filed and start digging through the documents to identify who those particular actors were. From your description, it sounds to me like there was perhaps some fraud or deception at the very onset.

My second question would be has there been a change in the circumstance with this borrower? Off the top of my head, their $15,000 a year income was not going to support a $150,000 home purchase; maybe it would at 1 percent, but not at 11 percent. So what has happened to that borrower's circumstances? If their situation has changed, other social and financial resources may be available to help them. Often, people are unaware of state and county programs that can help, but that may not be publicized widely due to limited funds. A good housing counselor should be in touch with what is available, and should work on this case to figure out what assistance might be brought to bear to solve the situation.

Barring more information, this sounds like an unsustainable situation for this family. A short sale negotiated with their lender may be the only option. They sell the home for whatever they can get for it. The lender accepts whatever they can get. The lender is going to lose money in the foreclosure regardless. The question is will they lose more or less. A short sale can help the buyer get out with whatever credit rating they have left intact. Obviously, there will not be any equity if the value of the home has dropped that much. The best solution is to prevent the emotional and psychological damage to the family caused by foreclosure, and ultimately putting that home into the hands of a new buyer, rather than having a vacant home.

AUDIENCE MEMBER: The Chicago Tribune had an article about a real estate agent, an appraiser, and a loan officer of a lending institution who were in collusion to make such a loan. The FBI looked at cases like this. They targeted Illinois as a hot spot for these types of activities. Judy, you might want to look at that approach as a possible recommendation.

AUDIENCE MEMBER: I am a big supporter of many approaches like pre-purchase counseling. My experience is that most people do not get an attorney in making the biggest purchase of their life. I am not talking about just low-income families either. Many of them think that the attorney for the lending institution is their attorney, but he is not there to represent their interest. My question is how much do you think that having an attorney would help, and do you stress the importance of having an attorney when they buy a house or make an offer? I can still remember the house in Madison I sold to a woman who was an attorney. When we went through that closing process, she was just blown away. She never saw anything so complicated.

MR. JAMES WHEATON: Well, I will answer that question wearing two different hats. NHS is a counseling agent, and works with literally thousands of potential homebuyers in a given year. We stress that very few people in the homebuying transaction are on the buyer's side, strictly speaking. The attorney is one, and the independent home inspector that the buyer hires is the other. That is about it. Everyone else has other interests they have to serve in the transaction. We stress that very strongly in our counseling.

Now, switching hats, NHS is a state-licensed mortgage lender. We have a related entity called Neighbor Lending Services. As a mortgage lender, we often deal primarily on the phone with attorneys representing buyers. Legal representation in home purchases spans a very broad spectrum of quality. Just having an attorney is not always a panacea for all problems. Clearly, having representation is critical, but we tell people constantly not to hire someone just because they say they are an attorney. Talk to your friends, neighbors, your co-workers, and others you know who have gone through a closing and ask the key questions. Did they answer your questions? Did they return your phone calls? Did they talk to you prior to the day of the closing? Did you meet them the first time at the closing when you have a stack of documents to sign? I would venture to say that half the time that is the borrower's experience with the closing attorney.

MR. ALLAN KINGSTON: I second what Jim said. He was being very kind. It would be wonderful if every buyer could have an attorney to advise him or her. That would be a great thing. However, the quality of the advice most folks receive, if they get an attorney, is abysmal. It is sad. I have seen legal counsel suck money from unfortunate homeowners more times than I have seen them really be of help. We keep a full-time legal counsel engaged in doing nothing but working with homeowners. We work with hundreds of homeowners. We simply cannot provide our legal services to everybody we deal with. It would be helpful if we could, but for many reasons, we cannot.

AUDIENCE MEMBER: Jim, I want to applaud you for the work you are doing to help families establish long-term successful homeownership. I would like more information on your work you are doing. What percentage are rescue loans, where you are helping someone get out of a bad loan? In addition, how many are what might be called "enhanced loss mitigation," where a loan was not necessarily abusive initially, but a family has run into some difficulty and you want to help them sustain homeownership?

MR. JAMES WHEATON: We expect to deal with somewhere between 1,000 and 1,200 clients each year who are either in or about to enter foreclosure. They have missed their first payment, and cannot make it. They need some assistance and advice. They may have been served with notice of foreclosure or are even farther down in the process.

The Illinois foreclosure process is lengthy. If a homebuyer does nothing from the day they miss their first payment until the sheriff shows up at the door, the process takes about 14 or 15 months. We see people in every stage of that process. We try to achieve a save in 50 percent of those cases. A save means working with the lender to develop a plan the homeowner can sustain, such as a loan modification, a refinance with a short sale, or a short payoff to a lender. In some cases, that save may be the sale of a home to another family. Our goal is two-fold. First, we try to put the individual borrower into the best situation possible. Second, a cliché in the NHS network is that the neighborhood is the client, and so we try to keep that home from becoming vacant and a blighting influence on the neighborhood.

So how does that 50 percent break down in practice? The majority of these saves now are resulting from mitigation and negotiation with lenders. Again, through our initiative, we are facilitating shared knowledge and shared learning among lenders. We are helping them see what others are doing and how certain servicers push the envelope in what they offer to customers. We have helped lenders look more closely at what they can do under investment agreements; in some cases, they find they can do more with one investor than with another.

Overall, our approach pushes the envelope by having the industry help us solve the problem rather than just offering an alternative loan or refinancing people into another product.

MS. ROBIN COFFEY: We are going to take one more question.

AUDIENCE MEMBER: Going back to the lawyers, have we thought about asking the American Bar Association to come and work with us on this issue? We in the financial industry have taken homeownership on as our issue. The ABA could help, whether through promotion, funding, or providing free legal services. We have not given them the opportunity to join to with us in the forum. We need to ask them to join with us because they represent a profession making a fair amount of money from this industry.

MS. ROBIN COFFEY: We will take up that question.

(A short recess was held.)

Panel 3–Where Do We Go From Here? The Future of Subprime Lending

MS. JUDITH KENNEDY: Let me begin by telling you about the people who are here. We have an extraordinary group that will synthesize what we have heard this morning, and share with us their own experience. This very difficult issue seems to be like an amoeba that keeps moving and transforming. Every time we think we are in control, we find we are not. So having the perspective of our last panel may help us divine the future shape and direction of this issue's evolution.

Former Federal Reserve Governor Ned Gramlich has played a major role as the key arbiter for federal bank regulators on subprime lending issues. In addition, he has been the key information source on indicators such as the growth of subprime lending and the extent of involvement by insured depository institutions.

In addition, we particularly are happy to have Tom Curry, a member of the Board of Directors of the Federal Deposit Insurance Corporation. Tom is going to play two roles today. Tom was the Massachusetts State Banking Director before he came to the FDIC, so he has the benefit of experience on the state level as well as about nine months of experience at the federal level. One reason a lot of us were excited when Tom Curry came to town is he has also been involved in founding some of our Massachusetts nonprofit members. Having a bank regulator who is also very experienced in all of the challenges of non-profit work is great.

Everyone here from Chicago knows Malcolm Bush. He is the long-time President of the Woodstock Institute and former chair of the Bank Regulations Committee for the Federal Reserve's Consumer Advisory Council. Malcolm is one of the leading thinkers and speakers on community reinvestment and community development.

Denis O'Toole, Malcolm Bush, Thomas Curry, Edward Gramlich, Judith Kennedy

Last but not least, Denis O'Toole, from HSBC Household. He is an honest broker who understands the importance of linking business and government for the best possible policy outcome, and is very familiar with these policy issues.

When Allen Fishbein said this morning, "Let the laboratories of democracy in the states work," I thought it would be fun to have a poll up here about whether or not that would be a good idea. Before we do that, I would ask each of the panelists if you have a couple of opening comments on what you heard today and where you think we will go from here. With an approaching election, I would ask you to gaze into your crystal ball to give us insight on who wants comprehensive legislation, when do they want it, and what it would look like. Ned Gramlich, in your years working with this issue, where do we go from here?

MR. EDWARD GRAMLICH: Okay. Thank you very much, Judy, for your kind words. At sessions like these, I find it a little more comfortable to listen than to talk. That is partly because I have a lot to learn, but also because when I talk, I get two questions. Why did we do some things that we did, and why did we not do some other things. Therefore, I realize I am a little bit vulnerable.

"There is a good-news-bad-news story about the growth in subprime lending. "

First, the discussion this morning has been very good at summarizing the issues. There is a good-news-bad-news story about the growth in subprime lending. The home ownership rate has gone up. In general, this is probably a good thing. People get a chance to build wealth. The high foreclosure rate in the subprime market has been central to our conversation today. Indeed, I will speak to that problem. According to our data, the non-foreclosure rate in the subprime market is still about 90 percent; so some, even much of the subprime market's extension of credit may be doing some good. Nevertheless, there are problems we are well aware of and are working to solve.

Now, I would like to comment on a few things said today before I address Judy's question. Steven Hornburg hit the government a little bit on making the pricing information available. Part of the reason for that void is we simply do not have that much data on subprime loan annual percentage rates. If you look at the distribution of loan rates in the prime market, all of the APR's seem to be at about the prime rate, but then you have this long tail of higher rates. However, we just do not have much comparable data for subprime loans. Disincentives against such disclosure exist for lending institutions.

On the Home Owners Equity Protection Act (HOEPA), Michael Calhoun complained about burdensome prepayment penalties. We had a hearing on HOEPA four years ago, where everyone was talking about lowering the trigger rate and including single premium credit insurance in the points and fees tests. We did that. However, it is like squeezing a balloon.

"Lenders with thorough compliance exams make roughly 45 percent of subprime loans."

We squeezed on trigger rates and credit insurance, and now points and fees are a problem.

Robert Mooney talked about supervision. For the share of loans in the subprime market, probably the most reasonable measure, our data shows a 45-45-10 pattern. Lenders with thorough compliance exams make roughly 45 percent of subprime loans. Subsidiaries of bank holding companies make the next 45 percent. The Fed has authority to regulate those institutions. Oversight of these institutions is complicated and fraught with politics, but we are moving ahead on that front. Independent mortgage companies make the final ten percent of loans in the subprime market. Everyone would like to see some regulation in that segment, but it is hard to know or find agreement on how to do it.

I agree with everything said on education and training. At the Neighborworks® America, where Tom and I serve on the board, we are doing our best on education and training. We have been working very hard on these activities, and now have a new book that you can get from Ken Wade on the industry's in's and out's. We also have been one of the main sponsors of the Homeownership Preservation Initiative James Wheaton described earlier today. However, we have a great deal of work remaining to do.

Now, a short answer to Judy's question is, "It's complicated." We all understand that national legislation would introduce more efficiency in the lending process, as national lenders would not need different programs for every state. In addition, we all understand that national legislation will be hard to come by. There has been extensive lobbying for such a law, but not much has happened. You will have to make your own political forecast, but Congress has not acted in recent history since HOEPA passed in 1994.

Therefore, turning to forecasting what will happen in the states, state laws on predatory lending could be all over the map. State regulatory regimes could gradually converge on a model for best practices for state regulation on predatory lending. In many areas of policy, national legislation was passed after incubating at the state level. Maybe this is one of those examples, and maybe it is not. I will take a definite "maybe" position on that. It is worth considering everything to combat predatory lending.

MS. JUDITH KENNEDY: Tom, you have been in a laboratory of democracy as a State Banking Commissioner. Now, you are inside the Beltway as director of the FDIC.

MR. THOMAS CURRY: I still have some provincial characteristics I have not shaken yet. My view of where the states are and how this will wash out is similar to Governor Gramlich's assessment. I am more optimistic about our direction due to the continuing role of the states in this process. Their contribution has been positive, if viewed over time. **From the work of the Fed, as well as the enactment of HOEPA and some state laws, a consensus is developing on identifying a predatory loan and its characteristics.** A common understanding is emerging on practices or terms often used with these loans that are inappropriate.

We have seen states experiment and learn from the results, a validation of the belief that states are laboratories of democracy. Where states have gone too far, provoking a negative response from market forces or rating agencies, they have pulled back. Georgia's legislature quickly reacted to the adverse market reactions to some of their law's restrictions, showing that states can be laboratories of democracy, trying and improving new approaches.

As a state bank regulator with responsibility for non-bank mortgage lenders and brokers, my experience shows that the real test for the state system—and the federal system as well—is supervision of these entities.

The states have progressed on this front. More and more states recognize the need to put in place strong licensing and regulatory regimes for lenders in general, and for subprime lenders and predators in particular. Usually, the state licensing function falls in the state bank supervisor's bailiwick. In my career in Massachusetts, I learned the need to adopt the bank regulatory model. A system should be in place with regular, periodic, and on-site examinations of lenders' and brokers' activities. This approach helps compliance by providing a deterrent effect.

However, procedures used by bank examiners are not necessarily appropriate to combat inappropriate market conduct and practices of brokers. Whether the Commonwealth of Massachusetts or the state of New York, states are moving toward testing market conduct. This approach uses investigators to get beyond the formal records to assess how lenders and brokers initiate these transactions and whether the sales practices used are appropriate.

Let me highlight some of the tactics we experimented with in Massachusetts.

• For instance, we would target all brokers using a particular subprime lender. In such an examination, we

Thomas Curry

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would see if we could discern any pattern or practice of abuses among the brokers.

• We would also explore how well the lender regulated or policed its brokers.

• Finally, using post-closing questionnaires, we would determine whether the legal transaction differed from the terms and conditions originally presented by the broker and lender to the borrower.

• We also would show up unannounced at closings to see what actually transpired at that closing and if the lender or broker used a bait and switch ploy.

States are creatively experimenting with different practices to address and curb inappropriate broker or predatory lending practices. States are also just beginning to share information and coordinate such activities as enforcement and licensing.

MS. JUDITH KENNEDY: Tom presents an ambitious agenda for the states. Malcolm, how does it look from the perspective of a community development researcher and experienced practitioner?

MR. MALCOLM BUSH: This conversation is very useful. Let me drill down into the research mentioned today. The research shows that the overall numbers do not represent the full scope and burden of this problem. The impact of predatory lending is more dramatic if, instead of focusing on overall national and regional statistics, you look at how it affects specific populations and communities.

"The impact of predatory lending is more dramatic if, instead of focusing on overall national and regional statistics, you look at how it affects specific populations and communities."

From 1995 to 2002, Chicago foreclosure starts—the beginning of the foreclosure process—increased by 238 percent, going from almost 7,500 to over 25,000 a year. As NHS first pointed out to us, foreclosures over this period shifted from being predominantly an FHA problem to a conventional loan problem. Over these eight-years, FHA-related foreclosures in Chicago increased by 105 percent, but conventional foreclosures increased by 350 percent, a major shift in the market segment producing the majority of foreclosure starts.

Taking these statistics down to the neighborhood level, the data show that this foreclosure problem is especially concentrated in predominantly minority communities. Predominantly white Chicago neighborhoods–those with less than ten percent minority populations in 2000—saw a 215 percent increase in foreclosures over these eight years. Over that same period, neighborhoods with minority populations of 90 percent or greater saw foreclosures increase by 544 percent.

In a related analysis, we controlled for neighborhood economic and demographic conditions, and found that subprime lending had a substantial impact on neighborhood foreclosure start levels. Between 1996 and 2001, for every 100 additional subprime loans made on owner-occupied properties in a typical neighborhood, nine additional foreclosure starts occurred in 2002 alone, over and above the 11 starts in an average Chicago tract. As you might imagine, these foreclosure starts are related to increased subprime lending. Between 1996 and 2001, a tract with 100 prime home purchase loans was expected to have only 0.3 additional foreclosures in 2002. A tract with 100 additional subprime home purchase loans was expected to have almost nine additional 2002 foreclosures.

This morning, Michael Calhoun of the Center for Responsible Lending talked about our research. I am going to turn the tables now and talk about his organization's research. One of the questions arising from the enactment of North Carolina's predatory lending law is whether lending declines in a manner that reduces legitimate credit to borrowers. Teasing out this impact is very complicated, but recently, the Mortgage Bankers Association asked Abt Associates to see what actually happened in North Carolina. The results of this research present some interesting trends.

First, a few years after the law was enacted, overall mortgage lending in North Carolina grew at essentially the same rate as in two comparison states. This study found that, after enactment of the North Carolina law, subprime lending by banks grew faster than in the comparison states. In addition, this study found that within North Carolina, subprime originations dropped for non-bank lenders, while more than doubling for bank lenders. Finally, in examining North Carolina's subprime market, the Abt study found that the state's subprime market still remained more developed than those of the neighboring states, consistent with two other studies' results. These studies support this conclusion with their findings that the subprime market share in North Carolina remained higher than in comparison states after the law was passed.

This clearly is good news. These statistics suggest that passage of this law helped foster new market opportunity for bank subprime lenders. More important, it looks as if the new North Carolina law is heavily affecting non-bank subprime lenders, constricting the lending volume in an industry segment where, as we have heard repeatedly today, much of the predatory abuse seems to occur. One could conclude that the North Carolina law has achieved its intended effect on their target.

A side-by-side comparison, done by the Center for Responsible Lending, of the study's results and how the MBA characterized those results revealed an interesting piece of information. The Center found that the study did not say what the MBA claimed. The Center concluded that the MBA summary presented a weighted view of good research, a conclusion echoed even by the actual researchers.

We can also learn from agreements between community groups and large lenders, as well as the "best practices" models that large lenders have established to change their approach to subprime lending.

On the one hand, I favor these agreements if they push best practices. However, these agreements have serious shortcomings. These problems are not hypothetical, and I say this with due consideration to experience. For instance, they are not enforceable; they are subject to change at the whim of the bank. We recently negotiated with a major lender who, only a few months ago, categorically agreed not to do A- loans. A few weeks ago, guess what happened? The same lender announced that it was going to do A- loans due to a change of opinion at the highest levels of the corporation.

Another problem is that often the banks do not provide the data necessary to monitor their compliance with the agreement. Quite frankly, over 30 years of experience suggests that if the data are not available for public inspection, you cannot put a lot of faith in adherence to an agreement's standards. Lastly, these agreements cover only a small number of banks, although typically large operations; they represent only a small fraction of the total number of banks.

I agree with Governor Gramlich's assessment of the chances for movement towards congressional adoption of the Miller-Watt bill, a standard we would be very happy to see put into national legislation. This bill does not contain a preemption provision, which would cause difficulty for some people here today. Preemption goes back to the notion of the role of states as laboratories of democracy. They can provide models to consider in creating federal legislation, but their job is not done when a national law is passed. We see federal legislation as setting a floor for responsible behavior, not a ceiling. With rapid changes and continued evolution in mortgage markets, state experimentation will still be needed even if federal legislation is enacted.

MS. JUDITH KENNEDY: Denis?

MR. DENIS O'TOOLE: I have three things to say to this audience. First, I agree with Malcolm that it takes time. One of my mentors once said to me, "Denis, the issues never change. It's the bill numbers that change." From that advice, you can get a sense of how long we have been working on many of these issues. Since 1992, two matters have been defining issues on my legislative agenda and for my company: regulating GSEs and curbing predatory lending. To put things in perspective, when you watch stories on CNN or read stories in the print media, they are always interested in an immediate result. However, in our business of public policy, results evolve over a longer period. So solving issues such as predatory lending takes a long time to accomplish. Many bills will be introduced and considered, but passing major reform takes time.

My second point is that this country's legislative issues are much more integrated, in part due to technology. Part of being a global bank is recognizing you deal with a global world. However, unlike some of our Washington colleagues, I think if you are going to be involved in discussions like we are having here today, you cannot focus exclusively at the national policy level. Rather than viewing this issue as a win or lose proposition determined on the federal stage, you have to deal at both the state and the federal levels.

I have seen states evolve, and believe they are much quicker at making policy changes. In Judy's and my time in Washington, I have seen a huge change in how states are viewed. When I came to Washington, state governments were much maligned; people had little confidence in the states. Quite honestly, those with the least confidence in state governments were many of the people in this room active in civil rights and other progressive issues of the 1960's. When the Republicans gained control at the national level, they returned power back to the states. As a result, anyone now involved in public policy must understand the need to work at both levels.

While working for a global bank, I do not automatically oppose democratization and experimentation at the state level in our internal deliberations. However, as a global bank, we are in competition somewhat with companies in the European Union. In some cases, we see Europeans moving towards preemptive regulation.

These observations lead me to my third point. I believe these dialogues are beneficial for getting all issues on the table. In that spirit, I would like to introduce an additional perspective to today's conversation. I was at a conference last week in Washington attended by the CEOs in the banking industry. As the person paid by these CEOs for doing what I do, I checked what the CEOs said were their key issues.

"My second point is that this country's legislative issues are much more integrated, in part due to technology. Part of being a global bank is recognizing you deal with a global world."

I thought this audience might find it interesting that one of their first issues, if not their number one goal, is what they called "regulatory rationalization." They see too many regulatory agencies overseeing their business. They are concerned that so many regulators involved in the process opens a company up to tremendous legal liability. From their point of view, they worry about the threat of litigation hanging over our entire society. As a result, rationalizing the regulatory structure is high on the CEOs list of concerns. A related concern is regulatory burden, a subject that the bank regulators know has been on the agenda for a very long time.

Their second priority, a topic discussed in this symposium, is getting uniform national standards on privacy and predatory lending. Privacy has been on the banking agenda for a long time at the CEO level. I found it interesting that they have now identified predatory lending as an area where they want to get something done. The third issue that they brought up is the direction of banking industry regulation, and CEOs see two big issues on their horizon. Finally, the future of GSEs is the topic of much discussion and speculation. I am not sure people have an idea what to do on the question of Fannie and Freddie's role and regulation.

The CEOs expressed these concerns as the IMF prepared to meet in Washington. These are many issues, and more than ever the CEOs of such Washington institutions now have to think in terms of global issues. Perhaps because of this worldview, some of my banking friends tend to view a federal solution as a Holy Grail. Despite the pressures of globalization, however, let me reiterate my firm belief. Today's banking industry has to play this game on at least three different levels: federal and state, as well as international.

QUESTIONS AND DISCUSSION

MR. MALCOLM BUSH: Judy, I would like to jump in here. You mentioned preemption. Of course, the OCC's preemption of the application to national banks of state laws on predatory lending dramatically alters the rosy assessment of what the states can do. The OCC action was a devastating blow, made worse by the fact that the OCC's guidance demonstrated a sophisticated understanding of the multitude of practices that can hurt consumers. Unfortunately, the OCC did not translate their guidance into the actual regulation, and instead set a single bullet standard not capable of addressing many facets of predatory abuse. Moreover, in preempting state law, the OCC took away states' ability to go beyond the regulation's inadequate protections. This action has been one of the most devastating blows to consumers in the last several years.

MS. JUDITH KENNEDY: I want to stay with that point for a minute. I come away from this session remembering the 90-10 statistic: 45 percent plus 45 percent adds up to 90 percent of subprime lenders involved in some way with insured depository institutions, with the remaining ten percent totally independent firms. Inside the beltway, suggesting that HUD go out and do real examinations on that ten percent of the industry stretches the imagination. However, some fraction of the other 90 percent are regularly examined. Mr. Gramlich saw the glass as half full because only ten out of every 100 subprime loans are in foreclosure, while Malcolm Bush sees a 10% foreclosure rate as a glass half empty. This begs the question of what laws are enforced, and in whose interest is it to require better enforcement?

MR. EDWARD GRAMLICH: In the interest of full disclosure, we bandied about two 90-10 splits. One 90-10 split represents the overall foreclosure versus non-foreclosure rate for subprime loans. Carefully listening to Malcolm's talk suggests he does not dispute the fact that overall, only ten percent of subprime loans end up in foreclosure, while 90 percent do not. I am perfectly willing to admit that some of those 90 percent that do not end up in foreclosure still have some kind of problem. I thought our discussion of HOEPA was very good in pointing that out. I also recognize that subprime loans in foreclosure are geographically concentrated in certain neighborhoods. So just focusing on the overall 90-10 ratio understates the impact of predatory lending. I certainly agree with that conclusion.

The other 90-10 split involves supervision. That ratio represents the split between loans made by subprime lenders who are and are not examined for compliance. Lenders with a complete compliance exam make 45 percent of loans in the subprime market. Forty-five percent are made by subsidiaries of holding companies where yes, we have legal authority to regulate, but actual oversight is a little more complicated. We are working on how to oversee these lenders, and some of the Reserve Banks are actually doing that. Assessing these subsidiaries' performance is potentially in the purview of compliance exams. The final ten percent of these loans are made by independent mortgage companies covered either under the states or by the FTC. I do not think HUD would ever conduct regular compliance examinations of these firms. Anecdotal evidence suggests that many of the problems occur in this segment, but what anyone can do is unclear absent new

“...but what anyone can do is unclear absent new legislation at either the federal or the state level.”

legislation at either the federal or the state level.

So these are the numbers. Is the glass half-empty or half full? You can spin them in whatever way you want. I am just presenting you the numbers and what, in my opinion, represents a non-spun view of them. I will let you do the spinning.

MR. THOMAS CURRY: Expanding on Governor Gramlich's comments, state regulations and examinations overlap federal coverage for the 45 percent of the loans made by subsidiaries of bank holding companies. Throughout the country, states previously not regulating non-bank mortgage lenders are increasingly doing so, and doing it aggressively primarily because of the impacts and consequences for local communities and their residents.

My other point is an area needing attention: the regulation of mortgage brokers currently is left largely to the states. We have dealt with the product issue, and we all know what a predatory loan looks like. We may not be able to do it neatly, but we have a good idea. The big problem is how those products are pedaled to individuals. The broker community does the marketing, and that is where state oversight really needs to be uniform. The states need to develop a process of examination and strong enforcement using a market conduct approach.

MR. MALCOLM BUSH: Judy, the glass could be half-full and half-empty at the same time. Let us look at this situation in a little more detail. Illinois passed its law several years ago, and then the problem becomes one of implementation.

“...a recent survey found that the majority of new Los Angeles homeowners think the value of their newly acquired property will increase by 22 percent annually for the next ten years.”

In addition,we have discussed the problem of high-cost, high-fee loans. A much broader problem is consumers getting into loans for which they pay too much, dramatically affecting their retirement and ability to acquire assets. Recently, *The Economist* did a story chiding the United States for its profligate ways. The article pointed out a recent survey found that the majority of new Los Angeles homeowners think the value of their newly acquired property will increase by 22 percent annually for ten years.

This statistic highlights another facet of the challenge we face. We are dealing with more than just the effect of mortgages that cost too much for low-income borrowers. Middle-income people are taking on costly mortgages with the unrealistic assumption that rising house prices mean they do not have to save for retirement. So the scope of the problem is much larger than just devastating foreclosures.

MS. JUDITH KENNEDY: I know there are other questions.

AUDIENCE MEMBER: This symposium has been very helpful to me. I agree with Governor Gramlich when he says the problem is a moving target. Subprime market players change tactics when regulators address a specific abuse. By the time you can enforce a new requirement, predators have already moved on to a new abusive practice. The other issue troubling me is borrower motivation. Education has some value, but we still have not addressed the deep-rooted problem of motivation. Even if you know better, you are going to go where you hear “yes.” Any other advice is not important at that time.

What if we looked at percentages of loan outcomes by lending institutions? Then, unless caused by circumstances unforeseen by the lender, a high percentage of foreclosures from a small percentage of lenders could trigger special scrutiny or enforcement actions. Is this a possible solution?

In light of this symposium's theme of “Let's Work Together,” my other question is how? I did not hear the answer today. How can we work together to bring about change? Even assuming everyone here today is in the ranks of the “good guys,” others will still do loans we think should not be made. How can we work together to combat this problem?

MS. JUDITH KENNEDY: Great question.

MR. EDWARD GRAMLICH: Let me try to answer that. I wear two hats here. Wearing my Federal Reserve hat, we have legal authority under HOEPA to make it difficult either to sell certain products, such as single premium credit insurance, or to act in certain ways. The “squeezing-the-balloon” problem I referred to earlier means you can make it hard to have a loan with one feature, but then lenders come up with another feature. You are always behind the game.

Along with Tom, I wear another hat; we are both on the board of the Neighborhood Reinvestment Corporation, which now goes by the trade name of

NeighborWorks® America. As the Chicago NHS is part of our network, we ultimately are sponsors of the Homeownership Preservation Initiative Jim Wheaton presented earlier today. Two aspects of that initiative use elements of our proposed solution. We are starting a very significant data study resembling your proposed "success analysis" as part of that initiative. We are getting foreclosure data that is quite new, and has all of our analytic economists very excited. We are going to try to get to the bottom of who gains, who loses, how much, and how does it happen? These issues are not well understood, and we are trying to work along with the Chicago initiative to gain new knowledge.

Jim also mentioned another important point. Very often, predatory lending and unfavorable refinancing does not result from an education deficit. Sometimes the borrower knows what is going on, but they are desperately strapped for cash. Therefore, another piece of the solution is coupling the lending with a way to tap alternative sources of credit. That feature is part of the Homeownership Preservation Initiative, and has been part of the lending counseling done by network members of NeighborWorks® America for a while. We are trying to address these problems, and we will continue to work on solutions.

MS. JUDITH KENNEDY: What are we doing to work together? Today's dialogue is part of that effort. These discussions are valuable because if we, the vanguard in fighting predatory lending, do not understand the facts, perceptions, and experiences, how can this problem be solved? Armed with reliable information, we can advocate for solutions.

Let me just use this question as an excuse to ask Denis O'Toole another question. I have heard the Attorney General of Iowa say publicly that since the North Carolina law was enacted, North Carolina business actually has increased for what used to be Household/HSBC North America. If true, what is the problem with the North Carolina law?

MR. DENIS O'TOOLE: If you look at a certain segment of the market, this is true. I think the tough question when talking about regulating subprime lending is, "Are we in danger of moving to a two-tiered system in this country?" The great majority of us work for larger financial institutions under the bank examination process. As I visit these people, the most frustrating question seems to be what to do with brokers. The issue seems to be how to get states to regulate the entry of brokers into the market appropriately.

"I think the tough question when talking about regulating subprime lending is, 'Are we in danger of moving to a two-tiered system in this country?'"

While many say the states are the solution to this problem, they are pushed in two directions. Many want the states to regulate brokers more aggressively. This pressure runs counter, however, to those who push states to encourage—or at least not discourage—free markets by not erecting barriers to people who want to start companies. If you go after the brokers, what kind of political backlash will you face from the small business community? The large bank CEOs I mentioned earlier are deeply troubled that these unregulated mortgage companies and brokers are having a free lunch because they can fly under the radar, while their own banking operations are facing more regulatory burdens.

I do not know the answer to the problem, unless the best-practices dynamic previously mentioned takes hold. If, for example, at some point, 75 percent of the states pass similar laws addressing predatory lending, is passage by a majority of the states not a democratic validation of that approach? Under those circumstances, why not enact that approach as national law? I suspect the reaction from companies like mine would be, "You cannot make the standards too high." Some would say there is a long tradition that, for the largest companies, the most stringent regulations are the best regulations. Stringent regulations can put your competitors out of business. In our democratic system, I do not know whether it would be acceptable to make the regulatory bar so high that only a few companies can comply. If you happen to be one of those companies, it could be a very good situation. However, what about the politics of all of the small entrepreneurs who complained that General Motors was made into the standard for the country?

MR. EDWARD GRAMLICH: When we held the HOEPA hearings, I kept hearing repeatedly that predatory lending is actually not good business. We have not done that study, but I would love to test that proposition. If you actually look at these independent loan companies, a lot of them do not last very long. Brokerage firms enter and exit the market regularly and in large numbers. This high rate of firm turnover suggests that starting a brokerage firm may not be the best line of business. I am not sure why this is the case, but that topic is worth studying.

AUDIENCE MEMBER: One question that has not come up today is "referring up" and the influence of bank holding companies' structures on whether or not that occurs. This seems to be a very important question in the context of Governor Gramlich's 45-45-10 split in the industry. I have heard that some large lenders, whether a depository or non-bank affiliate, will charge differently depending on which channel you enter for a mortgage. Obviously, lenders are not required to give a borrower the best credit for which they qualify. So even within this 45-45-10 structure, apparently these holding company structures use different pricing policies for different loan channels that can further disadvantage mortgage applicants. Opportunistic pricing drives what people have to pay, and in many cases, borrowers pay a lot more than they should over the life of their loan.

MR. EDWARD GRAMLICH: That is true. Bob Mooney of the FDIC would tell you that when compliance examiners come in and look, they would notice such overcharges. A full-bore compliance exam would identify and root out that practice. I am unsure what the legal grounds would be, but unfair and deceptive practices might be a starting point. With other parts of the market that are less carefully regulated, obviously what you said is true. While not a violation of law, it is a violation of good banking practice. This abusive practice is an obvious candidate for action, but our current legal framework makes it a little bit hard to attack this problem.

AUDIENCE MEMBER: An important point mentioned many times today is that the average subprime borrower is taking a refi loan because they have a huge amount of debt. They need to consolidate or pay that debt off, and they need a new loan. Normally, banks do not see that kind of client, and we do not serve them very well.

Refer up works best when the product mix in the subprime and prime worlds is broadened and used by the best company.

> "The firm that figures out how to broaden their product mix and use all channels to serve customers' needs for all of these products will be successful."

The firm that figures out how to broaden their product mix and use all channels to serve customers' needs for all of these products will be successful. The subprime business has much better credit scoring mechanisms that serve a broader range of customers, but only with a very narrow product. This explains why the "refer up, refer down" model has not worked well yet. The products and the clients are so different. Wider adoption and integration of that credit scoring capability will yield tremendous benefits. Over the next two or three years, the key story will be subprime business affiliates of bank holding companies starting to take advantage of that broader marketing opportunity.

AUDIENCE MEMBER: While not accounting for all the price difference, is it true that different loan channels have different cost structures? Would that account for pricing disparities among an institution's different channels?

MR. MALCOLM BUSH: On the previous point, if both the prime and subprime channels have a variety of products, would you still aim for the day when you would offer the same pricing to a similarly situated customer, regardless of the channel they entered?

AUDIENCE MEMBER: Almost the same price. Mr. Hornburg's point about channel costs is correct, but these different costs are not huge. The difference could be between 50 and 100 basis points. The ideal is that, no matter what channel the customer enters, they get the best product for which they qualify at the best price.

MR. MALCOLM BUSH: We are not there yet.

AUDIENCE MEMBER: I agree, but many people are working to move us towards this ideal.

MS. JUDITH KENNEDY: Some institutions are committed to this ideal, and say so on their web sites.

AUDIENCE MEMBER: We are committed to achieving this ideal, but the truth is that it is very hard to do. We are willing to admit that we have not figured it out yet. Greater minds than mine are committed to and working on moving our business towards this model. If we are able to evolve our business practices in this direction, efforts to combat predatory abuse will move to a very different framework.

MS. JUDITH KENNEDY: Maybe we can also move forward if we reach a point where, to compete, banks need to advertise their examination results in the media, and must have a consumer-friendly web site.

Thanks to all of our panelists who shared their experience and insights. Most of all, thanks to all of you for joining us today and helping us learn how together, we can win the battle against predatory abuse.

The National Association of Affordable Housing Lenders (NAAHL) represents America's leaders in moving private capital to those in need. Started in 1990, NAAHL encompasses 200 organizations committed to increasing private lending and investing in low- and moderate-income communities. Members are the "who's who" of private sector lenders and investors in affordable housing and community economic development: banks, thrifts, insurance companies, community development corporations, mortgage companies, loan consortia, financial intermediaries, pension funds, foundations, local and national nonprofits, and allied professionals.

By pooling the knowledge and resources of our members, we can do an even better job of making a real difference. Through conferences, publications, public policy advocacy and other activities, NAAHL supports private investment in communities: in affordable housing, small business, micro-enterprises and community development. NAAHL is open to all community investment practitioners.

The Center for Community Lending, a 501 (c) 3 foundation, was formed by nonprofit organizations in 2000. It is dedicated to conducting and sponsoring research and education about community lending to expand the availability of credit, promoting revitalization of distressed neighborhoods and families, eliminating discrimination in lending and promoting equality of opportunity for access to credit.

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