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CONSUMER PROTECTION

Federal and State Agencies Face Challenges in Combating Predatory Lending

Statement of David G. Wood, Director
Financial Markets and Community Investment

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Highlights

Highlights of GAO-04-412T, a testimony before the Special Committee on Aging, U.S. Senate

CONSUMER PROTECTION

Federal and State Agencies Face Challenges in Combating Predatory Lending

Why GAO Did This Study

While there is no universally accepted definition, the term "predatory lending" is used to characterize a range of practices, including deception, fraud, or manipulation, that a mortgage broker or lender may use to make a loan with terms that are disadvantageous to the borrower. Concerns about predatory lending have increasingly garnered the attention and concern of policymakers, consumer advocates and participants in the mortgage industry. This statement is based on GAO's report, released at today's hearing, and discusses federal and state efforts to combat predatory lending; factors that may make elderly consumers more susceptible to predatory lending; the roles of consumer education, mortgage counseling, and loan disclosures in preventing predatory lending; and how the secondary mortgage market can affect predatory lending.

What GAO Recommends

In its report, GAO suggested that Congress consider (1) providing the Federal Reserve Board with the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of financial and bank holding companies to ensure compliance with federal consumer protection laws applicable to predatory lending, and (2) giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

www.gao.gov/cgi-bin/getrpt?GAO-04-412T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at 202-512-8678 or woodd@gao.gov.

What GAO Found

Federal agencies have taken a number of enforcement actions, sometimes jointly, using various federal consumer protection laws to combat predatory lending. The Federal Trade Commission (FTC) has played the most prominent enforcement role, filing 19 complaints and reaching multimillion dollar settlements. The Departments of Justice and Housing and Urban Development have also taken various predatory lending-related enforcement actions. Federal banking regulators report little evidence of predatory lending by the institutions they supervise. However, concerns exist about nonbank mortgage lending companies owned by financial or bank holding companies. While FTC is the primary federal enforcer of consumer protection laws for these entities, it is a law enforcement agency that conducts targeted investigations. In contrast, the Federal Reserve Board is well equipped to routinely monitor and examine these entities and, thus, potentially deter predatory lending activities, but its authority in this regard is less clear.

As of January 2004, 25 states, as well as several localities, had passed laws to address predatory lending, often by restricting the terms or provisions of certain high-cost loans; however, federal banking regulators have preempted some state laws for the institutions they supervise. Also, some states have strengthened their regulation and licensing of mortgage lenders and brokers.

While there are no comprehensive data, federal, state, and consumer advocacy officials report that elderly people have disproportionately been victims of predatory lending. According to these officials and relevant studies, predatory lenders target older consumers in part because they are more likely to have substantial home equity or may live on limited incomes that make them more susceptible to offers for quick access to cash. Older consumers may also have cognitive or physical impairments such as poor eyesight, hearing, or mobility that limit their ability to access competitive sources of credit.

GAO's review of literature and interviews with consumer and federal officials suggest that consumer education, mortgage counseling, and loan disclosures are useful, but may be of limited effectiveness in reducing predatory lending. A variety of factors limit their effectiveness, including the complexity of mortgage transactions, difficulties in reaching target audiences, and counselors' inability to review loan documents.

The secondary market—where mortgage loans and mortgage-backed securities are bought and sold—benefits borrowers by expanding credit, but may facilitate predatory lending by allowing unscrupulous lenders to quickly sell off loans with predatory terms. In part to avoid certain risks, secondary market participants perform varying degrees of "due diligence" to screen out loans with predatory terms, but may be unable to identify all such loans.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be here today to discuss federal and state efforts to deter predatory home mortgage lending, especially as it affects the elderly. While there is no universally accepted definition, the term "predatory lending" is used to characterize a range of practices, including charging excessive fees and interest rates, making loans without regard to borrowers' ability to repay, or refinancing loans repeatedly over a short period of time without any economic gain for the borrower. No comprehensive data are available on the extent of these practices, but they appear most likely to occur among subprime mortgages—those made to borrowers with impaired credit or limited incomes. Predatory practices, often targeted at the elderly, minorities, and low-income homeowners, can strip borrowers of home equity built up over decades and cause them to lose their homes.

My statement today is based on the report on predatory lending that you requested and are releasing today.[1] Specifically, my statement discusses (1) federal laws related to predatory lending and federal agencies' efforts to enforce them; (2) actions taken by states to address predatory lending; (3) factors that make elderly consumers susceptible to predatory lending practices; (4) the roles of consumer education, mortgage counseling, and loan disclosure requirements in preventing predatory lending; and (5) how the secondary market for mortgage loans can affect predatory lending. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans. In preparing the report, we examined federal laws, as well as selected state and local laws, and interviewed officials from federal, state, and local agencies. At GAO's request, federal agencies identified enforcement or other actions they have taken to address predatory lending. We also met with officials from industry and consumer advocacy groups and reviewed relevant literature. We conducted our work in accordance with generally accepted government auditing standards from January 2003 through January 2004.

[1]U.S. General Accounting Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280 (Washington, D.C.: Jan. 30, 2004).

In summary:

- Federal agencies have addressed predatory lending by enforcing a variety of federal laws, including the Federal Trade Commission Act, the Home Ownership and Equity Protection Act (HOEPA), the Real Estate Settlement Procedures Act (RESPA), and the Truth in Lending Act (TILA). The Federal Trade Commission (FTC) took 19 enforcement actions against predatory home mortgage lenders and brokers between 1983 and 2003—17 of them between 1998 and 2003—to combat alleged deceptive acts or other illegal practices, with some resulting in multimillion dollar settlements. The Department of Justice and the Department of Housing and Urban Development have also taken individual and joint enforcement actions related to abusive lending. While federal banking regulators—the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System (the Board), the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—report little evidence of predatory lending by the depository institutions that they supervise, concerns exist about nonbank mortgage lending companies that are owned by financial or bank holding companies. Our report recommends that Congress consider making statutory changes to provide the Board with clear authority to monitor, examine, and take enforcement actions against nonbank mortgage lending subsidiaries of financial and bank holding companies.

- As of January 2004, 25 states, 11 localities, and the District of Columbia have passed their own laws addressing predatory lending, according to a database that tracks state and local legislation.[2] In addition, some states have strengthened the regulation and licensing of mortgage lenders and brokers, and state law enforcement agencies and banking regulators have taken a number of enforcement actions under state consumer protection and banking laws. However, a state law may not apply to all mortgage lenders within the state. The Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration have asserted that federal law preempts some state predatory lending laws for the institutions they regulate, stating that federally chartered lending institutions should be required to comply with a single uniform set of national regulations.

[2]Information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation. These laws only include state and local laws that placed actual restrictions on lending. For example, they do not include local ordinances that consist solely of a resolution that condemns predatory lending.

- While there are no comprehensive data, government officials and consumer advocacy organizations have reported that elderly consumers have been disproportionately targeted and victimized by predatory lenders. Elderly consumers appear to be favored targets for several reasons—for example, because they may have substantial equity in their homes or live on limited incomes that make them susceptible to offers for quick access to cash. Further, some seniors have cognitive or physical impairments such as poor eyesight, hearing, or mobility that may limit their ability to access competitive sources of credit. While most government and private class-action enforcement activities seek to provide redress to large groups of consumers, some private efforts have focused on helping older victims of predatory lending.

- A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. Most of these efforts seek to serve the general consumer population, but a few education initiatives have specifically addressed predatory lending and the elderly. GAO's review of literature and interviews with consumer and federal officials suggest that while consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending. For example, consumer education is hampered by the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers, lack of access to relevant loan documents, and the sheer volume of mortgage originations each year limit the potential impact of universal counseling. And while efforts are under way to improve the federally required disclosures associated with mortgage loans, the complexity of mortgage transactions hinders the effectiveness of disclosures, especially given the lack of financial sophistication among many borrowers who are targeted by predatory lenders.

- The secondary market for mortgage loans—which allows lenders and investors to sell and buy mortgages and mortgage-backed securities—provides lenders with an additional source of liquidity and may benefit borrowers by increasing access to credit and lowering interest rates. But the secondary market may also inadvertently serve to facilitate predatory lending, both by providing a source of funds that enables unscrupulous originators to quickly sell off loans with predatory terms and by reducing incentives for these originators to ensure that borrowers can repay their loans. Secondary market participants use varying degrees of "due diligence"—a review and appraisal of legal and financial information—to avoid purchasing loans with abusive terms, but even the most extensive due diligence may not detect some predatory lending practices. Some states have passed laws making secondary market buyers liable for violations by loan originators, although such laws may have the unintended consequence of reducing the availability of legitimate credit to consumers.

Background

While there is no uniformly accepted definition of predatory lending, a number of practices are widely acknowledged to be predatory. These include, among other things, charging excessive fees and interest rates, lending without regard to borrowers' ability to repay, refinancing borrowers' loans repeatedly over a short period of time without any economic gain for the borrower (referred to as "loan flipping"), and committing outright fraud or deception—for example, falsifying documents or intentionally misinforming borrowers about the terms of a loan. These types of practices offer lenders that originate predatory loans potentially high returns even if borrowers default, because many of these loans require excessive up-front fees. No comprehensive data are available on the incidence of these practices, but banking regulators, consumer advocates, and industry participants generally agree that predatory loans are most likely to occur in the market for "subprime" loans. The subprime market serves borrowers who have limited incomes or poor or no credit histories, in contrast with the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. Subprime lending is not inherently abusive, and, according to officials at HUD and the Department of the Treasury, the emergence of a subprime mortgage market has enabled a whole class of credit-impaired borrowers to buy homes or access the equity in their homes. Originators of subprime loans most often are mortgage and consumer finance companies but can also be banks, thrifts, and other institutions.

Serious data limitations make the extent of predatory lending difficult to determine. However, there have been a number of major settlements resulting from government enforcement actions or private party lawsuits in the last 5 years that have accused lenders of abusive practices affecting large numbers of borrowers. For example, in October 2002, Household International, a large home mortgage lender, agreed to pay up to $484 million to homeowners to settle states' allegations that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and fees. In addition, the rate of foreclosures of subprime loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. Some consumer groups and industry observers have attributed this development, at least in part, to an increase in abusive lending, particularly loans made without regard to borrowers' ability to repay. Additionally, groups such as legal services agencies have reported seeing an ever-growing number of consumers, particularly the elderly and minorities, who are in danger of losing their homes as a result of predatory lending practices.

Federal Agencies Have Taken Enforcement and Other Actions to Address Predatory Lending, but Face Challenges

As shown in figure 1, Congress has passed numerous laws that federal agencies and regulators have used to combat predatory lending. Among the most frequently used laws—HOEPA, the Federal Trade Commission Act, TILA, and RESPA—only HOEPA was specifically designed to address predatory lending. Enacted in 1994, HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization. However, HOEPA covers only loans that exceed certain rate or fee triggers, and although comprehensive data are lacking, it appears that HOEPA covers only a limited portion of all subprime loans. The Federal Trade Commission Act, enacted in 1914 and amended on numerous occasions, authorizes FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. TILA and RESPA are designed in part to provide consumers with accurate information about the cost of credit.

Figure 1: Federal Laws and Statutes Used to Address Lending Practices Generally Considered to be Predatory

	Governing federal statute					Enforcing federal agencies			
Predatory lending practice	**TILA**	**HOEPA[a]**	**RESPA**	**FTC Act**	**Title 18 of U.S. Code**	**Federal banking regulators**	**FTC**	**HUD**	**DOJ**
Failure to disclose actual loan costs	●	●	●			●	●	●	
Prohibited fees and payments			●			●		●	
Lending without regard to ability to repay		●				●	●		
Loan flipping		●				●	●		
Fraud and deception				●	●	●	●		●
Prohibited prepayment penalties		●				●	●		
Prohibited balloon payments		●				●	●		

Source: GAO.

[a]HOEPA covers only a limited portion of all subprime loans.

Other federal laws that have been used to address predatory lending practices include criminal fraud statutes that prohibit certain types of fraud sometimes used in abusive lending schemes, such as forgery and false statements. Also, the Fair Housing Act and Equal Credit Opportunity Act—which prohibit discrimination in housing-related transactions and the extension of credit, respectively—have been used in cases against abusive lenders that have targeted certain protected groups.

Using these or other authorities, federal agencies have taken a number of enforcement actions and other steps, such as issuing guidance and revising regulations. Among federal agencies, FTC has a prominent role in combating predatory lending because of its responsibilities in implementing and enforcing certain federal laws among lending institutions that are not depository institutions supervised by federal banking regulators. FTC reported that it has filed 19 complaints—17 since 1998—alleging deceptive or other illegal practices by mortgage lenders or brokers and that some actions have resulted in multimillion dollar settlements. The Department of Justice, which is responsible for enforcing certain federal civil rights laws, has taken two such enforcement actions related to predatory mortgage lending practices and has taken an additional action on behalf of FTC. The Department of Housing and Urban Development has undertaken enforcement activities related to abusive lending that focus primarily on reducing losses to the Federal Housing Administration insurance fund.[3] It has also taken three enforcement actions in abusive mortgage lending cases for violations of the Real Estate Settlement Procedures Act's prohibitions on certain types of fees.

Federal banking regulators have stated that their monitoring and examination activities have uncovered little evidence of predatory lending in federally regulated depository institutions. Four of the five federal banking regulators reported taking no formal enforcement actions involving predatory mortgage lending, while the fifth—the Office of the Comptroller of the Currency—reported that it has taken one formal enforcement action against a bank engaged in abusive mortgage lending. Regulators noted that they have taken informal enforcement actions to address questionable practices raised during the examination process and required their institutions to take corrective actions. The banking regulators have also issued guidance to the institutions they supervise on avoiding direct or indirect involvement in predatory lending. In addition, in 2001 the Board made changes to its regulations implementing HOEPA that, among other things, increase the number of loans HOEPA covers. The Board also made changes to its regulations implementing the Home Mortgage Disclosure Act in 2002 that make it easier to analyze potential patterns of predatory lending.

Federal agencies and banking regulators have coordinated their efforts to address predatory lending on certain occasions through participation in interagency working groups and through joint enforcement actions. For example, FTC, the Department of Justice, and the Department of Housing and Urban Development coordinated to take an enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws within its jurisdiction.

Issues related to federal oversight and regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Nonbank mortgage lending companies owned by financial or bank holding companies (i.e., nonbank mortgage lending subsidiaries) account for an estimated 24 percent of subprime loan orginations, according to the Department of Housing and Urban Development, and some have been the

[3]The Department of Housing and Urban Development's Federal Housing Administration mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

target of notable federal and state enforcement actions involving allegations of abusive lending.[4] The Board may be better equipped than FTC to monitor and examine these holding company subsidiaries because of its role in overseeing financial and bank holding companies, but the Board does not have clear authority to do so. Our report recommends that Congress consider (1) making appropriate statutory changes that would grant the Board the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices and (2) giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries. In commenting on our report, the Board stated that while the existing structure has not been a barrier to Federal Reserve oversight, the approach we recommended for consideration by the Congress would likely be useful for catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would present tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on whether or not they are part of a holding company, and additional costs. However, these nonbank mortgage lenders are already subject to a different supervisory scheme than other lenders. We agree that costs could increase and believe that Congress should consider both the potential costs and benefits of clarifying the Board's authorities.

Many States Have Passed Laws Addressing Predatory Lending, but Federal Agencies Have Preempted Some Statutes

In response to concerns about the growth of predatory lending and the limitations of existing laws, 25 states, the District of Columbia, and 11 localities have passed their own laws addressing predatory lending practices, according to a database that tracks such laws. Most of these laws regulate and restrict the terms and characteristics of high-cost loans—that is, loans that exceed certain rate or fee thresholds. While some state statutes follow the thresholds for covered loans established in HOEPA, many set lower thresholds in order to cover more loans than the federal statute. The statutes vary, but they generally cover a variety of predatory practices, such as balloon payments and prepayment penalties, and some include restrictions on such things as mandatory arbitration clauses that can restrict borrowers' ability to obtain legal redress through the courts.

[4] These nonbank mortgage lending subsidiaries are owned by the bank or financial holding companies and are not the direct operating subsidiaries of the bank itself.

Some states have also increased the regulation of and licensing requirements for mortgage lenders and brokers, in part to address concerns that some unscrupulous lenders and brokers have been responsible for lending abuses and that these entities have not been adequately regulated. For example, some states have added educational requirements that lenders and brokers must meet in order to obtain a license. In recent years, state law enforcement agencies and banking regulators have also taken a number of actions against mortgage lenders involving predatory lending. For example, an official from Washington State's Department of Financial Institutions reported that the department had taken several enforcement actions to address predatory lending, including one that resulted in a lender being ordered to return more than $700,000 to 120 Washington borrowers for allegedly deceiving them and charging prohibited fees.

Three federal banking regulators—the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision—have issued opinions stating that federal laws preempt some state predatory lending laws for the institutions that they regulate. The regulators note that such preemption creates a more uniform regulatory framework, relieves lending institutions of the burden of complying with a hodgepodge of state and federal laws, and avoids state laws that may restrict legitimate lending activities. State officials and consumer advocates that oppose preemption argue that federal laws do not effectively protect consumers against predatory lending practices and that federal regulators do not devote sufficient resources toward enforcement of consumer protection laws for the institutions they oversee. In response, federal banking regulators have noted that federally supervised institutions are highly regulated and subject to comprehensive supervision. The regulators also said they found little to no evidence of predatory lending by the institutions they regulate.

Predatory Lenders May Target Elderly Consumers

Consistent observational and anecdotal evidence, along with some limited data, indicates that, for a variety of reasons, elderly homeowners are disproportionately the targets of predatory lending. Because older homeowners, on average, have more equity in their homes than younger homeowners, abusive lenders could be expected to target these borrowers in order to "strip" the equity from their homes. According to federal officials and consumer groups we contacted, abusive lenders often try to convince elderly borrowers to repeatedly refinance their loans, adding more costs each time—an abuse known as loan flipping. In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who may have limited incomes but require funds for major home repairs or medical expenses. The financial losses older people can suffer as a result of abusive loans can result in the loss of independence and security and a significant decline in their quality of life.

A number of factors may make the elderly particularly susceptible to predatory lending practices. For example:

- Diseases and physical impairments associated with aging—such as declining vision, hearing, or mobility—can restrict elderly consumers' ability to access financial information and compare credit terms. In such situations, potential borrowers may be susceptible to the first lender to offer what seems to be a good deal, especially if the lender is willing to visit them at home or provide transportation to the closing.

- Some older people may also have diminished cognitive capacity, which can impair their ability to comprehend and make informed judgments on financial issues. According to a report sponsored by the National Academy of Sciences, elderly people may be more likely to have conditions or disabilities that make them easy targets for financial abuse and they may have diminished capacity to evaluate proposed courses of action.[5] Representatives of legal aid organizations have said that they frequently represent elderly clients in predatory lending cases involving lenders that have taken advantage of a borrower's confusion and, in some cases, dementia.

- Several advocacy groups have noted that some elderly people lack social and family support systems, potentially increasing their susceptibility to unscrupulous lenders who may market loans by making home visits or offering other personal contact.

- Elderly homeowners often live in older homes and are more likely to need someone to do repairs for them. Federal officials, legal aid services, and consumer groups have reported that home repair scams targeting elderly homeowners are particularly common. For example, a joint report on predatory lending by the Department of Housing and Urban Development and the Department of the Treasury noted that

[5]Richard J. Bonnie and Robert B. Wallace, eds., "Elder Mistreatment: Abuse, Neglect, and Exploitation in an Aging America," Panel to Review Risk and Prevalence of Elder Abuse and Neglect, National Research Council (Washington, D.C.: National Academies Press, 2003), 393.

predatory brokers and home improvement contractors have collaborated to swindle older consumers.[6] A contractor may come to a homeowner's door, pressure the homeowner into accepting a home improvement contract, and arrange for financing of the work with a high-cost loan. The contractor then does shoddy work or does not finish the agreed-on repairs, leaving the borrower to pay off the expensive loan.

Federal agencies, states, nonprofits, and trade organizations have conducted and funded financial education for consumers as a means of improving consumers' financial literacy and, in some cases, raising consumers' awareness of predatory lending practices. Because the elderly may be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some of their education efforts on this population. For example, the Department of Justice offers on its Web site the guide "Financial Crimes Against the Elderly," which includes references to predatory lending. The Department of Health and Human Services' Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory lending practices targeting older consumers. AARP, which represents Americans age 50 and over, sponsors a number of financial education efforts, including a borrower's kit that contains tips for avoiding predatory lending.

However, federal consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons. For example, age is not a protected class under the Fair Housing Act, which prohibits discrimination in housing-related transactions. In addition, the Home Mortgage Disclosure Act (HMDA)—which requires certain financial institutions to collect, report, and disclose data on loan applications and originations—does not require lenders to report information about the age of the applicant or borrower. An exception is the Equal Credit Opportunity Act, which prohibits unlawful discrimination on the basis of age in connection with any aspect of a credit transaction.

Little comprehensive data exist on the ages of consumers involved in federal and state enforcement actions and private class-action lawsuits

[6] HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report* (June 2000).

involving predatory lending. Such actions generally seek to provide redress to large groups of consumers, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than $60 million. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans; an estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly.

Some nonprofit groups—such as the AARP Foundation Litigation, the National Consumer Law Center, and the South Brooklyn Legal Services' Foreclosure Prevention Project—provide legal services that focus, in part, on helping elderly victims of predatory lending. The AARP Foundation Litigation, which conducts litigation to benefit Americans 50 years and older, has been party to 7 lawsuits since 1998 involving allegations of predatory lending against more than 50,000 elderly borrowers. Six of these suits have been settled, and the other is pending.

The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

While representatives of the mortgage lending industry and consumer groups have noted that financial education may make some consumers less susceptible to abusive lending practices, GAO's review of literature and interviews with consumer and federal officials suggest that consumer education by itself has limits as a tool for deterring predatory lending. First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, provisions of the loan, and situation of the borrower—determine whether a loan is in a borrower's best interest. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information for them to determine whether a loan contains abusive terms. Second, predatory lenders and brokers tend to use aggressive marketing tactics that are designed to confuse consumers. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to such tactics. Finally, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information.

Prepurchase mortgage counseling—which can offer a "third party" review of a prospective mortgage loan—may help borrowers avoid predatory loans, in part by alerting consumers to predatory loan terms and practices. The Department of Housing and Urban Development supports a network of approximately 1,700 approved counseling agencies across the country and in some cases provides funding for their activities. While beneficial, the role of mortgage counseling in preventing predatory lending is likely to be limited. Borrowers do not always attend such counseling, and when they do, counselors may not have access to all of the loan documents needed to review the full final terms and provisions before closing. In addition, counseling may be ineffective against lenders and brokers engaging in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents.

Finally, disclosures made during the mortgage loan process, while important, may be of limited usefulness in reducing the incidence of predatory lending practices. Certain federal laws, including TILA and RESPA, have requirements covering the content, form, and timing of the information that must be disclosed to borrowers. However, industry and consumer advocacy groups have publicly expressed dissatisfaction with the current disclosure system. In July 2002, the Department of Housing and Urban Development issued proposed rules intended to streamline the disclosure process and make disclosures more understandable and timely, and debate over the proposed rules has been contentious.[7] Although improving loan disclosures would undoubtedly have benefits, once again the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices. Moreover, even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Finally, as with mortgage counseling, revised disclosures would not necessarily help protect consumers against lenders and brokers who engage in outright fraud or who mislead borrowers about the terms of loans in the disclosure documents themselves.

[7] 67 Fed. Reg. 49134 (July 29, 2002).

The Secondary Market May Benefit Consumers but Can Also Facilitate Predatory Lending

The existence of a secondary market for subprime loans has benefited consumers by increasing the sources of funds available to subprime lenders, potentially lowering interest rates and origination costs for subprime loans. However, the secondary market may also inadvertently facilitate predatory lending by providing a source of funds for unscrupulous originators, allowing them to quickly sell off loans with predatory terms. Further, the existence of a secondary market may reduce the incentive for originating lenders—who generally make their profits from high origination fees—to ensure that borrowers can repay.

Purchasers of mortgage loans undertake a process of due diligence designed to avoid legal, financial, and reputational risk. However, the degree of due diligence purchasers undertake varies. Officials of Fannie Mae and Freddie Mac—which are estimated to account for a relatively small portion of the secondary market for subprime loans—told us that their organizations undertake a series of measures aimed at avoiding the purchase of loans with abusive characteristics that may have harmed borrowers. In contrast, according to some market participants, the due diligence of other secondary market purchasers of residential mortgages may be more narrowly focused on the creditworthiness of the loans and on their compliance with federal, state, and local laws. However, even the most stringent efforts cannot uncover some predatory loans. For example, due diligence may be unable to uncover fraud that occurred during the loan underwriting or approval process, some excessive or unwarranted fees, or loan flipping.

Under some state and local legislation, purchasers of mortgages or mortgage-backed securities on the secondary market may be held liable for violations committed by the originating lenders—referred to as "assignee liability" provisions. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders, but some argue that it can also discourage legitimate lending activity. Secondary market purchasers that are unwilling to assume the potential risks associated with assignee liability provisions have stopped purchasing, or announced their intention to stop purchasing, mortgages originated in areas covered by such provisions. Assignee liability provisions of the Georgia Fair Lending Act were blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgements

For further information on this testimony, please contact David G. Wood at (202) 512-8678, or Harry Medina at (415) 904-2000. Individuals making key contributions to this testimony included Jason Bromberg, Randall C. Fasnacht, Jr., Elizabeth Olivarez, and Paul Thompson.

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