



NEWS RELEASE

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Before the

Robert Morris Associates/Consumer Bankers Association

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It is always an honor to have the opportunity to speak at a conference sponsored by Robert Morris Associates or by the Consumer Bankers Association -- this afternoon is a real doubleheader in that regard. Also, I could hardly think of a more appropriate forum than a "Consumer Risk Management" conference, sponsored by RMA and CBA, to talk about today's hottest consumer lending *and* credit quality topic -- predatory lending.

Concerns about predatory lending are attracting a great deal of attention in Washington and at the state and local level. Less than two weeks ago, the House Banking Committee held a day-long hearing on predatory lending, with testimony from *nine* regulatory agencies, scores of representatives from community and consumer organizations and the financial industry. There are at least five bills now pending in Congress to deal with predatory lending. In addition to expanding the coverage and provisions of the Home Ownership and Equity Protection Act ("HOEPA"), some of these bills would also impose restrictions on home mortgages generally, regardless of the rate.

Predatory lending also is the focus of attention at the state and local level. For example, North Carolina has enacted an anti-predatory lending law that is based on the high cost loan concept in HOEPA. In fact, it appears that the North Carolina law served as a model for some of the bills pending in Congress. To give you a flavor of additional state activity, Utah and West Virginia have recently enacted laws designed to address abusive practices in mortgage lending. The states of California and Massachusetts are considering high cost mortgage legislation, and the New York Banking Department has published its second regulatory proposal to address the issue. Finally, there is activity at the local level, such as here in Chicago, where the city is considering an ordinance that would bar what it would call “predatory lenders” and affiliates of such companies from doing business with the city, including being a depository of city funds.

What I’ll do this afternoon is discuss the concept of predatory lending, including the difficulty we face in trying to define and measure this activity, and describe the Federal government’s efforts in this area. But I also want to underscore the significance of the role *your institutions* need to play. This is an issue of major significance for the banking industry -- not only to help stop unacceptable practices by a few bad actors, but also to affirm the banking industry’s leadership role in promoting responsible lending to all segments of customers. To paraphrase a recent observation by Congressman John LaFalce, the industry should ensure that it is mainstreaming new consumers and new entrepreneurs -- not questionable practices -- into our banking system.

Let me begin by defining terms -- or perhaps I should say, by not exactly defining terms. “Predatory lending” often is used to refer to practices that share one or more of the following characteristics:

- Loans made in reliance on the value of the borrower’s home, without a proper evaluation of the borrower’s ability to repay without resort to foreclosure on the collateral, with the possible or even intended result of foreclosure or the need to refinance under duress;
- Pricing terms that far exceed the true risk and cost of making the loan;
- Targeting persons that are less financially sophisticated or otherwise vulnerable to abusive practices, or have less access to mainstream lenders, such as the elderly and persons living in low-income areas;
- Practices that are fraudulent, coercive, unfair or deceptive, or otherwise illegal;
- Loan terms and structures that make it difficult for borrowers to reduce their indebtedness;
- “Packing” into the loan unearned, or otherwise unwarranted fees or services, which may include prepaid single premium credit life insurance; and
- Loan “flipping,” that is, frequent refinancing with fees which strip equity from a borrower.

While we may all be able to agree that the individual lending practices that I listed are abusive, devising a general definition to the term “predatory lending” that avoids being either over-inclusive or under-inclusive is challenging.

“Subprime” lending illustrates the problem. As you all know, we have seen tremendous advances over the last several years in credit availability. With the increase in the availability of mortgage credit has come greater opportunities for home ownership and the accumulation of wealth -- two longstanding objectives of social and economic policy in the United States. Not surprisingly, improved access to credit can mean higher loan prices for subprime borrowers whose credit profiles present greater risks. While higher loan prices do not necessarily indicate abuses, testimony at the recent Congressional hearing stated that most predatory lending practices occur in the subprime market. And some observers have broadly -- and inaccurately -- characterized all subprime loans as predatory loans.

It does not follow that the improved access to credit by subprime borrowers generally involves predatory lending practices. There are a great many responsible subprime lenders who make credit available at rates that reflect the costs and risks of such lending without engaging in abusive lending practices, and these lenders frequently provide access to credit for borrowers whose options might otherwise be limited.

We do need to recognize, however, that some of the characteristics that cause a borrower to be a “subprime” credit, are also characteristics that may make that customer vulnerable to predatory lending practices. But when does “subprime” lending become “predatory” lending? The key is often what occurs at “ground level,” in the interactions between lenders and their customers.

If you will permit me to borrow a notion from the Discovery Channel to illustrate, you could say that a classic “predator” traps the unwary and preys on the weak. Put in the lending context, a predatory lender ensnares vulnerable customers with loan products designed to prey on their weakness, to bleed them financially, and in some cases, strip them of their most precious possessions. Loan features such as high rates, collateral requirements, payment structure, fees and services included, frequency of refinancing, and inadequate and misleading disclosures are simply means that can be tailored to that end.

Certain loan features may be indicators of higher risk of predatory lending patterns, HOEPA-covered loans are an example, but not all loans with such features will necessarily be predatory. This makes the extent of predatory lending occurring very difficult to quantify, but like pornography, you know it when you see it. Drawing on anecdotal evidence, some studies have concluded that predatory practices persist to a sufficient degree as to warrant legislative or regulatory action. For example, the 1998 Joint Report to Congress of the Federal Reserve Board and HUD proposing reforms to the Truth in Lending Act and RESPA stated that “[a]busive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections.”

When confronting this issue, two observations made at the recent Congressional hearing bear repeating. First, predatory lending often involves the abuse of credit terms that otherwise can be of value to many consumers. Second, these abuses seem to be occurring mostly in the unregulated

sector of the market by lending institutions that do not undergo periodic compliance examinations -- and thus additional governmental resources may be needed in order to track down -- and shut down -- the breeding ground of predatory loans.

These considerations, and the “you know it when you see it” nature of some predatory lending illustrates the difficulty faced by legislators who want to target abuses without affecting otherwise legitimate practices or affecting access to credit. The current challenge is to define predatory lending in such a way that distinguishes it from responsible subprime lending, and that draws the line between predatory and legitimate lending practices so that abuses can be addressed without impairing access to credit.

Without a doubt, government has a role in addressing predatory lending but, I hasten to add, by no means does it have the only role. Even if predatory activity is not being conducted to any significant degree by banks, the mere existence of some practices that have such potentially disastrous effects on homeowners and that could pose serious risks to the banking industry warrants the attention of the bank supervisory agencies. For these reasons, the OCC is taking a number of steps in this area. We plan to use our supervisory powers -- through our safety and soundness, fair lending, and consumer compliance examinations; our licensing and chartering process; and individual enforcement actions to address any potential predatory lending concerns that might arise in national banks and their subsidiaries.

For example, one common characteristic of predatory lending raises clear safety and soundness concerns. In our view, a mortgage loan for which there is no reasonable expectation of repayment without recourse to collateral is presumptively an unsafe and unsound loan, and making or purchasing such loans on a regular basis is inconsistent with safe and sound banking practices. To help address this concern, the OCC will issue guidance that directs our examiners to carefully review lending policies to ensure that they would not permit loans to be made or purchased for which there is no reasonable expectation of repayment without resort to the collateral. Loans fitting this profile will be adversely classified and further accrual of interest may be disallowed.

The OCC also intends to use its supervisory process to address the adverse fair lending implications of predatory lending. Areas where this can be manifested include selective marketing, customer targeting, and steering practices. We will be issuing additional guidance emphasizing that abusive lending practices increase the risks of unlawful discrimination. Depending on such risks, examiners may adjust the scope and focus of fair lending examinations.

The OCC also will continue to use its chartering and licensing authority to ensure that subprime lending by national banks or their subsidiaries will be conducted responsibly, and with appropriate consumer protections, in accordance with the applicable legal criteria. We will not approve proposals that are inconsistent with these principles.

Through our participation in an interagency working group -- which includes representatives from the bank and thrift regulatory agencies, the Departments of Justice and Housing and Urban Development, and the Federal Trade Commission -- we are working to learn more about predatory lending issues and to formulate possible responses. Also on an interagency basis, we plan to

address the CRA implications of predatory loans that might be originated or purchased by depository institutions. For example, it simply defies logic for equity-stripping loans to be viewed as helping to meet the credit needs of the bank's community for CRA purposes.

Finally, the other banking and thrift agencies have announced separate actions that they may take to address the risks of predatory lending within their regulated institutions. One agency has proposed the issuance of "effective practices" guidance to banks on how to underwrite or purchase loans that do not contain predatory terms.

The two principal government-sponsored housing enterprises -- Fannie Mae and Freddie Mac - - have announced their own initiatives to help ensure that their participation in the secondary mortgage markets does not lend support to predatory lending practices. Among other things, these institutions will require full-file reporting of borrower payment histories; will not purchase loans involving single-premium credit insurance; will require limitations on prepayment penalties to ensure that such provisions are not being employed in an abusive manner; and will not purchase loans that are priced so high as to qualify as "high-cost home loans" under HOEPA.

As I mentioned earlier, there are several bills pending in Congress to address predatory lending. Many provisions of these bills would fill gaps in the current legal framework and address many of the consumer abuses that exist. For example, they would attack "equity stripping" by strengthening the principle -- in HOEPA and in our safety and soundness supervision -- that home-secured loans should not be made without an individual determination that the borrower can reasonably be expected to repay the loan without resort to the collateral. They would also provide for "full file reporting" and ensure that responsible subprime borrowers can establish a credit history and have the opportunity to make the transition to lower-cost prime loans. The bills would address problems associated with loan "flipping" by further restricting the availability of balloon payments in HOEPA loans, by prohibiting the financing of fees in HOEPA loans that are refinanced with the same creditor, and by covering more loan brokers. Finally, they would address the "packing" of loans with fees for credit life insurance in which single premium payments are prepaid.

Federal, state, and local response to the concerns about predatory lending represent a two-edged sword for the banking industry. On the one hand, the industry should have no fear of standards designed to curb abusive lending practices. On the other hand, given the difficulty of legislating a precise definition of each potential characteristic of a "predatory" loan, the industry should be concerned that federal, state or local efforts could "overslide the base," and impose restrictions far beyond what is necessary to address consumer abuses that exist. For example, at some point, lowering the interest rate and fee thresholds for coverage under the new restrictions could deter responsible subprime lenders from entering the market. And, blanket bans on particular credit terms and loan structures -- such as pre-payment penalties and balloon payments - - could limit product choice and adversely affect a consumer's ability to negotiate other concessions, such as a lower interest rate or down payment.

Given these concerns and risks, what should the banking industry do? Because predatory lending is hard to define precisely, and practices or loan features that may be abusive in some

instances may be neutral, or even beneficial, in others, the industry should be very interested in avoiding a situation in which a regulatory or legislative response takes the form of a blunt instrument. In this regard, the industry could learn some valuable lessons from recent experience with another issue.

A little over two years ago, I spoke at a conference of the Consumer Bankers Association on an issue that ultimately played a major role in the debate over the financial modernization legislation. Part of my message was to issue a call to action by the industry. In that speech, I said:

“Failure by the banking industry to demonstrate leadership ... risks a ... backlash that could fuel legislative reactions at the federal and state levels [I]t is emphatically in the interests of the financial services industry ... to take the lead in demonstrating that self-regulation can and will work, and that public concerns ... can be addressed without requiring more draconian, externally-imposed solutions to the problem.

The banking industry today has a rare opportunity to step up to the plate and become a leader....”

As you might have guessed, that speech was about privacy. There are some parallels between the two issues that I urge you not to ignore.

For example, like privacy, there is a lot of emotional momentum on the predatory lending issue. Public interest organizations, regulatory agencies, and members of Congress all have voiced their concerns and announced proposals to address the issue. And, just as it was impossible to be “against” privacy, it is equally impossible *not to be against* predatory lending.

Both issues also raise significant reputation risk concerns for the banking industry. Both have an emotional content such that a set of bad facts has the potential to propel a legislative response. Do regulated depository institutions run the risk, for example, of being tarred with practices engaged in by a relatively few institutions, rarely involving insured depository institutions? Banks should be concerned when local governments threaten to withdraw city deposits unless they can certify that neither they nor their affiliates are “predatory lenders.”

Despite the fact that banks generally are engaged in responsible lending practices, legislative proposals already show the potential to “overslide the base” by imposing complete bans on loan terms such as prepayment penalties and balloon payment provisions in all mortgage transactions -- not just “high cost” loans. Interest rate caps have even been threatened by some.

This leads me to close by offering several suggestions, based on recent experience with the privacy issue:

- *First, do you know what your company is doing?* And I mean your whole company -- not just the bank. Are you satisfied that your company is not engaging in conduct that could sully the good name of your bank? If you don’t know, *find out*.

- *Second, has your company reviewed its lines of business to evaluate where there may be a higher risk of questionable lending practices? Does your company engage in any type of subprime lending? Is it conducted in the bank or in a separate entity? Are there risk management systems and controls in place to ensure that it is conducted responsibly, and without the kinds of abuses I have described? How do you audit that area? Have you considered appointing a special ombudsman for your subprime consumer lending business to focus on the unique concerns and risks that may arise there?*
- *Third, has your company evaluated how it uses third parties, such as loan brokers? Do you “know your brokers” and their practices? Do you have safeguards in place to ensure that the brokers’ fees, referrals, and other business practices do not raise fair lending, RESPA, or other legal risks? Do you require brokers to adhere to standards set by your company? Do you check to see whether they do? Most companies have sophisticated quality control and data integrity processes in place to protect their business operations. Do you have comparable systems in place to ensure the integrity of loans you obtain from brokers or buy in the secondary market?*
- *Fourth and finally, what have you done to show leadership? Compete to offer the best products -- ones that are both profitable and fill a credit need responsibly, on terms that are fair to consumers. Consider partnering with community-based organizations as a means of enhancing borrower financial literacy as well as developing new customers. Work to push the bad actors out of the business. Publicly embrace responsible lending standards -- whether they are developed by others, such as the Fannie Mae and Freddie Mac standards, by your company, or by an industry group. Government agencies should not have to write guidance for effective practices by depository institutions on how to avoid acquiring loans or securities backed by loans that have predatory features. You should be doing that yourselves.*

In fact, this subject would seem to be fertile ground for an industry initiative under the auspices of the CBA and/or RMA. The industry can and should take the opportunity to lead in addressing the predatory lending issue. Given where we are in this debate, the opportunity exists now for the industry to distinguish itself and to demonstrate what it is doing well.

You in this room, and the institutions you represent, have a challenge. How would your answer the four questions I have asked?

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The OCC charters, regulates and examines approximately 2,400 national banks and 58 federal branches of foreign banks in the U.S., accounting for more than 57 percent of the nation’s banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.