Written statement
before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

on

"PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES"

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Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to share our experiences and concerns about the growing problem of mortgage foreclosure in this country. Over the past fifteen years, AARP and AARP Foundation have been representing older homeowners facing foreclosure on abusive mortgage loans. The accumulated home equity and limited incomes of older homeowners have made them a primary target of predatory lending.

Fair and affordable financing is key to maintaining the dramatic increase in U.S. homeownership in the last decade, which reached a new high of 69% in 2004. It is especially important to sustain homeownership gains for those traditionally underserved, including low-income and minority communities. AARP is concerned that this record level of homeownership is at risk, however, as substantial numbers of homeowners experience problems with home mortgages. The key problem, which we are here to discuss today, is unsustainable loans made through predatory lending practices.

Today, many predatory loans are offered that target the most vulnerable Americans, including the elderly. We are very concerned that the current combination of minimal underwriting standards and exotic and complex mortgage products has created a perfect storm that is driving and will continue to drive homeowners into foreclosure. Allow me to give you three examples that illustrate our concerns and then review some measures we see as solutions to the most pressing problems.

The first case is from 1992, when we represented Mr. Pittman, an 82-year-old man on the verge of foreclosure. He had been a shoe salesman during his working years when he and his wife were able to purchase a modest home. Owning his home was perhaps the greatest single joy and source of pride in Mr. Pittman's life. His incompetence in later years, following the death of his wife, made him easy prey for predatory lenders. Mr. Pittman's mortgage had been paid off for eight years when he was offered a refinance by a broker that charged him 16 points on a $60,000 loan at a 17% interest rate. His mortgage payment was $800/month – the same as his total monthly income from Social Security and his small pension. The mortgage was starkly unaffordable and was typical of the subprime mortgages in the market prior to the passage of the Home Ownership and Equity Protection Act (HOEPA) in 1994. Since enactment of HOEPA, that picture has changed; HOEPA has had its intended effect of driving these bad products out of the market.

But HOEPA has not been entirely successful in curbing predatory mortgage lending practices, as my second example will show. In 1999, after HOEPA had been in effect for several years, we represented ten elderly and unsophisticated District of Columbia homeowners in a consolidated predatory lending case against a single lender. While a few of these homeowners had HOEPA loans, the points, fees, and interest rates on most of their mortgages squeaked just under the HOEPA thresholds. All had one thing in common: none could afford their mortgages.

They had worked all their lives in working-class jobs – in the cafeteria at NIH, on the cleaning crew at the Library of Congress, in various custodial jobs. Each had struggled to buy their homes, and most had raised children in them. When we met these elderly homeowners, they were in failing health. They were all retired – on Social Security, and perhaps a small pension. A few supplemented their income with small jobs: Mrs. Duncan, a 76-year-old Jamaican immigrant, received a small monthly check for doing in-home care for a mentally disabled woman; Mrs. Pittman did a little babysitting on the side. Imagine the surprise of AARP attorneys when, in reviewing the clients' loan documents, we discovered "self-prepared" tax returns that identified these folks as self-employed bookkeepers, accountants, and seamstresses. One gentleman, an 86-year old stroke victim in a wheelchair, had a tax return that described him as a computer programmer who made $30,000 a year.

As the case progressed, it became clear that the broker and lender had worked together to fabricate these tax returns to make it appear that our clients could afford mortgages whose monthly payments, in some cases, exceeded their incomes. Because our clients had owned their homes for decades, they had equity, and that was all the lender cared about. When we met them, they were all in default or had refinanced out of these mortgages into other, equally unaffordable ones.

In working on that case, AARP attorneys wrestled with the cause of these practices. We believed that the large banks that bought these mortgages could have easily prevented their origination if they had simply followed their own underwriting guidelines and done proper due diligence. Developments in recent years have forced us to see the stark reality—following underwriting guidance alone does not prevent the issuance of predatory loans, but this is not the case. In fact, predatory loans are consistent with today's underwriting policies, when they are used at all.

Historically, you may recall, mortgage applicants were required to establish their ability to repay with W-2s, tax returns, bank statements, or other verifications of income. I have vivid memories of applying for our first mortgage and worrying about whether we could establish that we met the 28% mortgage debt-to-income ratio that was the industry standard at that time. All of that has changed dramatically in the past few years.

The secondary market, which now controls the types of mortgage products offered and the underwriting standards that are applied, has made widely available what are called "stated income" and "low documentation" or "no documentation" mortgages. These mortgages require little or no verification that the borrower has the income necessary to repay the loan. The most recent innovation in this area is called the "no income, no asset" (NINA) loan. NINA loan applicants are not even *asked* to state, much less to *verify*, their income or assets. The income section of the loan application is simply left blank.

Industry representatives claim that these reduced documentation mortgages are useful to people who are self-employed or who want to qualify quickly. But they are harmful and predatory when abused – which is happening today. They are, we should add, much more expensive for the borrower and often more lucrative for the originators.[1] Research conducted for the Mortgage Bankers Association has revealed that these products, while "speeding up the approval process . . . are open invitations to fraudsters." In a sample of 100 stated income loans, the researchers found that almost 60% of the stated income amounts were inflated by more than 50%.[2] Even if there is a place for these loans in some specialized niches in the market, how can these products be responsibly used for a homeowner whose entire income comes from Social Security payments? And why would they be offered to salaried applicants whose income is readily established? They present real and clear hazards that are contributing to foreclosures. This is illustrated in my last example, a case filed in December 2005 in Brooklyn, New York.

The case involves a property flipping scheme perpetrated by a group of property investors, lenders, appraisers, and attorneys. The case alleges that the group conspired to sell our clients, all of whom were first-time home buyers, damaged houses that had been bought cheaply, cosmetically repaired, and rapidly resold at vastly inflated prices. Our clients' six homes were over-appraised by an average of $137,000.[3]

AARP attorneys could not fathom how our clients had qualified for mortgages on homes costing $315,000 to $419,000. Our investigation revealed that two of these homeowners were

[1] "Tremors at the Door," by Vikas Bajaj and Christine Haughney, *New York Times,* 1/26/07. See http://www.nytimes.com/2007/01/26/business/26mortgage.html?ei=5070&en=83083063d35e59a7&ex=1170565200&adxnnl=1&pagewanted=print&adxnnlx=1170459278-cykqqyeg4X3kWYQaE0/sLw.

[2] 2006 Mortgage Asset Research Institute's (AMARI) Mortgage Fraud Case Report at 12.

deemed "qualified" for their mortgages using the "no income, no asset" guidelines and a third using stated income that was inflated by the lender. One had been a salaried employee of the New York City Housing Authority for many years and therefore had stable (though modest) income, with clear documentation showing that her income was too low for her to afford the loan they were offering. Another was in her 70s and living only on Social Security benefits. All had income that was readily verified. But the homes would not have been sold nor the mortgage origination and other fees generated if their *verifiable* incomes had had to be considered. These "stated income" and "no income, no asset" products are the ideal vehicle to relieve unscrupulous lenders and brokers of the need to fabricate documentation, as was done in the past.

And this was not the only problem. In order to make the deal work, the lender piled on the risks – putting these folks into not one, but two mortgages each, commonly called "piggyback" lending. The first mortgage provided 80% of the purchase price, and the second mortgage, charging a much higher interest rate, made up the remaining 15-20% needed to close the deal. This structure may make sense, for example, for a first-year associate in a large law firm who will be able to pay off the second mortgage fairly rapidly as his or her income or bonuses increase significantly over a few years. But in the case of our clients, for whom steep income increases were not foreseeable, the piggyback mortgages, which depended on unreliable appraisals, combined with NINA loans, were a recipe for disaster that set them up for the defaults that inevitably occurred.

As these examples illustrate, inability to repay is the hallmark of predatory lending and is the single common thread among all of our cases stretching over fifteen years. We are very concerned that the inability-to-pay issues just described and the proliferation of stated and no income products

[3]Appraisal fraud has contributed to the foreclosure problem to a significant, but as yet unmeasured, extent. The 2006 Mortgage Asset Research Institute's Mortgage Fraud Case Report finds that appraisal fraud had increased from 2001-2005 and that the current figures will likely prove over time to be understated. MARI Report at 8-9.

create exponentially increased risk for homeowners, especially when combined with the so-called exotic mortgage products. The Office of the Comptroller of the Currency (OCC) and other regulators have warned against the dangers of this kind of risk-layering in their non-traditional mortgage guidance.

There has been a proliferation of new and confusing mortgage products, including "2/28s" and "3/27s" which offer a low interest rate for just two or three years that increases dramatically for the remaining 28 or 27 years of the mortgage; interest-only mortgages[4]; and payment option adjustable rate mortgages (ARMs), some of which are promoted with a 1% "teaser" rate that typically applies only to the first month of the mortgage and that can only adjust dramatically up, never down.[5] To the extent lenders underwrite the income supporting these loans at all, they do so only based on the deceptively low payments calculated on the low initial rate, not on the payment that will be charged once the loan becomes fully amortized and certainly not on the maximum rate

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[4] An interest-only mortgage is often structured with an initial fixed rate period during which time the homeowner pays only the interest owing on the mortgage and no principal. This arrangement reduces the payment amount during the initial period as compared with traditional fixed rate or adjustable mortgages, which require repayment of principal as well as interest. After the interest-only period, the mortgage rate becomes adjustable, typically higher than at the fixed rate, and both interest and principal are owing. Even when the interest rate does not increase, the payment will come as a shock, since the homeowner will now be required to repay principal over a period of 25 years instead of the original 30. For example, a traditional $200,000 mortgage at a fixed rate of 6% over 30 years would require a payment of $1199.10/month; an interest-only mortgage would require a payment of $1,000 for the first 5 years. Even at 6%, the payment would jump to $1288.60 in the 6th year. If, in addition, the rate increased to a modest 7.5% in the sixth year, the payment would be $1477.98. If $1199.10 was unaffordable to the consumer in the first place, those higher payments in the 6th and remaining years of the mortgage will create serious risk of default.

[5] Option ARMs, in theory, offer the homeowner the "option" to pick among a choice of payments. In reality, 70% of prospective homeowners select a credit-card-like, minimum payment option—currently as low as 1.5%—because it enables them to purchase a more expensive home. However, because the minimum payment amount (which is often less than the interest owing) only adjusts annually, while the interest rate adjusts monthly, this choice carries significant risks. A consumer who pays the minimum will face negative amortization and a constantly-rising principal balance of about 2.5% per year. Once the principal increases by a set amount—between 10-25%—the "minimum payment" deal is off and the consumer must immediately begin making fully amortizing payments, triggering real payment shock. For example, for a borrower who started out with a $200,000 mortgage with a 10% cap on principal, the mortgage will reset and become fully amortizing after 4 years with a principal balance of $220,000. An initial minimum payment of 1.5% or $690.24/month will rise to 7.5%/year or $921.79/month at the end of 4 years. At that point, the loan becomes fully amortizing. At 6% the payment would be $1394.09. At a modest increase to 7.5% the payment would rise to $1604.70.

that could be charged over the life of the mortgage. When these loans are originated without stating or documenting income, the result is just the kind of risk-layering the regulators have warned against.

Homeowners are often completely unaware that their conscientious payments based on "low introductory rates" are causing the balance on their mortgages to *grow* each month because the loans are negatively amortizing. These mortgages become a trap from which many homeowners never escape. The five-year prepayment penalties—often the norm for these mortgages—make it impossible for homeowners to refinance out of or otherwise avoid the complex series of "payment shocks" built into the mortgages. The trap has been fortified by the downturn in housing prices. Homeowners who have been able to escape foreclosure up to this point by repeatedly refinancing will have no further recourse. When the equity is gone, foreclosure is inevitable.

I cannot emphasize enough that this lack of underwriting standards is a disservice to the unsophisticated consumers who become the prey of predatory lending practices. These types of predatory loans strip equity from these hard-working Americans and set them up for failure. Requiring fair and accurate underwriting of prime and subprime loans is the first step in eliminating predatory mortgages and allowing these consumers to preserve their status as homeowners. Accurate underwriting will foster the development of a fairly priced subprime loan market.

Experience has taught that changes in the laws that regulate mortgage lending can improve the market for all. Immediately after HOEPA became effective, the number of loans above the HOEPA triggers plummeted; unfortunately, other abusive practices took their place. Our goal is to get ahead of this curve. AARP does not want homeowners to be caught in an endless "whack-a-mole" game, with the law always lagging behind the next wave of abusive practices. Our challenge is to find a way to address not only today's abuses but to think more comprehensively about how to make home mortgages safe and home ownership secure and sustainable.

In that vein, I wanted to share with you some of the policies that AARP believes should be put in place to curb today's abusive predatory lending practices, although these are by no means an exhaustive list of the policies we support. I also want to provide the caveat that predatory lenders may look for new practices that skirt whatever law is in place. Therefore, as effective as these policies may be in curbing today's egregious practices, we need to find a way to allow for new, innovative solutions to curb future abuses.

Of foremost importance is the need to require sensible underwriting policies that take into account a consumer's ability to make monthly payments based on all the terms of a loan. Underwriting should not be based not on the lower "teaser" rate, but should ensure that consumer has the ability to repay over the life of the loan. And remedies should be available for consumers when lenders falsify their income.

We also urge you to support the elimination of incentives for mortgage brokers and lenders to steer consumers into loans that are riskier than necessary or that charge excessive points and fees. For example, the inclusion of prepayment penalties in most subprime mortgages can serve as a *quid pro quo* for making expensive "yield-spread premium" payments to mortgage brokers, which increase the interest rate on the loan. Prepayment penalties, which can cost families thousands of dollars when they refinance or pay off their loans early, often are not accompanied by offsetting benefits to the borrower, such as a lower interest rate. Instead, they can serve as one way of stripping home equity or trapping borrowers in costly loans.

We also urge you to support accountability for abusive loan servicing. Abusive servicing can occur when loan servicers fail to promptly credit mortgage payments, resulting in unfair late fees and other charges to borrowers even when the payments are received on time. For example, a single late payment can lead to an escalating accrual of fees, month after month, even when the consumer has made all other payments on time. This occurs when each payment is credited first to the late fee and then to interest and principal, leading to multiple late charges for a single payment in arrears. Servicers should credit payments first to the principal and then to fees and other charges.

There are also a number of other policies that can help prevent predatory loans, such as a prohibition on mandatory arbitration clauses, further restricting or prohibiting balloon payments on loans covered by HOPEA, and strengthening assignee liability, among others.

In summary, today I have shed light on just a few of the egregious cases in the predatory lending market. More should be done to protect vulnerable home buyers from predatory practices, while leaving room for new policy solutions to deter future unscrupulous practices that will arise to skirt new consumer protections. AARP very much appreciates the Committee's work on this issue and looks forward to working with you to protect vulnerable consumers, particularly older homeowners, against predatory mortgage lenders.