Opening Statement of
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Home Ownership and Equity Protection Act of 1994
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Good afternoon Governor Kroszner and members of the staff of the Board of Governors of the Federal Reserve. My name is Mark Pearce, and I am Deputy Commissioner of Banks for the State of North Carolina. The Office of the Commissioner of Banks licenses and supervises over 1,600 mortgage lenders and brokers and over 17,000 individual loan officers. Thank you for permitting me the opportunity to testify before you today on possible regulations issued under the Home Ownership and Equity Protection Act (HOEPA), the national predatory lending law.

I do not envy your task. The mortgage market in this country is innovative and highly competitive. The evolution of the mortgage market has led to an efficient means of enabling capital to reach people that once had great difficulty in obtaining homeownership opportunities. Much of this system developed outside of depository institutions and was the result of market forces, not regulatory requirements.

On the other hand, these market forces have outpaced regulatory control and even the expectations of market experts. The same tools used to expand options for homeownership have mutated and been marketed in a manner that undermines sustainable homeownership. The laws, regulations, and systems designed to monitor the practices and the purveyors have not been up to the task of preventing abuses.

And so, the Board of Governors has an awesome responsibility – it must weigh the pressing need to reduce abusive lending with the recognition that market innovation has benefited the vast majority of homebuyers in this country through increased choice and lower costs.

In my comments today, I wish to offer you North Carolina's experience with these issues, and my views on today's marketplace. Despite the challenges, I believe HOEPA can be updated to inoculate against some of the ills we are seeing in the marketplace, without having a negative impact on innovation or market access.

The North Carolina Experience

In 1999, my home state of North Carolina enacted the first state-level supplement to HOEPA in order to reduce the incidence of predatory lending. At that time, the major abuses affecting North Carolina borrowers were financed single premium credit insurance, equity stripping through high fees and prepayment penalty charges, and the “flipping” of home loans, the practice of refinancing a home loan without a reasonable, net tangible benefit. This law passed with almost unanimous support – lenders and advocates, Republicans and Democrats. Despite this broad support, there were lenders that pulled out of the state – with great fanfare – only to return quietly a year or two later, once it became clear that other market participants were more than willing to serve the North Carolina market.

Over the past eight years, there have been a number of studies that have sought to assess the impact of North Carolina’s law on predatory lending and on lending in the market. While this argument is interesting and worth study, it is nearly irrelevant to the current debate about subprime hybrid ARMS, nontraditional mortgage products, and mortgage fraud. In short, while researchers built models and policymakers debated, market participants adapted to abide by the law without missing a beat, and unscrupulous lenders developed new tools and techniques to take advantage of our most vulnerable homeowners. Many of these tools were a perversion of innovative products designed to serve higher-income and more knowledgeable homeowners.

In 2001, North Carolina enacted a comprehensive licensing and supervision scheme for mortgage brokers, mortgage lenders, and individual loan officers. In the course of just five years, the Office of the Commissioner of Banks developed a state-of-the-art computer system to implement the licensing system, licensed thousands of companies, and tens of thousands of individual loan officers. Our office has conducted over 250 hearings on mortgage licensing matters. As we have implemented the system, we have continued to refine it, amending our licensing statute in each of the last five legislative sessions. Maybe we just didn’t get it right the first time, but I believe this frequent revision reflects a work in progress to find the right infrastructure to support the evolving mortgage delivery system.

Let me give you an example: A mortgage broker has its headquarters in Florida. The mortgage broker has a branch office in Ohio. The Ohio branch office has a loan officer that is licensed to do loans in multiple states. The mortgage broker works with a variety of multi-state lenders, some that are state-chartered non-depositories, some that are depositories or subsidiaries, some that are affiliates of depositories, and some that are joint ventures of different stripes from any of the above. Now, when a North Carolina homeowner receives a mortgage loan, the loan ultimately funded may touch three or four licensed entities. And this does not even consider many lead generators on the front end and correspondent lenders, and securitizers, on the back-end. And all of this gets us through origination of the loan and does not include entities that may service (or sub-service) the loan after origination.

This example illustrates two additional points. First, given the multi-state and dispersed method of originating loans, is it any wonder that the states, through the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, have banded together to develop a national licensing system to track these moving pieces more efficiently and cooperatively? The national licensing system will go on-line on January 1, 2008 and is the result of three long years of cooperative development. North Carolina will join the system next year, and will do so even though we have designed and implemented our own system just in the past five years.

Second, the fact that HOEPA regulations can apply to all participants in the mortgage market make them an extremely useful tool in correcting abuses in the marketplace. While state laws and regulations provide important laboratories for experimentation, we need federal support to be optimally effective in rooting out abusive lending.

In addition to licensing standards, the North Carolina mortgage licensing statute sets out duties expected of mortgage originators. Mortgage brokers have a duty to make reasonable efforts to secure a loan reasonably advantageous to the borrower and a duty to act with reasonable skill and care. All mortgage originators must act in good faith and fair dealing in connection with the brokering or making of a mortgage loan. These principles-based standards provide us with the ability to address many abuses in the marketplace, but reliance on principles-based rules alone will not provide the specificity to channel origination activity consistently away from abusive loan terms.

By now, it is old news that liquidity in the global capital markets with an appetite for mortgage securities coupled with excess capacity in the commission-driven origination sector led to a deterioration of underwriting quality and to mortgage fraud. In North Carolina, our examinations and observations in the last couple of years have noted:

1. sales and marketing practices that focus on initial monthly payment of the loan, often at the exclusion of meaningful information about future payment shock;
2. loan products with payment shock built in, leading the homebuyer to face a big jump in monthly mortgage payment regardless of changes in interest rates;
3. subprime loans originated with stated income; and
4. loans with indications of some level of material misstatement in the loan process.

What has been the impact of these practices? Frankly, it is hard to say. In 2007, North Carolina’s foreclosure filings are up about 10% from 2006 levels. For the three years between 2003 and 2006, North Carolina’s foreclosure filing rate was essentially flat. This is significantly below many other states in the country. I believe North Carolina’s foreclosure numbers are less stark than some other states due to a combination of a relatively affordable homeownership environment with moderate price appreciation and wage growth, lower proportion of subprime lending and adjustable rate lending than national average, and impact of predatory lending law and licensing enforcement to reduce incidence of loans with high fees and prepayment penalties. I’ll leave it to the economists to figure out how these factors played together, but I think they all played a part.

That is not to say that North Carolina has been a complete success story. In the three years after the predatory lending law, the rate of foreclosure filings more than doubled. In particular, foreclosure rates in newer-built subdivisions in metro areas increased dramatically. I believe payment shock and fraud are baked into many of these loans. Our continued moderate economic and home price growth may simply mask problems witnessed by my colleagues in other states, such as Michigan and Massachusetts.

As a result of this experience, we have increased our investigation and examination staff to address mortgage fraud. We have sponsored legislation to make mortgage fraud easier to prosecute as a felony, building on the success of a similar law in Georgia. We have sponsored legislation to make it easier to identify the loan originators active at the neighborhood level to help us see patterns of poor lending. We are developing better analytics to assess changes in origination activity faster to prevent our examination process from being a forensic exercise. We are looking at affiliated relationships between builders and lenders. We are aggressively enforcing our laws against brokers that have failed to uphold appropriate standards and lenders that have made loans without consideration of a borrower's ability to repay the loan. We have adopted the nontraditional mortgage guidance, and continue to work closely with other states to develop collaborative approaches to examination and enforcement. We are in the process of updating our requirements for financial responsibility of lenders, brokers, and loan officers to make sure participants have the wherewithal to keep promises made to North Carolina consumers. I do not think any of these steps is a silver bullet, but they all work together to establish fair standards in the marketplace.

Suggestions for the Board of Governors and Regulations Under HOEPA

The Federal Reserve has the opportunity to increase North Carolina's ability to police the mortgage market in a way that promotes wealth building homeownership. Updating the HOEPA regulation with a relatively small number of clear prohibitions and changes can remove much of the abusive lending we have witnessed in North Carolina.

<u>Regulations under HOEPA</u>

1. *Regulate prepayment penalties.* North Carolina law addresses prepayment penalties in three ways. First, North Carolina's predatory lending law includes prepayment penalties in points and fees (excluding one point if prepayment penalty length is less than 30 months). Second, North Carolina makes high prepayment penalties a separate threshold for high-cost home loan protections (any loan with a prepayment penalty longer than 30 months or more than 2% of the loan amount). Finally, North Carolina prohibits prepayment penalties for loans of under $150,000, which protects lower-income homeowners from getting locked into a loan. I recommend that the Board use its authority to prohibit unfair or deceptive practices to prohibit prepayment penalties in subprime loans. Given estimates by Freddie Mac and Fannie Mae of the number of borrowers with

subprime loans that would qualify for prime loans, we should remove barriers to these families to transition to less expensive loan products. In the alternative, the Board could revisit the HOEPA definition of points and fees to include all prepayment penalties in this calculation.

2. *Ban stated income loans in the subprime market, unless borrowers have irregular income.* Stated income loans are a major avenue for commission of mortgage fraud. We routinely find significant and material overestimation of income in subprime loans and are expending significant resources to address this fraud. In North Carolina, many subprime loans are hybrid ARMs with a stated income feature; however, these borrowers could have received a fixed rate loan at a comparable rate if they had provided full documentation of their income. While there are legitimate reasons for stated income loans, almost all borrowers in the subprime market have readily-verifiable and steady sources of income.

3. *Establish requirement that lender consider a borrower's ability to repay the loan at fully-indexed rate based on a fully-amortized payment schedule*. While this requirement is in the Agencies' nontraditional mortgage guidance (which North Carolina has adopted) and the proposed statement on subprime lending, many states may feel constrained about enforcing standards based on guidance directed at depository institutions. North Carolina has general authority under its requirement of good faith and fair dealing to enforce failure to use prudent underwriting in the mortgage origination process, but a regulation will eliminate any uncertainty in other states.

4. *Require escrows for taxes and insurance for subprime loans*. This requirement helps lenders and borrowers avoid unnecessary foreclosures caused by failure to budget for tax or insurance bills, and eliminates deceptive comparisons between loans with escrows and those without escrows. Since most subprime loans are sold on the basis of the monthly mortgage payment, we have observed instances where borrowers were sold a new loan thinking they were lowering their payment, when in reality they were only paying principal and interest on the loan. When the tax bill or insurance bill came later, they were forced to refinance the loan. Thus, failure to include escrows not only leads to deceptive marketing, but to flipping.

Improvements to Disclosures

In addition to improvements to existing HOEPA regulations, I would encourage the Federal Reserve to work closely with other federal agencies to revise the disclosures provided in the mortgage process. Having spoken with borrowers and lenders alike, I have never heard someone tell me that our current set of disclosures are effective in helping borrowers shop for the best loan for them. In fact, today's disclosures have the effect of enabling unscrupulous lenders to hide abusive terms in an incomprehensive mountain of paperwork, only to then assert that deceived borrowers should have been aware of these terms because they were disclosed in the thick stack of documents signed at a closing. At the same time, reputable lenders have burdensome costs of producing complex disclosures that are read or used by their customers.

On behalf of CSBS, I am pleased to offer a suggested disclosure form for your consideration. Although this is by no means a final or perfect product, we believe it is critically important to improve our disclosure system. This form sets forth information that would benefit many consumers as they shop for mortgage loans, while recognizing that no disclosure system will prevent abusive loans and will not in any way obviate the need for substantive regulation that I described earlier. I would encourage the Federal Reserve to once again use focus groups to develop new disclosures, as not everyone can decipher the literary style of lawyers and financial service regulators.

Conclusion

Today's dynamic mortgage market requires industry participants, regulators, policymakers, and advocates to work together to develop fair rules. The recent problems in the subprime market have exposed both the strengths and weaknesses of reliance on markets to promote responsible lending practices. Lenders, and investors in loans made by those lenders, have paid a price for irresponsible lending practices. The mortgage market itself has rapidly adapted to this "market correction" and yesterday's financial crisis has become today's market opportunity for other participants in the market.

At the same time, the irresponsible practices have had a devastating impact on some families and their communities. Market forces alone will not protect our most vulnerable homeowners. State and federal government must use the right tools at the right times to keep pace with changes in the marketplace. HOEPA did not solve predatory lending in 1994, and the North Carolina predatory lending law in 1999 did not either. The joint federal and state regulatory efforts on nontraditional mortgage guidelines and the statement on subprime lending are positive efforts, but still insufficient. I respectfully encourage the Board of Governors to update HOEPA to address practices that have caused harm, while recognizing that this is a continual work in progress.

Thank you for the opportunity to testify today. I look forward to your questions.