

PREPARED STATEMENT OF
THE FEDERAL TRADE COMMISSION

on

EFFORTS TO COMBAT
UNFAIR AND DECEPTIVE SUBPRIME LENDING

Before the

SENATE SPECIAL COMMITTEE ON AGING

Washington, D.C.

February 24, 2004

I. INTRODUCTION

Mr. Chairman and members of the Committee: I am Howard Beales, Director of the Bureau of Consumer Protection of the Federal Trade Commission.¹ I appreciate the opportunity to appear before you today on behalf of the Commission to discuss the Commission's efforts to combat unfair, deceptive, and other illegal practices in the subprime mortgage lending industry, among all consumers, including the elderly. The damage to consumers that dishonest and unscrupulous lenders can cause – loss of their life savings or even their homes – is potentially catastrophic. The Commission has maintained a vigorous enforcement program, achieving notable successes in halting illegal practices and returning hundreds of millions of dollars to defrauded borrowers. At the same time, the agency has been careful to avoid discouraging honest subprime lenders from making credit available to consumers.

The testimony today will discuss the Commission's authority to act against illegal subprime lending practices; the operation of the subprime lending market, including the considerable benefits that access to credit can provide subprime borrowers; and the Commission's enforcement and consumer education efforts.

II. THE COMMISSION'S LEGAL AUTHORITY

The Commission has jurisdiction over lenders in or affecting interstate commerce, other than banks, savings and loan institutions, and federal credit unions.² As part of its consumer protection mandate, the Commission enforces Section 5 of the Federal Trade Commission Act

¹ The views expressed in this statement represent the views of the Commission. My oral presentation and responses to any questions you have are my own, however, and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

² 15 U.S.C. § 45(a).

(“FTC Act”), which broadly prohibits unfair or deceptive acts or practices.³ That section has provided the basis for most of the Commission’s enforcement activity in this area. The Commission also enforces a number of laws that address specific aspects of mortgage lending and servicing practices, including the Home Ownership and Equity Protection Act⁴ and a number of consumer credit statutes.⁵

III. THE SUBPRIME LENDING MARKET

Subprime lending (also commonly referred to as “B/C” or “nonconforming” credit) refers to the extension of credit to persons who are considered to be higher-risk borrowers, usually due to their impaired credit histories. In recent years, subprime mortgage lending has grown dramatically. In 2003, subprime lenders originated \$332 billion in mortgage loans,⁶ compared to \$125 billion in 1997.⁷ Thus, the widespread availability of mortgage credit to subprime borrowers is a relatively new development.

The dramatic rise in subprime mortgage lending is part of a broader trend in this country of increasing availability of credit to populations that in the past could not qualify for it.⁸

³ See 15 U.S.C. § 45(a).

⁴ 15 U.S.C. § 1639. HOEPA, which is part of the Truth in Lending Act (“TILA”), provides additional protections for consumers who enter into certain non-purchase money, high-cost loans secured by their homes.

⁵ See the TILA, 15 U.S.C. § 1601 *et seq.*, which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions; the Equal Credit Opportunity Act, 15 U.S.C. § 1691 *et seq.*, which prohibits discrimination against applicants for credit on the basis of age, race, sex, or other prohibited factors; the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*; and the Fair Debt Collection Practices Act, 15 U.S.C. § 1692 *et seq.*

⁶ See “Top 25 B & C Lenders in 2003,” *Inside B & C Lending*, Feb. 9, 2004, at 2.

⁷ See “Top 25 B & C Lenders in 1999,” *Inside B & C Lending*, Feb. 14, 2000, at 2.

⁸ See, e.g., “An Overview of Consumer Data and Credit Reporting,” *Federal Reserve Bulletin*, February 2003, at 70; Fred H. Cate, Robert E. Litan, Michael Staten, and Peter Wallison, “Financial Privacy, Consumer Prosperity, and the Public Good: Maintaining the Balance,” AEI-Brookings Joint Center for Regulatory Studies, March 2003, *passim*.

Businesses increasingly use credit data to undertake risk-based pricing of credit and other products. Creditors' decision making has moved away from simple approval or denial and towards using credit data in a more finely-calibrated evaluation of what loan terms to offer.⁹ Consumers with excellent credit histories are offered products with optimal terms. Those with poorer credit histories, who in the past might have been turned down for credit, may now qualify, albeit on less favorable terms commensurate with the risk. The expansion of credit availability, which has been facilitated by our national credit reporting system,¹⁰ brings substantial benefits to consumers, including more choices for more consumers at more reasonable rates.

The growth in subprime mortgage lending has brought similar benefits. Subprime loans have provided access to mortgage loans, and thus home purchases, in communities that have been underserved in the past. Of course, subprime loan terms are less favorable than those available to prime borrowers, but higher rates are appropriate when commensurate with the greater credit risks involved. Empirical evidence suggests that subprime loans are different from prime loans in terms of the variety, complexity, and level of risks they pose.¹¹

IV. THE COMMISSION'S ENFORCEMENT ACTIVITIES

⁹ *Id.* See also Fred H. Cate, Robert E. Litan, Michael Staten, and Peter Wallison, "Financial Privacy, Consumer Prosperity, and the Public Good: Maintaining the Balance," AEI-Brookings Joint Center for Regulatory Studies, March 2003, at 12; "An Overview of Consumer Data and Credit Reporting," *Federal Reserve Bulletin*, February 2003, at 70 ("[consumer report] data and the credit-scoring models derived from them have substantially improved the overall quality of credit decisions and have reduced the costs of such decision-making"), citing Gates, Perry and Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved?" *Housing Policy Debate*, vol. 13, issue 2, 2002, pp. 369-91; and Barron and Staten, "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience," Credit Research Center, Georgetown University, 2002.

¹⁰ As the Commission testified last year, "[t]he development of a national consumer reporting system, with its sophisticated risk models and automated underwriting, has contributed greatly to making credit more widely, inexpensively, and rapidly available." Prepared Statement of the Federal Trade Commission on the Fair Credit Reporting Act, before the Senate Committee on Banking, Housing and Urban Affairs, July 10, 2003.

¹¹ See Office of the Comptroller of the Currency, "Working Paper: Economic Issues in Predatory Lending," July 30, 2003 at 11.

For the subprime market to operate efficiently for the benefit of consumers, it is critical that it be free of deception and other illegal practices. As the market has grown, however, some lenders and loan servicers have engaged in illegal practices to the detriment of borrowers. The Commission, working with its federal and state law enforcement partners, particularly, the State Attorneys General, has been active in bringing enforcement actions against such conduct. In recent years, the agency has settled or prosecuted cases against twenty companies in the subprime mortgage lending industry, involving numerous illegal practices by companies of various sizes, as well as companies operating in various regions of the country.¹² Several of these cases have resulted in large monetary judgments, including a record-setting \$215 million consumer redress order against Citigroup and The Associates.¹³

I would like to highlight a few of our recent enforcement efforts.

Citigroup/The Associates

In a landmark case concluded in September 2002, the Commission charged that two of Citigroup Inc.'s subsidiaries, Associates First Capital Corporation and Associates Corporation of North America ("The Associates"), engaged in systematic and widespread deception and other illegal lending practices.¹⁴ The Commission's complaint alleged that the defendants – at one time the largest subprime lenders in the U.S. – lured consumers into high-cost loans through false and misleading statements and half-truths about loan costs, packed single-premium credit insurance into loans, and violated numerous federal laws, including the TILA, the Fair Credit

¹² See *infra* pp. 4-8 and note 23.

¹³ The Commission also has acted to halt illegal practices in connection with subprime personal loans (that is, loans not secured by real estate). See, e.g., *Stewart Finance Co., Inc.*, No. 1:03-CV-2648 (N.D. Ga. 2003) (charging Stewart Finance and its affiliates with violating federal lending laws in the making of personal loans to consumers).

¹⁴ *The Associates*, No. 1:01-CV-00606 (N.D. Ga. 2001).

Reporting Act, and the Fair Debt Collection Practices Act. The defendants paid \$215 million for consumer redress to resolve the charges, in addition to a concurrent \$25 million class action settlement.

First Alliance Mortgage Co.

In another major case focusing on loan origination practices, the FTC and others, including six states, private plaintiffs, and the AARP, reached a major settlement with mortgage lender First Alliance Mortgage Co. in March 2002.¹⁵ The complaint alleged that the defendants' loan officers in their sales presentations made blatantly deceptive claims about monetary and other loan terms. Most disturbingly, the defendants allegedly promised consumers that the loans contained no upfront fees, when in fact they imposed exorbitant origination fees, typically 10 percent and as much as 20 percent of the loan. The settlement required the defendants to pay an amount equal to virtually the entirety of the corporate assets, as well as a \$20 million payment from the individual who founded and ran the company. Recently, the Commission announced that the redress fund will ultimately total about \$65 million for nearly 20,000 borrowers.¹⁶

Mercantile Mortgage Co. and Mark Diamond

In July 2002, the Commission, the Department of Housing and Urban Development ("HUD"), and the State of Illinois jointly settled a case against a regional subprime lender, Mercantile Mortgage Company, Inc., charging violations of the FTC Act, TILA, HOEPA, and the Real Estate Settlement Procedures Act.¹⁷ The Commission alleged that the company's employees, and one mortgage broker who was acting as its agent in soliciting and closing loans

¹⁵ *First Alliance Mortgage Co.*, No. SA CV 00-964 (C.D. Cal. 2000).

¹⁶ <http://www.ftc.gov/opa/2004/02/first.htm>. Injured borrowers have already been sent partial redress and will be receiving a second check in the near future.

¹⁷ *Mercantile Mortgage Co.*, No. 02-5079 (N.D. Ill. 2002).

on its behalf, misrepresented key loan terms to borrowers. As a result, many borrowers did not realize that their loans required large “balloon” payments at the end of their terms. The settlement required the company to make a \$250,000 payment for consumer redress and create a program to offer refinanced loans on favorable terms to certain borrowers with balloon loans.

At the same time, the Commission and the State of Illinois jointly sued the mortgage broker involved and ultimately reached a settlement providing for an additional \$270,000 in consumer redress.¹⁸ Last month, we sent redress checks to the consumers the broker solicited in an average amount of \$1,000.

Fairbanks Capital Corp.

In November 2003, the Commission, along with HUD, announced a settlement with Fairbanks Capital Corp. and its parent company.¹⁹ Fairbanks is one of the country’s largest third-party subprime loan servicers – it does not originate any loans, but collects and processes payments on behalf of the holders of the mortgage notes. The Commission alleged that Fairbanks received consumers’ payments that were made on time, but failed to post them until after the payment deadline had expired, and then imposed late fees and other charges as a result. It also challenged Fairbanks’ alleged practice of charging for homeowners’ insurance even though the borrowers already had insurance in place. The Commission further alleged that Fairbanks charged numerous fees to those borrowers whom it deemed were in default that were not authorized by the mortgage contract or by state law, or that were based on services that Fairbanks never performed. And, the complaint charged Fairbanks with violating federal laws in using dishonest or abusive tactics to collect debts, and in reporting consumer payment

¹⁸ *Mark Diamond*, No. 02-5078 (N.D. Ill. 2002).

¹⁹ *See Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003).

information to credit bureaus that it knew was inaccurate.

Through the settlement, Fairbanks will pay \$40 million in consumer redress.²⁰ Fairbanks also agreed to halt the alleged illegal practices and implement significant changes to its business practices to prevent future violations.²¹ Consumers have no choice about who services their loans, because loans are routinely transferred from servicer to servicer, and consumers cannot simply take their business elsewhere if they are mistreated. For that reason, it is essential that servicers comply with their legal obligations.

Capital City Mortgage Corp.

In January 1998, the Commission filed suit in federal court against Capital City Mortgage Corporation, a Washington, DC-area mortgage company, alleging numerous violations of federal laws both in its origination and servicing of subprime mortgage loans. For example, the complaint alleges that the defendant assessed unauthorized fees on borrowers' accounts, misrepresented the amount of money needed to pay off the loan, and foreclosed on borrowers who were in compliance with their loan terms.²² This case is scheduled for trial next month.

Other FTC Enforcement Efforts

In addition to the cases described above, the Commission has brought fourteen other actions alleging law violations by companies in the subprime mortgage industry.²³ As part of

²⁰ The FTC/HUD consent decree is being coordinated with a proposed class action settlement in which the company will make additional refunds to consumers. Both the FTC redress settlement and the proposed class action settlement, *Alanna L. Curry, et al. v. Fairbanks Capital Corp.*, No. 03-10845 (D. Mass. 2003), are pending court approval.

²¹ The Commission charged Fairbanks' former CEO with similar law violations, and he agreed to a settlement with the FTC and HUD requiring \$400,000 for consumer redress.

²² *Capital City Mortgage Corp.*, No. 1:98-CV-00237 (D.D.C. 1998).

²³ *Action Loan Co.*, No. 3:00CV-511-H (W.D. Ky. 2000); *First Plus Financial Group, Inc.*, No. 99-23121 (F.T.C. 2000); *NuWest, Inc.*, C00-1197 (W.D. Wash. 2000); *Delta Funding Corp.*, No. 00-1872 (E.D.N.Y. 2000); *Barry Cooper Properties*, No. 99-07782 (C.D. Cal. 1999); *Capitol*

this effort, the Commission has developed cooperative relationships with its sister federal enforcement agencies, as well as states and others, to coordinate enforcement. Working together allows us to leverage our resources to obtain increased remedial and deterrent effects of our actions. The many settlements that the FTC has obtained from subprime lenders provide a deterrent to others who might consider engaging in this type of conduct.

The Commission and other agencies routinely share information about potential targets and enforcement techniques. In 2003, for example, the FTC and the American Association of Residential Mortgage Regulators co-sponsored two enforcement summits that brought together representatives of federal and state agencies working in this area to share information and ideas. Activities such as these increase the effectiveness of our law enforcement.

V. CONSUMER EDUCATION

Of course, educated consumers are the first line of defense against fraud and deception. This is especially true for subprime borrowers, given the complexity of the loan transaction and many borrowers' limited experience in obtaining mortgages.

The Commission has implemented extensive programs to educate consumers about financial literacy generally, and subprime borrowing specifically. In October 2003, for example, the Interagency Task Force on Fair Lending (of which the Commission is a part) published a brochure, entitled "Putting Your Home on the Loan Line is Risky Business,"²⁴ that alerts consumers to the risks of home equity loans and makes recommendations to help borrowers avoid those risks. The Commission also has included education materials on mortgage loans in

Mortgage Corp., No. 2:99CV580 (D. Utah 1999); *CLS Financial Services, Inc.*, No. 99-CV-1215 (W.D. Wash. 1999); *Granite Mortgage, LLC*, No. 99-CV-289 (E.D. Ky. 1999); *Interstate Resource Corp.*, No. 1:99-CV-5988 (S.D.N.Y. 1999); *LAP Financial Serv., Inc.*, No. 3:99-CV-496 (W.D. Ky. 1999); *Wasatch Credit Corp.*, No. 99-CV-579 (D. Utah 1999); *Fleet Fin., Inc.*, No. C3899 (F.T.C. 1999); *Nationwide Mortgage Corp.*, No. 85-0976 (D.D.C. 1985); *R.A. Walker and Assoc.*, No. 83-2462 (D.D.C. 1983).

²⁴

Available at <http://www.ftc.gov/bcp/online/pubs/credit/risky.htm>.

numerous consumer redress distributions. For example, this month we mailed over 800,000 consumer redress checks to claimants in our case against The Associates that included a bookmark containing tips for shopping for a home equity loan.²⁵

VI. SUBPRIME LENDING AND OLDER CONSUMERS

A recent study found that the population of subprime borrowers tends to be older than the population of prime borrowers;²⁶ more than a quarter of subprime borrowers are 55 years of age or older, compared to only 14% of prime borrowers.²⁷ Therefore, while older Americans may have benefitted more from the expansion of the subprime market, they also may have suffered more injury from deceptive practices in the market. The Commission is not aware of any evidence that subprime lenders are engaging in illegal practices that specifically target the elderly. In our experience, the illegal practices cut across demographic groups. Nevertheless, these illegal practices can be particularly devastating to seniors.

The Commission has taken an active role in educating older consumers about abusive lending practices (as well as other consumer issues). We recognize that the American population is aging, and issues facing older consumers are therefore a priority for the agency. In recent years, the FTC has developed a series of publications, launched dedicated Web pages, and worked with numerous federal agencies and private sector partners to develop and disseminate plain-language education materials in English and Spanish aimed at, or of particular relevance

²⁵ To further the goal of preventing abusive lending, the FTC is conducting a research program designed to learn more about how consumers search for mortgages, what consumers understand about mortgage agreements, and how changes in the disclosure process might improve consumers' ability to avoid deception. *See* Notice of Proposed Information Collection Activity, 68 Fed. Reg. 19,825 (Apr. 22, 2003).

²⁶ Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, "Subprime Borrowers: Mortgage Transitions and Outcomes," *Journal of Real Estate Finance and Economics* (forthcoming 2004).

²⁷ *Id.*

to, older consumers. For example, among our numerous free publications are ones entitled “Getting Credit When You’re Over 62”²⁸ and “Reverse Mortgages.”²⁹

The Commission has been working to protect older Americans from illegal lending practices by educating them and using enforcement actions to halt law violations and return money to the victims. We will continue our vigorous efforts.

VII. CONCLUSION

The Commission believes that it is very important to preserve the benefits that increased access to credit bring, while preventing illegal practices from flourishing in the marketplace. Through our enforcement and consumer education, the Commission continues to work to protect consumers of all ages.

²⁸ Available at <http://www.ftc.gov/bcp/online/pubs/credit/over62.htm>.

²⁹ Available at <http://www.ftc.gov/bcp/online/pubs/alerts/revralrt.htm>.