

Testimony of  
**Center for Responsible Lending**  
by

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On

**“Improving Consumer Protections in Subprime Home Lending”**

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Mr. Chairman Dorgan, Ranking Member DeMint, and members of the Subcommittee, thank you for the invitation to appear before you concerning what has become one of the most important developments in the US economy in this young century. We have yet to know how many families will suffer the heart-wrenching and economically devastating experience of being forced from their homes and neighborhoods by foreclosure. The most recent estimate is for a total of 6.5 million foreclosures by 2012.<sup>1</sup> The subprime industry itself is decimated, and the International Monetary Fund recently estimated that direct mortgage losses will exceed \$500 billion, and consequential losses could reach nearly a trillion dollars.<sup>2</sup>

At root, it was the industry itself that recklessly abandoned sound business sense, with the consequences to the economy magnified and multiplied through complex financial instruments that spread the infection like a pandemic.<sup>3</sup> There were other factors, of course, but the consequences would have been much more contained had old fashioned common sense and prudence prevailed. Though it was highly profitable for a long while, in the end that recklessness ill-served everyone.

How could it have gone so wrong? How could it have gotten so far out of hand before anyone noticed? Many are trying to sort out what went wrong, and that is as it should be. It is not simply a finger-pointing “blame game” to do so, for an accurate diagnosis is a necessary precondition both for both effectively treating the resulting problems, and preventing a recurrence. The truth is, there is plenty of blame to go around. Many forces came together to bring this economic storm about, and we can’t afford to ignore any of them as we look for solutions to today’s consequences and preventions for tomorrow. But today, we look at just one of those pieces – one agency among many with some authority in the fragmented system

My testimony today is on behalf of the Center for Responsible Lending (CRL) ([www.responsiblelending.org](http://www.responsiblelending.org)), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. We are affiliated with a community development lender, Self Help, which provides carefully underwritten subprime loans to people who have been under-served by other lenders. Self Help has provided over \$5 billion of financing to 55,000 low-wealth families, small businesses, and nonprofit organizations, and our loan losses have been less than one percent per year.

In addition to my experience as a senior policy counsel with CRL, I was previously an assistant attorney general in Iowa and Deputy Administrator of the Iowa Consumer Credit Code. This allows me to bring to this testimony some personal perspective on both the possibilities and limitations of public enforcement.

## **I. INTRODUCTION: A CURSORY OVERVIEW OF THE RISE AND FALL OF THE SUBPRIME MARKET**

There are many contributors to the meltdown, and far too many players involved to adequately describe in short testimony. But at root, the bottom line is this:

- Far too large a portion of the subprime mortgage industry from its inception has put origination volume ahead of prudent lending practices. Underwriting for sustainability never was its strong suit. Nearly half of all subprime loans originated in 1999 and 2000 suffered delinquencies, and foreclosures were initiated at least once on 1 in 4 to 5 subprime loans originated during those years.<sup>4</sup> But, as we shall see, other factors obscured those early cracks in the foundational fundamentals.
- For a long time, the underlying weakness in the industry was obscured to all but those most closely attuned to that market by at least two factors.
  - First, the share of the subprime market was relatively small, and so ill-effects were relatively contained. Some \$138 billion of subprime loans were originated in 2000. By 2006, there were \$600 billion in subprime originations, and some \$400 billion of “alt-a” which includes many of the nontraditional loans, particularly payment option ARMs.<sup>5</sup>
  - Second, as long as housing prices appreciated, the troubled loans could avoid completed foreclosures by taking the “exit ramps” of refinancing or sale. Ultimately, these loans were paid off – albeit by what is termed “distress prepayment.” These “distress prepays,” many of which led directly to new subprime or non-traditional originations,<sup>6</sup> disguised the fundamental weaknesses except to those who looked carefully. So, though nearly 1 in 5 of the originations of 1999 and 2000 had a foreclosure filed, only about 1 in 8 went to a completed foreclosure. But when completed foreclosures were combined with “distress prepays,” by May, 2005, almost 1 in 4 subprime

loans originated in those two years had failed to prove sustainable.<sup>7</sup>

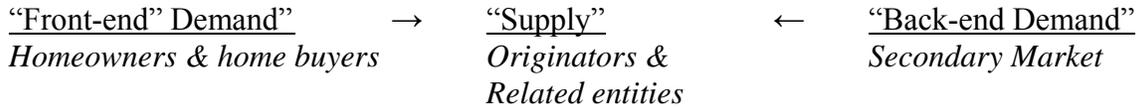
- The continuing inflation of the housing bubble in some regions of the country, the fact that a large share of the nation's economy was based on housing and housing-related activity (including consumer spending generated by the "wealth effect"<sup>8</sup>) meant that far too many in public life and the private sector encouraged what, we now see, is a "debt bubble" that underlay the housing bubble.
- The invention of complex financial instruments like "collateralized debt obligations," often rated as investment grade, attracted more investors, vastly increasing the secondary market's demand for these loans. Appetite for the higher-yield instruments – which, as theory tells us, are higher yield because they are higher risk – increased at least in part because other complex financial instruments like "credit default swaps" were thought to insure against the "risk" part of that equation. In other words, the demand for "riskier" investments increased because they thought they could get the higher returns on the upside, while "insuring" against the downside.<sup>9</sup> Subprime securitizations jumped from about \$52 billion in 2000 to over \$200 billion in 2007, according to Inside Mortgage Finance MBS database.
- The perverse incentives from the "back-end" demand side encouraged the originators to make the riskier kinds of loans, and the voracious appetite from that back-end demand led to a virtual abandonment of fundamental underwriting principles in order to generate loans to feed that appetite.<sup>10</sup> The combination of riskier products and weak underwriting fed off each other in a downward spiral of massive defaults.
- With the bursting of the housing bubble, and declining housing values even outside the "bubble" regions – the "exit ramps" of refinance or sale for troubled borrowers were cut off. And then a feedback loop kicks in – the more housing values decline, the more loans that are caught in the downward spiral, which, in turn, affects housing values of entire neighborhoods, not just the homes securing the troubled loans.<sup>11</sup>

This is the 2-minute version of the arc of the subprime and nontraditional mortgage meltdown. It was, in short, a systemic breakdown. For purposes of today's hearing, we are focusing primarily on the first item on the list – the abuses and the breakdown of sound business practices in the origination of these loans, and what one regulator could – and could not – do about that. But to understand what happened at that "front-end" of the market, we also have to understand the "back-end" of the market – what Wall Street wanted.

### **The Supply and Demand(s) of the Subprime Market**

Traditional economics thinks in terms of a "supply and demand" curve. But that is not what has been operating in this market, especially over the past five or so years.

Instead, the “supply” side – the originators of subprime and non-traditional loans – is sandwiched between two “demand” sides.



The “*front-end*” demand (in theory) was from refinancing homeowners and home buyers. As a practical matter, however, much of that front-end demand was “generated” demand, not natural demand. In the early years, these loans were overwhelmingly refinance loans, and they were “sold, not bought” -- they were loans in search of borrowers, not the other way around. But there was a self-feeding nature to this market, as the originators wished to ensure continued growth through more originations. There isn’t a great deal of downside to assuring repeat business for local grocers – in fact, that helps keep those grocers on their toes. But for sellers of debt – debts on which borrowers are contractually obligated – there’s a downside to looking for repeat business – trying to get more borrowers deeper into debt and keeping them longer carries with it seeds of predictable, and foreseeable, problems.

Much of the “product” the originators supplied tried to assure that origination volume would “grow.” Whether the “packing and flipping” model of old-line finance companies like Associates that was the “dysfunctional” part of the market attracting attention in the early part of this century,<sup>12</sup> or the subsequent standard “exploding ARM” – the 2/28 hybrid ARM that functioned almost like two-year balloon loans – increasing origination volume was the primary goal. For those lenders that sold their loans on the secondary market, the concern with how those loans performed over time was, to too large a degree, “not their problem.” Their job was to make loans. It was origination that they were paid for, not performance over time. It was somebody else’s problem to live with the consequences – which brings us to the back-end demand side.

More recently, as the housing prices wildly appreciated in some areas of the country, a larger portion of subprime loans (though still a minority) and nontraditional loans were used to purchase homes. But the core problem was the disconnect between houses prices and affordability. The housing affordability index in California in 2005 was just around 14%.<sup>13</sup> Though the answer to a housing affordability problem is not unaffordable mortgages, we pretended as though it was, and the same weak underwriting – perhaps even worse – infected the purchase money market.<sup>14</sup>

The “*back-end*” demand side was the secondary market -- investors looking for investments to buy. The way it let its guard down by creating what it thought of as graded risk, widely dispersed risk, and insured-risk is a story for another day and another hearing.<sup>15</sup> As it relates to the practices of the originators, though the bottom line is that Wall Street valued most highly (that is, paid the most for) precisely the *kinds of products and terms that made the loans most risky for the borrowers.*<sup>16</sup> In short, the secondary market created perverse incentives, and the originators responded to those perverse incentives.

For those who apply common sense, not complex mathematical models, to business, this has been one of the most maddening aspects of the meltdown: the “what

were they thinking?” factor. Give it just a moment’s thought. There are roughly three categories of default risk: *borrower* risk – the “creditworthiness” of the borrower; *macroeconomic* risks – unemployment, housing prices; and *loan product and term risks*. That is to say, some kinds of loan products and some loan terms themselves exacerbate the risk of default and foreclosure, irrespective of borrower traits.<sup>17</sup> In an industry that claimed to be serving a niche where the “borrower” risks were higher (setting aside the question of steering), common sense would tell a lender to minimize the risk from the other two factors by selling the *least* risky loan products and terms. (That’s what the sensible 19 and 20 year olds in an economics class recently said when I put the question to them.) Instead the standard industry practice was to *compound* the risk by making the standard products on the market the riskiest kinds of products -- they pushed the products and loans terms that made these loans more, not less, likely to default.

Why would they do that? There are a number of reasons. In part, ignoring underwriting to push a borrower to the maximum on capacity to pay, or pushing an exploding ARM is likely to force the borrower into seeking a refinance later – a new origination. In part, some of the products, like teaser-rate ARMs and POARMs are tailor-made for deceptive sales pitches – low-balling the monthly payments made it easier to sell a complex, risky loan. But the biggest incentive of all was the perverse incentive – the fact that those were the products and terms that Wall Street paid the originators the most for. In the end, it was the “back-end” demand, with its increasingly voracious appetite asking for more and more volume, and paying those originators more for the toxic products than the less remunerative “plain vanilla” products, that drove this market.

That’s a birds-eye view of what happened. There was a very long supply chain along the way – from local brokers and settlement agents to national lenders to global investment houses. Deconstructing what happened to oversight, then, -- the question of “who was minding the store” – isn’t simple. This wasn’t “a store” -- this was a megamall, and lapses in security were everywhere. The unfettered explosion and subsequent implosion raises questions of whether deregulation of both lending markets and investment markets went too far. It raises questions of whether legislators, regulators and the public did have, or could have had, adequate insight into what was happening in time to have stopped it. It raises questions about whether regulators had adequate tools, adequate resources, or adequate will to have done something more. And if not, what do they need for the next time.

Today, we look at only one aspect of this process: the practices of the non-depository originators as they dealt with consumers (the “front-end” demand side): first, how well equipped was the Federal Trade Commission to deal with the problems on its watch, and, second, within the limits it faced, how well did it perform. We believe that for it to have performed optimally, it needed better tools and more resources. But within the confines of those limitations, could it have done more? Probably yes.

## **II. “REGULATION” -- IT COMES IN DIFFERENT FLAVORS**

Before evaluating the FTC’s performance as a regulator, it is necessary to distinguish among kinds of regulation. As the industry began to unravel, it was common to hear that these loans were mostly made by the “unregulated” segment of the mortgage market -- non-depository lenders. In fact, virtually the only major segment of this daisy

chain that is truly unregulated is the very tail end – the complex derivatives market.<sup>18</sup> But there are differences in the *kinds* of regulation and oversight to which the various segments were subject. There is *substantive* regulation – the laws and rules that set down the rules of the game. There is *oversight* – routine and regular monitoring that allows regulators on-going access to the regulated industry to keep on top of its compliance. Finally, there is *enforcement* – investigating alleged violations and prosecuting them after the fact.

#### A. The Underlying Infrastructure: Legal Authority and Political Will

Regulatory agencies are creations of the law, and have only the authority that the law gives them. The *scope of their authority* is set by the law that creates them: The *laws they enforce with respect to the entities within their jurisdiction* are only those that the legislative branch – federal or state as relevant – enacts. And finally, *the resources they have to do their job with* are determined by their enabling law.

In other words, it all starts with elected officials -- here in Congress, and out in the state capitols. An agency may be – and should be – taken to task if it does not use the tools it has to tackle a problem. But if the agency’s jurisdiction is inadequate in the first place, it is because the enabling laws make it so; if the laws the agency is to enforce are inadequate, it is Congress and the state legislatures that must act first to strengthen them; if the resources are inadequate, and the agency is funded by appropriations, then it is the body that makes the appropriations that must step up and reassess its spending priorities. As we will see, some, though not all, of the FTC’s inadequate responses can be traced back here.

While the tools and the resources must be sufficient, so too must be the will of the agency’s leadership. No matter how strong or weak the regulatory infrastructure is, it depends upon the will of the regulator to make the most of what it has. If a regulator – any regulator – believes that the best regulation is the least regulation – then it matters little what the regulatory structure looks like. Regulators must believe in the importance of their job in order to do it right. For nearly three decades, the prevailing political and economic philosophy has been that the markets work best when left alone, with minimal intervention. Whether that was part of the problem, and contributed to a too- weak regulatory response is a legitimate question. It is, however, ultimately is a political question. We will not discuss it today, but only note that it is a question that must be answered at some point.

#### B. The Legal Tools: The Substantive Law Relating to Abuses in the Subprime and Non-traditional Market

In our 2-minute overview of the root of the problem, we identified a few areas of abuse in the origination marketplace.

*Marketing:* Sometimes there were misleading advertisements, although often the problem with subprime ads was not misrepresentations about cost or terms, but a complete absence of information about costs or terms. While prime borrowers could easily find information about prevailing rates for “plain vanilla” fixed rate mortgages, there was very little transparency about prices and terms for subprime markets. While

advertising rules in the Truth in Lending Act,<sup>19</sup> or general prohibitions against deceptive advertising practices set some ground rules, there was nothing clearly illegal about advertising of what could be called the “ ‘Come into my parlor,’ said the spider to the fly” variety.<sup>20</sup> Though some of the “trust us” variety of advertising could be argued to create a fiduciary duty or related duty for originators, this was an area of the law that was in flux through out this period.

Moving from mass marketing to individual sales marketing, there are some specific requirements – mostly regarding disclosures. The Truth in Lending Act requires some early disclosures about loan costs and repayment terms for mortgage lending, and more disclosures at closing. The Real Estate Settlement Procedures Act (RESPA) requires some early disclosures and closing disclosures about closing costs. But generally, it is simply the prohibition against “unfair and deceptive acts and practices” in commerce that is an agency’s primary tool to attack deception in a sales pitches.

*Loan Terms and Products:* There is little substantive law that governs loan products and terms. In some states, some of the higher-cost, higher fee loans were subject to additional requirements by the “state-HOEPAs,” but, for the most part, those laws took aim at the kinds of abuses that were more prevalent in the predominant business models in the late 90s and early 2000s. In fact, to some extent, federal law made it impossible for states to squarely address in substance some of the risk-enhancing products. One of the unintended consequences of the 1982 Alternative Mortgage Transaction Parity Act (AMTPA), which preempted state laws limiting “creative” mortgages – like adjustable rate loans and balloon loans, was to encourage the growth of ARMs to take advantage of that federal preemption.<sup>21</sup> That same law preempted state laws on prepayment penalties from 1996 to July 1, 2003 in most states – another “risk-enhancing term.”

*Perverse Incentives and conflicts of interest:* There are few laws in place to effectively address the perverse incentives that led originators to respond to Wall Street’s incentives to push the higher-cost, riskier loans. At the beginning of the subprime era, the trade association of mortgage brokers considered themselves to owe a duty to their customers, and some courts had held that there was a fiduciary duty.<sup>22</sup>

But the industry’s self-image changed, and it became a legal battle as to whether brokers had a duty to provide their customers with the most appropriate and best loan for them. While individuals could, and did use the common law regarding fiduciary duty, and UDAP claims as a tool, as a clear and potent message to deter such practices industry-wide, it was insufficient. And creditors making their own loans have never had such a duty. As the fundamental problem of putting people into loans ill-suited to their needs and situations, it was only as the crisis became too great to be ignored did state legislatures respond. Since the spring of 2006, several states have enacted laws that specifically impose on originators some kind of duty with respect to their customers.<sup>23</sup> The federal government has yet to respond. The Federal Reserve Board has proposed some UDAP regulations pursuant to its authority under the Home Owners Equity Protection Act (HOEPA), but we believe that those rules, if enacted as proposed, would not significantly reduce these perverse incentives.

*Weakened underwriting:* The massive failure of underwriting, one of the most fundamental causes of the break down, is the conduct that the existing law was perhaps most inadequate to address. While there is legal precedent to argue that it is “unconscionable” or unfair to make a loan knowing that there is little reasonable probability of repayment,<sup>24</sup> that, too, has been more successful on an individual basis than system-wide. In fact, with respect to the highest cost loans, those subject to the federal HOEPA, there is a prohibition against a “pattern and practice” of making loans without regard to the ability to repay, but as long ago as 1998, the FRB and HUD admitted that was very difficult to enforce.<sup>25</sup>

Here, too, the recent spate of state laws that began to address the current generation of abuses addressed the need to consider ability to repay. Federal financial regulators issued underwriting guidances for non-traditional loans in 2006, and for subprime loans in 2007.<sup>26</sup> Many state financial regulators adopted parallel guidelines shortly thereafter. The FRB’s proposed HOEPA UDAP rules would extend to the subprime market a prohibition against a “pattern and practice” of making loans without regard to ability to repay. However, as the Board admitted a decade ago that it was a rule difficult to enforce, it seems equally an equally unpromising solution today.

Of the laws that might be applied to the abuses in the market, the primary one within the FTC scope of authority was section 45 of the FTC Act, the federal UDAP. Though the FTC has authority to enforce the Truth in Lending Act and the Equal Credit Opportunity Act, among others, the nature of the recent abuses were such that its UDAP authority was the primary weapon available to it. However, the FTC’s ability to wield that weapon is governed by rules of engagement which make it difficult to prevent abuses.

### C. Prophylactic vs Retrospective Regulation: Prevention vs. law enforcement:

Regulation can be forward looking – preventative, or it can be retrospective. They can set the standards to be met, and exercise oversight to continually monitor the market to assure compliance. Or it can be retrospective – an investigation begins only after there is reason to believe that violations have occurred, and prosecution follows.

*Preventive* regulation comes in two forms: *rule-making* and *routine oversight*, that is, regular, recurring monitoring for compliance with the ground rules. The law-enforcement model – the one available to the FTC, is *retrospective*. By definition, it has preventive value only to the extent that the fear of prosecution deters potential violators. In assessing the FTC’s performance, it is useful to compare its capacity for preventive regulatory action with that of financial regulators.

#### *1. Rule-making: The FTC’s “Mag-Moss” Albatross*

The FTC has rule-making authority to define “unfair or deceptive acts and practices” in commerce generally: it is a “generalist” with a scope that encompasses the practices for all of American’s businesses – except those that are explicitly entrusted to another agency, such as federally chartered depository institutions. Federal UDAP rule-making authority for federally chartered depository institutions is given to the Federal

Reserve (for banks), the OTS (for thrifts) and NCUA (for credit unions.)<sup>27</sup> If the FTC promulgates a relevant UDAP rule, such as one which deals with consumer credit, then the federal banking agencies are mandated to enact “me-too” rules, unless they determine it is not “unfair or deceptive” when a depository institution does it, or when the FRB deems it would interfere with monetary and payment system functions.

The FTC has promulgated some UDAP rules which have been very important in making the consumer finance marketplace fairer and more honest. Of particular importance is the “preservation of claims and defenses rule,”<sup>28</sup> which assures that lenders that finance merchants can’t separate the consumer’s obligation to pay from the seller’s obligation to comply with the law and contract.

Unfortunately, Congress in 1975 enacted a special rule-making procedure which the FTC must use to promulgate rules defining what “unfair and deceptive practices” are. This so-called “Magnuson-Moss” or “Mag-Moss” rule-making is much more cumbersome, lengthy, and expensive, than the standard agency “notice-and-comment” rule-making procedure prescribed by the Administrative Procedures Act. Just how much of an albatross this “Mag-Moss” rule-making procedure has been for FTC’s UDAP rule-making is evident from its experience with the Credit Practices Rule.

It was standard practice in consumer finance contracts to use boiler plate language in adhesion contracts that let the creditors engage in harsh collection tactics – waivers of exemptions even when the credit did not finance the acquisition of the exempt goods, or taking wage assignments. The proposal began internal development in the early 1970s, and the proposed rule was published in 1975. As it happened, this was my first year as a practicing lawyer. Under the Mag-Moss rule-making, industry has an opportunity to turn rule-making into a quasi-legislative process, complete with hearings and the right to cross-examine. My own first foray into the national scene of consumer law was to testify at one of the regional hearings the FTC held on the proposal, in October, 1977, where I was questioned by industry representatives. Fat volumes were published with the report from the hearing and recommendations over the next few years – two, if memory serves. The final rule was published in 1984, to be effective in 1985. There was a legal challenge to the rule from the industry -- under Mag-Moss, there are even special rules for judicial review of these rules. Finally, some ten years after it was first proposed, the US Court of Appeals for the DC Circuit upheld the rule and it became effective.<sup>29</sup>

During the process for the “credit practices rule,” I went from a totally green new practitioner to a consumer specialist with a decade’s experience. Clearly, Mag-Moss’ rule-making procedure is not a recipe for a nimble regulatory response to rapidly evolving dysfunctions in the marketplace.

## *2. Oversight – Routine Monitoring*

Another way an agency can get ahead of the curve to prevent abuses or stop them before they get out of hand is through the exercise of oversight authority. The distinction between the regulatory authority over depository lenders and non-depository lenders is particularly stark here, because so much of the root failure here – the collapse of underwriting standards – occurred in the “back offices.” Unlike earlier trends in predatory lending – insurance packing and “equity-stripping” which was visible on the

face of the consumers' loan documents, failure of underwriting is almost asymptomatic until the failure starts showing up in performance. Asymptomatic, that is, unless it happens in depository institutions, where regulators routinely examine for "safety and soundness."

To argue that pushing inappropriate loans on borrowers, or failing to underwrite, fell on the "illegal" side of the UDAP law, or in a grey area is one issue the FTC had to resolve for itself, but clearly financial regulators can do so. Because depository institutions hold depositors money, and because those deposits are generally insured by the FDIC, "safety and soundness" oversight is the core mission of financial regulators. Financial regulators therefore have routine access through their examination authority. Whether the financial regulators paid enough attention to both the origination and investment activities of their institutions is a question for another day and another committee,<sup>30</sup> but as to today's question – the FTC, by contrast, does not have this clear "safety and soundness" authority.

In sum, the FTC was not the best equipped agency to engage in prevention. Its UDAP rule-making does not give it the flexibility and nimbleness necessary to respond to fast-moving abuses in the marketplace, and it can only act once evidence of a problem surfaces outside the internal walls of the lender, such as from a whistleblower, or an accumulation of complaints. Its preventative capacity, then, is all tied up in whether its enforcement is sufficiently vigorous to act as a deterrent.

### *3. Law Enforcement – Prosecutions and Deterrence*

Earlier in this testimony, I've intimated that the nature of the predominant abuses in the subprime market have shifted over the past decade. The root causes of the most recent crisis we've identified as a massive failure of underwriting and "suitability" (for want of a better word to describe appropriately matching product and borrower).

Before that, the visible abuses were the "packing, stripping and flipping" model. The combination of state laws, the FRB's amendment to add credit insurance premiums to the list of HOEPA's trigger fees, the FTC's enforcement action against Associates and the states' action against Household in fact did send strong deterrent messages to the industry.

Unfortunately, the message received by the industry was – "don't engage in *those particular* abuses." The shift in the kinds of abusive practices was even more problematic, as it turned out. As to the new generation of problem practices, one might offer an explanation for the FTC's caution, if not a justification. The FTC is a "generalist" agency, whose expertise is in general unfair and deceptive business practices fair competition. The central abuses of the past few years – underwriting and suitability – might have seemed more within the purview of "specialist" financial regulators. Further, absent misrepresentations, those abuses may more properly fall within the "unfairness" rubric. So, while deceptive sales representations are clearly covered by "deception," for an agency that seems uncomfortable in enforcing its unfairness jurisdiction in any case, it is easy to explain an institutional caution about attacking the root abuses with its UDAP authority.

That is not to say that such caution was necessary. Indeed, the states' action against Ameriquest, number one among subprime originators for three years before the states case was completed and publicized,<sup>31</sup> was an example of the states using the parallel state UDAP authority to reach this most recent generation of abusive practices. Even more on point, the Massachusetts Attorney General posed the question squarely, by filing a lawsuit charging that Fremont Investment & Loan's practices were such as to make their loans structurally unfair, in violation of the Massachusetts UDAP statute.<sup>32</sup>

### **III. NECESSARY PRECONDITIONS FOR EFFECTIVE REGULATION**

For any public regulator to be effective in their role as watchdogs for the public, they require several things:

- **Tools.** They need adequate laws, and the authority to enforce those laws. The UDAP law was the most relevant tool. An aggressive Commission could have done more, but then again, Congress could have provided them both more targeted tools, and more encouragement to take on this industry.
- **Resources.** The FTC is the default agency charged with policing most of the market: everyone not specifically assigned elsewhere is under the FTC's watch, from the major mortgage loan servicers and originators to a mom-and-pop payday store to telemarketing fraudsters to identity theft to purveyors of phony health products. Resources are obviously a problem. But even looking just at this one slice of American commerce, when the business standards of a \$600 billion industry fall so far that bad practices are the norm, not the exception, public enforcement resources will be insufficient.
- **Expertise.** At the federal level, the FTC is the agency with expertise in unfair and deceptive acts and practices. Financial regulators are the agencies with the expertise in the fundamentals of banking and lending.<sup>33</sup> The SEC is the agency with expertise in the secondary market. This crisis implicated all of them. Though the federal financial agencies coordinated responses, such as the joint guidances, perhaps fragmented oversight kept anyone from looking at the whole picture until it was too late.
- **Undivided loyalty to the public good.** The FTC is funded primarily by appropriations, and is answerable to the taxpayers. By contrast, some of the federal financial regulators are funded by the entities they regulate, raising the prospect of "regulatory capture." To make matters worse, depositories can choose their regulator – they can choose between state and federal regulators, and choose among federal regulators, raising the prospect of "charter competition," as regulators may be unduly soft on their own to capture their own "market share." The FTC, therefore, has no inherent conflict of interest.

### **IV. THE FTC'S ENFORCEMENT RECORD ON PREDATORY LENDING**

As of last September, the FTC had brought 21 actions relating to mortgage lending.<sup>34</sup> It includes actions against some of the major subprime lenders of their day: Associates, First Alliance (in which it cooperated with state enforcement), Delta

Funding (also in cooperation with state enforcement), and a servicing case against one of the biggest – and worst – subprime servicers (Fairbanks.) The Associates case began as a broad-based challenge to a wide array of abuses, though the settlement focused just on one of them.

However, as to the core abuses that are more directly responsible for today’s crisis, there is less activity – perhaps for the reasons we have described. Though it describes actions relating to deception and misrepresentation against some originators, including brokers, it does not appear to have squarely addressed the present abuses as violations of the UDAP law in and of themselves. The state of Massachusetts, instead, has taken the lead.

Some of its targets illustrate a persistent choice facing public enforcement officials with limited resources: how to prioritize between local actors doing greater harm to fewer people, and national actors doing somewhat less harm, but to many more people. Allocating resources to the former can be a rational choice. But in the meantime, what appears to be a “lesser harm” but one visited on far more people, can get out of hand. As we are seeing now, the consequences to the economy as a whole can be grave indeed.

In sum, the FTC has done more enforcement than other federal regulators, despite having less capacity to spot problems early on. However, it could have done more to get to the root causes of today’s problem.

## **V. RECOMMENDATIONS**

We appreciate the efforts of Senators Dorgan and Inouye in S. 2831, the proposal to reauthorize the FTC. There are several provisions that we especially welcome:

*Changes to the Mag-Moss Rule-making.* We particularly welcome Section 9 of S. 2831, which mandates the use of the APA rule-making, rather than Mag-Moss rule-making regarding subprime and non-traditional laws. We recommend, however, that the APA rule-making be used for all consumer protection rules. Section 8 of the bill, gives the Commission the authority to waive Mag-Moss rule-making for any consumer protection rule, but does not mandate the change as it does for mortgage rules. We believe that the current crisis demonstrates that consumer protection regulation is key to protecting an efficient economy – protecting it from wild swings of excess. Congress could send a strong message to the Commission that consumer protection, far from being a “drag” on commerce, is essential to a fair and efficient economy, and that the Commission should be proactive.

*Cooperative rule-making with bank regulatory agencies:* S. 2831 would give the FTC concurrent rule-making with federal bank regulatory agencies, and requires consultation and coordination “to the extent practicable.” We have recommended elsewhere independent and concurrent authority as a result of concerns about regulatory capture. We recognize that there are limits to this committee’s jurisdiction, and we welcome the steps taken in S.2831. We would hope, however, that Congress will make further refinements, to assure that adequate consumer

protection rules apply to all lenders. If the bank regulatory agencies do not act when they should, we believe that the FTC should have independent jurisdiction to do so, with due regard for the need for appropriate safety and soundness adjustments for depository institutions.

*State Attorneys General's authority to enforce federal UDAP law:* Giving state attorneys general authority to enforce federal UDAP law and other laws within the FTC's enforcement authority with respect to subprime or nontraditional loan is welcome. Adding fifty "cops on the beat" to supplement the FTC's limited resources will be of immeasurable help. While many state UDAP laws provided state AGs with jurisdiction over lending practices, that is not universally the case. For example, until recently, Ohio's UDAP statute exempted mortgage lenders from coverage. Neither Ohio's attorney general nor its citizens had that tool available to them to challenge abuses in the subprime market. Undoubtedly, that was a contributing factor to the serious foreclosure crisis in Ohio..

As we understand the proposed provision that prevents a state AG from exercising this new authority when the FTC has instituted an action,<sup>35</sup> the preemption would not preclude the AG from exercising any investigation and enforcement authority of state or federal laws that it has pursuant to its own state law. We hope that this is made abundantly clear.

*Aiding and abetting liability.* In today's complex marketplace, few transactions involve only a consumer and seller of goods or services. Clarifying aiding and abetting liability will help assure that all those involved can be reached by the law

*The bill should include a private enforcement right for consumers.* There is one change not present in S.2831 which we continue to recommend. Congress should provide a private right of action to enable consumers to enforce their own right to be free of unfair and deceptive acts and practices, for the FTC's resources will never be adequate to police the entire market, and public enforcement will never move fast-enough to prevent the foreclosures that are occurring – homeowner by homeowner – all over the country.

Thank you again for providing me with the opportunity to testify today on this important matter. I'm happy to answer any questions you might have.

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#### ENDNOTES

<sup>1</sup> Rod Dubitsky, Larry Yang, Wen Zhang, Thomas Suehr, *Foreclosure trends – a sobering reality*, Credit Suisse Fixed Income Research (April 23, 2008), <http://www.credit-suisse.com/researchandanalysis>. They estimate 2.7 million total subprime foreclosures and 4 million other mortgages.

<sup>2</sup> Christopher Swann, *IMF Says Financial Losses May Swell to \$945 Billion*, April 8, 2008, available at [http://www.bloomberg.com/apps/news?pid=email\\_en&refer=home&sid=aK1zAj5FZ9Io](http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aK1zAj5FZ9Io).

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<sup>3</sup> See, e.g. Roger Lowenstein, *Triple-A Failure*, New York Times Magazine, p. 36 (April 27, 2008)

<sup>4</sup> Ellen Schloemer, Keith Ernst, Wei Li and Kathleen Keest, *Losing Ground*, p. 13, Table 4, (Center for Responsible Lending, December, 2006).

<sup>5</sup> I Mortgage Market Statistical Annual: 2007, pp. 133, 209, 218.

<sup>6</sup> Though the subprime industry often justified itself as a “bridge to prime” for credit impaired borrowers, what data exists does not support that characterization. Subprime to subprime refinancings were more the norm, as far as we know. Although longitudinal studies by borrowers are difficult to trace, and therefore rare, what evidence does exist does not support the “bridge to prime” hypothesis. For example, in early 2007, CRL reviewed 106 Option One subprime loans originally written in 2004, and found that three in four refinanced into another subprime loan, while only 1 in 4 refinanced into a prime loan. “*Case Study in Subprime Hybrid ARMs Refinance Outcomes*,” (Center for Responsible Lending, February 21, 2007) available at [http://www.responsiblelending.org/pdfs/subprime-outcomes\\_2.pdf](http://www.responsiblelending.org/pdfs/subprime-outcomes_2.pdf). See also Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, Appx. B, p. 74, (The Reinvestment Fund, April 2007) (two-thirds of subprime loans refinanced into other subprime loans), available at [http://www.trfund.com/resource/downloads/policypubs/Lost\\_Values.pdf](http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf).

<sup>7</sup> *Losing Ground*, *supra* note 4.

<sup>8</sup> E.g. “[T]he President would like to push it to even higher levels of growth. But there are a number of other factors that go into it: low inflation; high productivity; *low interest rates, which allow the American people to refinance their homes, which puts more money into their pockets, which has been happening to the tune of hundreds of billions of dollars throughout the economy. All of those are causes for optimism about the state of the economy.*” (emphasis added.) White House [Press Briefing by Ari Fleischer, January 14, 2003](#).

<sup>9</sup> See, e.g. Interview with Prof. Michael Greenberger, Fresh Air (NPR April 3, 2008), <http://www.npr.org/templates/story/story.php?storyId=89338743>

<sup>10</sup> See, e.g. Structured Finance in Focus, *The Subprime Decline – Putting it in Context* p. 3, Moody’s Investors Service (March 2008) (“The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market.”); Interview with Alan Greenspan, *The Oracle Reveals All*, Newsweek, p. 32, 33 (Sept. 24, 2007) (“...you had Wall Street’s securitizers basically then talking to the mortgage brokers saying, ‘We’ll buy what you’ve got!’..The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn’t afford. We created something which was unsustainable. And it eventually broke. If it weren’t for securitization, the subprime-loan market would have been very significantly less than it is in size.”) Cf Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, p. 26-27 (January, 2008) (securitization weakens creditors’ incentive to screen the loans they make), available at <http://www2.law.columbia.edu/contracteconomics/conferences/laweconomicsS08/Vig%20paper.pdf>.

<sup>11</sup> See, e.g. Dubitsky, et al, *supra* note 1, at p. 6 (“We believe the housing markets in 2008 and 2009 will be under significant downward pressure due to the big rise in forced sales related to new foreclosures and REO properties....”)

<sup>12</sup> “Equity stripping’ through insurance packing, fee-padding, and loan flipping (frequent refinances by the same lender) was the “abuse du jour” as the century turned. Several state legislatures, including North Carolina, enacted state “HOEPAs” that closed the loophole in federal HOEPA that these lenders exploited; and the Federal Reserve Board amended federal HOEPA to close one of the loopholes, by making single-premium credit insurance count toward HOEPA’s 8-percent fee trigger. On the enforcement side, the Federal Trade Commission brought an enforcement action against Associates (which was purchased by Citigroup during the investigation), settled for \$215 million, and the states brought an enforcement action

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against Household, settling in 2002 for \$484 million. It is worth noting that Associates and Household were among the three subprime originators each year in 1998-2002. In 2001, the year before the enforcement actions were settled, they held 20% of the subprime market share between them.

<sup>13</sup> In 2005, the average income within the 4<sup>th</sup> quintile – the second *highest* quintile – was approximately \$70,000. Center on Budget Policy and Priorities, Arloc Sherman, “Income Inequality Hits Record Levels, New CBO Data Shows,” December 14, 2007, available at <http://www.cbpp.org/12-14-07inc.htm>. In 2005, the median home price in California was \$548,000 for an affordability index of 14%. State of California, Department of Housing and Community Development, Division of Housing Policy Development, “California’s Deepening Housing Crisis,” (February 15, 2006) at 2, 6.

<sup>14</sup> With the refinance market, homeowners had both the emotional tie to a home and neighborhood, as well as some equity in the home. “No down payment” home purchase loans meant that the loans were 100% loan-to-value from the day they were made. And with products like the non-traditional loans, the only equity to come for some time would be from continuing appreciation.

<sup>15</sup> See, e.g. Lowenstein, note 3, *supra* and Greenberger, note 9, *supra*.

<sup>16</sup> See, e.g., Gretchen Morgenson and Geraldine Fabrikant, *Countrywide’s Chief Salesman and Defender*, New York Times (November 11, 2007) (“Investors were willing to pay significantly more than a loan’s face value for A.R.M.’s that carried prepayment penalties, for instance, because the products locked borrowers into high-interest-rate loans with apparently predictable income streams.”)

<sup>17</sup> CRL’s president, Michael C. Calhoun testified to this subcommittee previously about the increased likelihood of default for several kinds of loan terms, such as prepayment penalties and adjustable rates, and the prevalence of risk-layering in this industry, which, of course, simply compounds the risk yet further. See Testimony of Michael C. Calhoun Before U.S. Senate Subcommittee on Interstate Commerce, Trade & Tourism “Federal Trade Commission Reauthorization,” Sept. 12, 2007.

<sup>18</sup> See *Greenberger*, *supra* note 9, discussing the Commodity Futures Modernization Act of 2000.

<sup>19</sup> 15 U.S.C. §§ 1661-1665b. These rules do not require that price terms be advertised. If the lender chooses to disclose some “trigger terms,” then the rules require some additional disclosures.

<sup>20</sup> See, e.g. Vanessa G. Perry and Carol M. Motley, *Reading the Fine Print: An Analysis of Mortgage Advertising Messages* (working paper, 2008).

<sup>21</sup> 12 U.S.C. §3801, *et seq.* (This preemption was available to state chartered lenders, not just to federally chartered institutions.)

<sup>22</sup> See generally National Consumer Law Center, *The Cost of Credit* §12.9.2 (3<sup>rd</sup> ed. 2005). See esp. note 686, which quotes an earlier version of the National Assoc. of Mtg Brokers’ Code of Ethics.

<sup>23</sup> E.g. Ohio and Minnesota.

<sup>24</sup> See, e.g. Iowa Code §537.5108(4); cases collected in National Consumer Law Center, *The Cost of Credit* §§ 12.5, 12.7.3.

<sup>25</sup> Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July 1998), at 62-63, available at <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>

<sup>26</sup> Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006); Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007).

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<sup>27</sup> 15 U.S.C. § 57a(f).

<sup>28</sup> 16 C.F.R. § 433, effective 1975.

<sup>29</sup> American Financial Serv. Assoc. v. FTC, 767 F.2d 957 (1985), *cert den.* (1986).

<sup>30</sup> Arguments that “non-bank” originators were primarily responsible for the shaky practices ignore the extent to which their practices were driven by the “back-end demand” we described earlier. And certainly depository institutions were a part of that aspect, as the losses and write-downs taken by major banks indicate. *See, e.g.* Todd Davenport, *OCC: Banks Lost \$10B on 4Q Trading*, Am. Banker (April 3, 2008). Additionally, some of the highly questionable practices concerning non-traditional loans have come from depositories, *see, e.g.* *Andrews v. Chevy Chase Bank*, 240 F.R.D. 612 (E.D. Wis. 2007), *app. pending*.

<sup>31</sup> After the 2002 enforcement actions against top originators Associates (purchased by Citigroup in 2000) and Household (purchased by HSBC in 2002), Ameriquest shot to the top in 2003, where it stayed until 2005. It alone held nearly 16% of the market share in 2004.

<sup>32</sup> *Commonwealth v. Freemont Investment & Loan*, No. 07-4373-BLS (Suffolk Cty Super Ct.), *prelim inj.* Granted Feb. 25, 2008.

<sup>33</sup> It took the OCC 25 years to use its UDAP authority at all, see Julie L. Williams and Michael S. Byslma, *On the Same Page: Federal Bank Agency Enforcement of the FTC Act to Attack Unfair and Deceptive Acts and Practices By Banks*, 58 Bus. Lawyer 1243 (2003).

<sup>34</sup> The actions are described in the Commission’s comments to the Federal Reserve Board *Home Equity Lending Market*, *Federal Reserve Docket* OP-1253 (Federal Trade Commission Letter, Sept. 14, 2006).

<sup>35</sup> S.2831, Section 11(f).