

*Transcript of Federal Reserve Board hearing on home equity lending, Boston, Massachusetts, August 4, 2000*

<http://www.federalreserve.gov/events/publichearings/20000804/20000804pm.htm>

0204

MODERATOR SMITH: Thank you. Mr. White.

5 MR. WHITE: I would also like to thank the  
6 Board for giving us this opportunity to participate  
7 in your deliberations. My name is Allen White.  
8 I've been a Legal Services attorney in Philadelphia  
9 for about 17 years now and have been interested,  
10 along with a few other people who are seeing the  
11 anecdotal stories about predatory lending, in trying  
12 to gather some data and some research to try and  
13 look at some of the big questions about subprime and  
14 predatory lending on a more empirical basis.

15 Recently Professor Mansfield and I  
16 gathered some statistics through a fairly tedious  
17 process of going through SEC filings on both the  
18 interest rates charged by subprime lenders and on  
19 foreclosures.

20 One of the definitions that's been offered  
21 of predatory lending is a loan that's made that has  
22 a substantial likelihood of being foreclosed on.  
23 And I think frequently these type of hearings in the  
24 last year have begun with some untested hypotheses,

0205

including the premise that a substantial portion of  
2 the subprime mortgage lending that's being done is  
3 somehow beneficial or providing useful -- or meeting  
4 social needs, and there are a small group of  
5 outliers who are harming consumers and homeowners.

6 And I think some of the data, the very  
7 little data that are out there, suggests that there  
8 is a serious problem. I think we handed out a  
9 couple of slides that I brought with me, graphics,  
10 that have the results of the tabulations that we  
11 made about foreclosures and serious delinquencies,  
12 and this was for about 15 or 20 lenders who reported  
13 their data publicly.

14 Perhaps not surprisingly, subprime  
15 foreclosures and serious delinquencies are  
16 substantially greater than foreclosures and serious  
17 delinquencies for conventional lenders. For  
18 conventional lenders, it's a little over 1 percent,  
19 and for the subprime industry, over 4 1/2. In fact,  
20 the Mortgage Information Corporation is now  
21 reporting for 1999 that those rates are approaching  
22 5 percent.

23 But the other two slides that I brought  
24 with me basically are intended to show that even

0206

1 that 4.6 or 5 percent rate of serious delinquencies

2 seriously understates the problem. First of all,  
3 every subprime lender whose data we've looked at has  
4 delinquencies and foreclosures increasing year after  
5 year, partly because their volume is growing, partly  
6 because the loans are seasoning.

7           So we have the example here of Equicredit,  
8 probably the number one -- it is in fact the number  
9 one originator of subprime loans, and you can see  
10 three years in a row having mounting delinquencies.  
11 And this is the pattern you will see with all  
12 subprime lenders.

13           Finally what the third slide is intended to  
14 illustrate, instead of looking at the foreclosures  
15 for a single lender -- for a single point in time, I  
16 should say, if you look at loans that are made and  
17 originated in a period of time and follow them  
18 longitudinally as a cohort of loans, a pool of  
19 loans, the numbers are much more dramatic.

20           In this particular pool of loans, of the  
21 6,000 loans we saw, over 1300 of those people who  
22 got those loans are now in foreclosure. And this is  
23 two years after the loans are originated. So it  
24 raises an interesting question, whether you should

0207

1 disclose to people who are taking these loans out,  
2 "You have a one-in-four chance of losing your home  
3 if you take this loan out.

. . .

0243

18           MR. WHITE: Well, at the risk of diverting  
19 the discussion a little, I would like to echo what  
20 Professor Golann said this morning, which is -- and  
21 I certainly don't want to take anything away from  
22 community education and outreach efforts; a lot of  
23 what is going on in Boston is wonderful -- but there  
24 is a basic problem that you have with the complexity

0244

1 of these transactions on the one hand and adult  
2 literacy on the other hand.

3           You have an American population about 40  
4 percent of whom can't really realistically compute  
5 with decimals and fractions. That's what the  
6 national adult literacy survey tells. Probably 90  
7 percent of people can't understand the trade-offs  
8 between points and interest over the life of a loan.

9           So you're just not going to -- Professor  
10 Golann talked about the Boston school system as  
11 being the culprit. I'm not sure where the blame  
12 lies exactly. I think part of it is just that these  
13 transactions are so inherently complex, we can't  
14 expect 100 percent of the population to be fully  
15 equipped to deal with the difference between an  
16 advantageous and a predatory loan.

17           So I get back to the most valuable thing

18 the Fed can do right now at this moment in history  
19 is exercise its power to substantively regulate  
20 these credit transactions. And let me just suggest  
21 what I view as the two most important, although  
22 there are certainly a lot of things you can do.  
23 First is to really seriously look at this  
24 question of no-benefit refinancing. And it's very

0245

1 difficult, it seems to me, for this industry to  
2 defend a transaction in which you take somebody who  
3 has a conventional 9 percent, 8 percent mortgage and  
4 refinance it at 12 percent, and they get a minimal  
5 amount of cash out, less than 10 percent of the  
6 loan. They're paying an effective rate for that new  
7 advance in the hundreds of percent.

8 Those are indefensible transactions, and  
9 they should be outlawed. And there is a very  
10 specific authority in Reg Z -- the Act, rather, for  
11 the Board to do that.

12 The second substantive area I think the  
13 Board really ought to look at is repayment ability,  
14 which I think ties very directly to the foreclosure  
15 numbers we've look at.

16 You know, you have this vast experiment  
17 that's going on right now. It used to be, you know,  
18 if a mortgage was going to be more than 41 percent  
19 of your income, you weren't going to get that loan.  
20 Now the standard in the subprime industry has crept  
21 up from 50 percent to 59 or 60 percent  
22 debt-to-income ratios, with very little regard to  
23 residual incomes and serious problems with  
24 verification of income.

0246

1 Those are all areas that it seems to me  
2 there is very clear authority for the Fed to  
3 regulate. And I think at least the Fed ought to set  
4 some guidelines and say, "Those of you lenders who  
5 are going to venture into the great beyond in taking  
6 risks with people's ability to repay are going to be  
7 subject to the possibility of being found in  
8 violation of these HOEPA standards."

9 Remember, the idea of a subprime borrower  
10 is somebody who has credit problems; in other words,  
11 payment history problems. There is nothing inherent  
12 about taking somebody, you know, who has problems in  
13 the past with paying their bills, saying, well, you  
14 should also give them a loan amount such that they  
15 are over conventional debt-to-income standards.

16 For some reason that has just happened and  
17 become kind of a norm, and one of the things the Fed  
18 can and ought to do is bring those payment ability  
19 norms back in line with the conventional market.

**Transcript of Federal Reserve Board Consumer Advisory Council Meeting, March 2006:**

MR. WHITE: Okay, thanks, Kurt. Since our last discussion of nontraditional products, I have had the opportunity to talk to some colleagues around the country who have had actual experience with these so-called nontraditional products. What I wanted to do today is share some specific information about the so-called option ARM, now that we have actually seen how these are marketed and seen actual closed transactions.

I brought with me today and shared with members of the Council yesterday an actual closed option ARM package that was sold to a borrower in Chicago, highly problematic in a variety of ways which I will explain shortly, and the package includes the Truth in Lending disclosure, the loan application and the monthly statement.

Let me just start with a comment that I think this emperor has no clothes. This product is sold as a so-called affordability product. I don't think it improves the affordability of houses or mortgages in any way, shape, or form.

I also think that the name, option ARM, is a totally deceptive and misleading product name. The essential feature of the option ARM product, which I sort of summarized on the last page on the back of the packet, is that it is a graduated-payment loan in which the initial payment pays necessarily less than the interest that is accruing.

Actually, we are familiar with these products in the student loan world. Student loans are typically offered with either level payments or graduated payments, and it is understood that the initial payments are negative amortizing. The balance goes up, and those are typically and appropriately given to students who have good income increase prospects, and they are called graduated payment loans. They are not called option payment loans. Every mortgage provides you with the option to either pay the minimum contractually required payment or to pay extra. Sometimes there are penalties for paying too much extra, but the fact that the consumer can choose to pay the minimum payment or pay more is not the inherent essential defining feature of this product.

So my initial comment in really drilling down and looking at this product and what it was and understanding it is that it is systematically being misrepresented in the market today.

You will also invariably in marketing and in the oral description of this product hear the sellers of the product say the minimum payment may not amortize the loan. It may cause your principal to go up. Well, that's not true. It will. It is guaranteed. The design of this product is that it is a negative amortization product for some period of time, and what we are seeing typically is a five-year negative amortization period.

This particular ARM was sold based on a monthly payment of \$500, and as we know, the very complex cost information about mortgages is often reduced for ordinary -- you know, not just illiterate consumers, but ordinary working class consumers--to one abbreviated cost information point, a monthly payment, and that is the extent of the cost information the consumer can understand.

So this particular consumer, we learn on their application, was previously paying \$920 a month on his mortgage, a house in Chicago, and obviously to pay \$500 is better than to pay \$900. Now the difficulty is that that \$900 loan, as far as I know, was a fixed rate, level payment product, and this \$500 will only last for the

first 12 months. After five years, if this consumer pays \$500, which steps up eventually, it will become \$1,000; and if interest rates go up, because it is also an adjustable interest rate, the worst-case scenario payment in year six is \$1,700 a month.

In addition, the \$500 does not include taxes and insurance, and I think we have discussed this problem of apples to oranges and monthly payments that include taxes and insurance and that don't; and it is becoming a fairly serious risk factor in the mortgage market, because more and more mortgages do not include an escrow for tax and insurance.

It is pretty clear from this consumer's application that the \$920 he was paying previously included taxes and insurance. So you have, in addition to the marketing material in the application, the actual monthly statement on the next to last page, which shows what the bill looks like when the consumer is sent this bill with their so-called payment options.

It turns out that this \$500 payment is really \$900 when you include his taxes and insurance. So he hasn't really "saved" anything, even on a cash-flow basis. Obviously, it is not a long-term savings product. It is a long-term reduce-your-equity product.

The second comment I want to make about the monthly statement is that, although there are different payment options, one payment option is prominently featured, and that's the minimum payment, and that is not surprising. In the same way that credit card statements have a minimum payment, then you obviously have the option to pay more, but the information that is communicated on a periodic basis to the consumer really puts the emphasis on paying the negative amortizing, less than interest monthly payment.

If this consumer wanted to pay an amortizing payment, that would be \$1,400 a 24

month, which in his case with \$1,600 a month in Social Security income is not really a viable option.

The other aspect of this, aside from the misleading sale of that low payment, is the fact that the application states -- well, two things about the income. One is it accurately states that the income comes from Social Security, which is not likely to increase very rapidly. It increases a little bit every year, but the other thing is that it was overstated significantly.

Now I don't have the information to know. There are two possibilities. One is this is a stated-income loan, so that the lender who got this loan from a broker did not know that this was not the consumer's true information. The other possibility is that it was documented but fictitious documents were created and put in the file, and we do see that happen from time to time. But in either case, it strikes me that, although most of the misrepresentation and deception happened at the broker level, the lender had enough information to have some concern about the suitability of this product to this borrower.

The other risk factor, of course, is because the principle will increase, this \$150,000 mortgage is going to become a \$160,000, \$170,000, \$180,000. The cap in the note, I think, is 125 percent negative amortization.

So the balance will increase, and that will only work -- the consumer will only be able in a crisis to sell their home or refinance it, if the property appreciates more rapidly. So there is an inherent assumption for these products that property values will keep going up.

I will share with you that I called one of these companies that advertises -- or a broker who advertises option ARMs, so-called option ARMs, and he explained to me, the reason these work is because property values go up 15 percent a year. So your equity will outstrip the increase in the debt.

I thought that was a wonderful example of using past results to predict future performance, which we all know is not a very reliable method, particularly in this market.

So my concern about these so-called option ARMs is that they are growing hugely. There is a newsletter called "Inside Alternative Mortgages" that reports that for the first six months of this year, option ARMs accounted for 9.2 percent of all single-family residential mortgages, almost 10 percent. That, by my calculations, is an annual rate of about \$270 billion.

The story that the industry tells that these products are a response to consumer demand -- I just don't find that convincing, that suddenly all the consumers who used to borrow either fixed-rate mortgages or somewhat traditional ARMs and who wanted to have mortgages where they paid down their balance now want a negative amortization product. I just don't believe that there is a consumer preference that is being revealed by that phenomenon.

I think what is happening is that we are reaching the end of a cycle of growth, both in property values and in mortgage originations, and there is sort of a level of desperation to try and keep that volume and that growth going, and the only way to get people into mortgages that you can qualify for on some level is to have a negative amortizing product that won't ever repay the balance.

I think these are tremendously dangerous and risky products from the consumer's standpoint. I am not a sophisticated enough economist to tell you what the systemic risks are. I think they are probably there, more for the bond market than for regulated institutions. But I know that for individual homeowners there is a huge risk that is being created here of foreclosures.

It strikes me that, if the products that we saw originated in 1999 and 2000 are going into default and foreclosure at the rate of 10 percent over the life of the loan pools, that we are going to see default and foreclosure rates higher than that with these products. So where that leaves me in terms of both the Board guidance and other steps that ought to be taken: I think the Board guidance is very valuable, very helpful. Clearly, this particular transaction violates the Board guidance in a number of ways. It is my understanding that this particular lender has already -- it has been pointed out to them, and they have taken some remedial actions. I am not sure to what extent that will solve the problem.

I think there is a deeper problem of systematic, deceptive selling of this particular product. I think that -- and I was encouraged to hear that the Fed staff is talking to the Federal Trade Commission about this product, because the advertising that I see -- I brought one, which I won't pass around, but the advertising systematically focuses on this initial payment, which is a negative amortizing payment, does not disclose in any meaningful way that the payment will go up, has to of necessity go up, go up dramatically, and the true nature of these products is not being explained or disclosed to consumers.

I think that it would be very easy if any of the agencies wanted to engage in a systematic enforcement plan to look at the marketing and the selling of this product and to take a lot of serious enforcement action.

The other suggestion I would make is that, because the guidance only applies to the supervised institutions, and the problem has been pointed out and I am sure we will talk about it some more, and it doesn't apply to the finance companies and so forth, one way to deal with that perhaps is to talk to the Federal Trade Commission about doing an advertising guide.

The FTC publishes in the Code of Federal Regulations guidance on marketing of specific kinds of products. They have one, you know, for funeral parlors, and they have one for -- They have a whole variety of advertising guides. They haven't written one in quite a while. But there is no reason that they couldn't produce a marketing guide on negative amortization loans or graduated-payment loans or whatever we want to call these that addressed some of these serious problems, I think, in the misinformation that is being used to market them.