Prepared Statement of the Federal Trade Commission

by
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before the
SENATE SPECIAL COMMITTEE ON AGING

on
Home Equity Lending Abuses in the Subprime Mortgage Industry

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I. INTRODUCTION

Mr. Chairman and members of the Committee: I am Jodie Bernstein, 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 serious problem of abusive lending practices in the subprime mortgage lending industry. These comments do not address those lenders within the subprime mortgage industry who play by the rules and provide an important source of capital to various segments of borrowers. I will discuss the recent growth of this industry, abusive lending practices that reportedly are occurring in the industry, and the Commission's recent activities in this area. First, however, let me briefly speak about the Commission's role in enforcing laws that bear on these problems.

The Commission has wide-ranging responsibilities concerning nearly all segments of the economy. As part of its mandate to protect consumers, the Commission enforces the Federal Trade Commission Act ("FTC Act"), which broadly prohibits unfair or deceptive acts or practices.[(2)] The Commission also enforces a number of laws specifically governing lending practices, including the Truth in Lending Act ("TILA"),[(3)] which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions, and the Equal Credit Opportunity Act ("ECOA"),[(4)] which prohibits discrimination against applicants for credit on the basis of age, race, sex, or other prohibited factors. The Commission has jurisdiction over most non-bank lenders.[(5)] In addition to our enforcement duties, the Commission also satisfies many requests for information about credit issues and consumer credit laws from consumers, industry, state law enforcement agencies, and the media.[(6)]

We increasingly are hearing reports of problems in the home equity loan business, and the Commission is working in a number of ways to address them. Commission strategies include law enforcement activities, often coordinated with other law enforcement officials, and consumer education. It is crucial that as many consumers as possible have access to capital, but, at the same time, this access must not be hindered by deceptive or other unlawful lending practices.

II. THE SUBPRIME MORTGAGE INDUSTRY

Subprime lending refers to the extension of credit to higher-risk borrowers, a practice also commonly referred to as "B/C" or "nonconforming" credit.[(7)] Loans to subprime borrowers serve communities that may have been underserved by other lenders in the past. In recent years, subprime mortgage lending has grown dramatically, with over 90% of all subprime mortgage loans made in or after 1993.[(8)] By the end of 1996, the total value of outstanding subprime mortgage loans exceeded $350 billion.[(9)] In 1997 alone, subprime lenders originated over $125 billion in home equity loans.[(10)] Subprime loans have become a significant and growing part of the home equity market. Subprime originations constituted 11.5% of the total home equity lending market in 1996; by the first half of 1997, they had grown to 15.5% of this market.[(11)] At the same time, the composition of companies involved in the subprime market is evolving. One of the dramatic changes in this market has been the growth in subprime mortgage lending by large corporations that operate nationwide.[(12)]

The subprime mortgage market has flourished because such lending has been profitable, demand from borrowers has increased, and secondary market opportunities are growing. Lenders typically price subprime loans to consumers at rates of interest and fees higher than conventional loans.[(13)] Higher rates and points can be appropriate where greater credit risks are involved, as is often the case with subprime loans.[(14)] Critics assert, however, that the interest rates and fees charged by some subprime lenders are excessive, and much higher than necessary to cover increased risks, particularly since these loans are secured by the value of a home.[(15)] Some attribute lenders' high rates on first mortgages in part to federal deregulation of certain state interest rate ceilings in 1980.[(16)]

The relatively high profit margins in the subprime mortgage industry have fueled demand in the secondary market from investors seeking higher-yielding securitized assets, especially in an environment of generally low interest rates.[(17)] In 1996, the subprime mortgage sector issued over $38 billion in securities, the largest increase in securitizations for any lending industry sector in that year.[(18)] The secondary market's expansion has, in turn, helped to sustain growth in the industry by enabling lenders to raise funds on the open market to expand their subprime lending activities.[(19)] Freddie Mac, one of the primary government-sponsored enterprises involved in the purchase of mortgages, recently announced plans to enter the secondary market in subprime loans by purchasing significant numbers of "A minus" subprime mortgages by 1998 and the higher-risk "B and C" loans by 1999.[(20)]

The market for subprime loans is expected to continue growing. Credit card delinquencies are rising and personal bankruptcies are at record levels, which negatively affect borrowers' credit histories, pushing more consumers into higher risk categories. Meanwhile, consumer spending continues to be strong.[(21)] Together, these factors increase the market for subprime loans. In addition, more borrowers generally may be seeking home equity loans due to the change in the tax code limiting allowable interest deductions to those on a first mortgage.

III. THE PROBLEM OF ABUSIVE LENDING PRACTICES

The enormous growth of the subprime mortgage industry has enabled many consumers to obtain home loans who previously would have had much more limited access to the credit market.[(22)] Questions increasingly are being raised, however, about certain lending practices, often referred to as predatory lending, that reportedly are occurring in the subprime mortgage market and about their effect on the most vulnerable consumers.[(23)] These abusive lending practices often involve lower-income and minority borrowers.[(24)] Elderly homeowners, in particular, are frequent targets of some subprime home equity lenders, because they often have substantial equity in their homes, yet have reduced incomes.[(25)] In many cases, those living in lower-income and minority neighborhoods -- where traditional banking services continue to be in short supply -- tend to turn to subprime lenders regardless of their credit history.[(26)] While subprime lenders point out that they are expanding access to credit to individuals who otherwise would be shut out of the market and consumers whose credit histories make them too risky for conventional loans, such lenders are in a position to take advantage of the consumers in the weakest bargaining position.

It is critically important for all consumers, especially those who live in lower-income communities, to have access to capital. Access that is based on deceptive mortgage lending, however, is false access. Deceptive lending practices hide from consumers essential information they need to make decisions about their single greatest asset -- their home -- and the equity they have spent years building.[(27)] Deceptive lending practices are particularly devastating because these loans usually are sought at a time of great need, when borrowers are most susceptible to practices that can strip them of substantial sums of money and, ultimately, their homes.

Reported abusive lending practices in the subprime mortgage market cover a wide range. We will mention here a few highlighted in recent reports. While the reported practices are quite varied, there are common traits. They generally aim either to extract excessive fees and costs from the borrower or to obtain outright the equity in the borrower's home.

Among the most harmful of these reported practices is "equity-stripping." This often begins with a loan that is based on equity in a property rather than on a borrower's ability to repay the loan -- a practice known as "asset-based lending."[(28)] As a general rule, loans made to individuals who do not have the income to repay such loans usually are designed to fail; they frequently result in the lender acquiring the borrower's home equity. The borrower is likely to default, and then ultimately lose her home through foreclosure or by signing over the deed to the lender in lieu of foreclosure. Such a scheme is particularly damaging because these vulnerable borrowers often have no significant assets except the equity in their homes.[(29)]

Another practice of serious concern is "packing," the practice of adding credit insurance or other "extras" to increase the lender's profit on a loan.[30] Lenders often stand to make significant profits from credit insurance, and therefore have strong incentives to induce consumers to buy it as part of the loan.[31] At the same time, observers have questioned the value to consumers who obtain the insurance in conjunction with their loans, given the high premium cost and comparatively low claims rate.[32]

Typically, the insurance or other extra is included automatically as part of the loan package presented to the borrower at closing, and the premium is financed as part of the loan. The lender often fails to provide the borrower with prior notice about the insurance product [33] and then rushes the borrower through the closing. Sometimes, the lender represents that the insurance "comes with the loan," perhaps implying that it is free. Other times, the lender simply may include the insurance in the loan closing papers with no explanation. In such a case, the borrower may not understand that the insurance is included or exactly what extra costs this product adds to the loan. Even if the borrower understands and questions the inclusion of the insurance in the loan, subprime borrowers are not in a position to negotiate loan terms. They often need to close the loan quickly, due to high debt and limited financial resources. Therefore, they generally will not challenge the loan at closing if they believe or are told that any changes may cause a problem or delay in getting the loan.

Lenders are permitted to require the purchase of credit insurance with a loan, as long as they include the price of the premium in the finance charge and annual percentage rate. In some instances, however, the lender effectively requires the purchase of credit insurance with the loan, but fails to include the premium in disclosures of the finance charge and annual percentage rate, as mandated under the Truth in Lending Act.[34] When the lender excludes the required insurance premium from the borrower's disclosures, the cost of credit may appear significantly lower than the true cost of the credit. As a result, the consumer cannot make an informed decision about the cost of the loan.[35]

Another practice that has recently received attention is some subprime mortgage lenders engaging in "flipping," the practice of inducing[36] a consumer to refinance a loan, repeatedly, often within a short time frame, charging high points and fees each time.[37] This causes the borrower's debt to steadily increase. Although a consumer's debt may be on the rise anyway if she borrows money in connection with the refinancing, in some cases, the amount of cash received may be smaller than the additional costs and fees charged for the refinancing. While a consumer's option to refinance is an integral part of a functioning mortgage market, subprime lenders engaged in "flipping" may misrepresent to the borrower the terms and ultimate benefits of the transaction, or induce the borrower to take on more debt than she can handle. By taking advantage of its unequal relationship with a particularly vulnerable consumer, an unscrupulous lender can compromise a borrower's ability to make an informed choice about financing options.[38]

Another reported abuse in the subprime mortgage industry is the targeting of consumers by home improvement contractors who are effectively working as agents of lenders.[39] One alleged abuse involves contractors who may obtain the borrower's consent for a loan with high rates and fees through the use of deception or coercion. For example, the contractor and homeowner may agree on a price for certain work. The contractor, after beginning work on the home, may then present the homeowner with loan documents from the lender indicating higher rates and fees than those that were agreed upon. The consumer is then pressured to sign the papers as drafted -- especially when faced with the untenable prospect of leaving the improvements unfinished. In another reported scenario, the contractor may receive the loan proceeds directly or indirectly from the lender without providing any services to the homeowner, or without providing services commensurate with the amount of the payment. Nevertheless, the lender may still demand full payment from the homeowner.

Abusive practices by home improvement contractors and their affiliated lenders[(40)] are particularly problematic because the targeted homeowners often start out with no mortgage at all or a market-rate first mortgage that they later are induced to refinance. Because of the home improvement scheme, however, a homeowner with an affordable mortgage or no mortgage, and who is seeking aluminum siding or new windows, may suddenly find herself with a high-cost home equity loan.[(41)]

After a loan is closed, consumers may be subject to loan servicing practices that extract monies not owed under the loan terms or that inhibit refinancing options with another lender.[(42)] A lender may provide inaccurate monthly-payment demands, adding fees and charges that are not owed. Because of the complexities of loan terms, it is difficult for the borrower to know whether the lender's payment demands are accurate. A lender also may fail to provide full or accurate pay-off information. Consequently, the borrower becomes tied to a lender without a means of escape.[(43)]

Some of these reported abusive lending practices may be illegal under various federal or state laws, including a number of laws enforced by the Commission. Depending on the particular facts, some of the practices may constitute deceptive or unfair practices in violation of Section 5 of the FTC Act or a comparable state statute. In addition, these practices may constitute violations of the TILA, as well as violations of the protections for high-rate and high-fee loans under the Home Ownership and Equity Protection Act ("HOEPA"), an amendment to the TILA that became effective in October 1995.[(44)] If a lender charges similarly-qualified borrowers higher prices based on age, race, and/or sex, such a practice would constitute pricing discrimination in violation of the ECOA.[(45)] Additionally, if a lender targets borrowers for abusive practices based on age, race and/or sex, such targeting, depending on the facts, also could violate the ECOA.

IV. THE COMMISSION'S RESPONSE

Given this background, the Commission is taking a variety of steps to address reported abuses in the subprime home equity market. First, the Commission is increasing its enforcement activities to halt subprime lenders who are engaged in abusive lending practices. At the same time, the Commission has been working with states to increase and coordinate enforcement efforts. The Commission also is educating consumers in order to help them avoid potential home equity lending abuses.

In January 1998, the Commission filed a complaint in the United States District Court for the District of Columbia against Capital City Mortgage Corporation, a Washington, DC-area mortgage lender, and its owner, alleging numerous violations of a number of federal laws resulting in serious injury to borrowers, including the loss of their homes.[(46)] The company allegedly made home equity loans to minority, elderly, and low-income borrowers at interest rates as high as 20-24 percent. Borrowers often faced foreclosure on their properties, after which the company would buy the properties at auction for prices much lower than the appraised value of the properties.

The Commission's complaint alleges that the defendants engaged in deceptive and unfair practices against borrowers at the beginning, during, and at the end of the lending relationship, in violation of Section 5 of the FTC Act. The complaint alleges that the defendants deceived borrowers about various loan terms; for example, by making representations that a loan was an amortizing loan that would be paid off by making payments each month. In fact, the loan was an interest-only balloon loan with the entire loan principal amount due after all of the monthly payments were made. The complaint also alleges that the defendants deceived borrowers during the loan period with phony charges of inflated monthly payment amounts, overdue balances, arrears, service fees, and advances. In addition, the complaint alleges that the defendants deceived borrowers regarding amounts owed to pay off the loans. Further, the complaint alleges that the defendants violated the FTC Act by: withholding some loan proceeds while requiring a borrower to make monthly payments for the entire loan amount; foreclosing on borrowers who were in compliance with their loan terms; and failing to release the company's liens on title to borrowers' homes even after the loans were paid off. In addition to the Commission's allegations of violations of the FTC Act, the Commission also charged the defendants with violations of the TILA, the Fair Debt Collection Practices Act,[(47)] and the ECOA.[(48)]

In the area of loans sold with credit insurance, the Commission has a long enforcement history. Most recently, the Commission settled a case last year against The Money Tree, a Georgia-based consumer finance lender, and its president. The case involved, in part, allegations that the company required consumers to purchase credit-related insurance and other "extras" along with their loans, without disclosing to consumers the true cost of their credit. The settlement, in part, requires Money Tree to offer refunds of certain insurance premiums to customers whose loans were open at the time the settlement became final. It also mandates that the company approve borrowers' loan applications prior to any discussion with the borrower regarding credit insurance and requires that the company provide expanded disclosures.[(49)] In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans.[(50)] The Commission is using the knowledge it has developed through the Money Tree and Tower Loan cases, as well as earlier enforcement actions,[(51)] to investigate potential insurance problems in home equity lending.

In addition to its casework and ongoing investigations, the Commission is sharing its knowledge and experience with other enforcement agencies and with consumers. Last year, the Bureau of Consumer Protection's Division of Credit Practices held joint law enforcement sessions on home equity lending abuses with state regulators and law enforcers in six cities around the country. These training sessions were conducted to assist states in exercising their relatively new enforcement authority under HOEPA[(52)] and to share information about recent trends.

In the area of consumer education, the Commission has developed a brochure focusing on consumer rights under HOEPA, for high-rate, high-fee loans covered by that law. In conjunction with the filing of the Capital City complaint, the Commission began distributing a Consumer Alert, advising consumers on how to avoid home equity scams. The Commission today is releasing a new consumer education brochure with additional advice for consumers on home equity abuses.

V. CONCLUSION

The Commission recognizes that abuses in the home equity lending market are a serious national problem. Due to sharp growth in the subprime mortgage industry, it appears that the abuses by subprime lenders are on the rise. As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers -- including the elderly -- are facing the possibility of paying significant and unnecessary fees and, in some cases, losing their homes. Using its enforcement authority, the Commission continues to work to protect consumers from these abuses.

ENDNOTES

1. The views expressed in this statement represent the views of the Commission. 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. . See 15 U.S.C. § 45(a).

3. . See 15 U.S.C. §§ 1601 et seq.

4. . See 15 U.S.C. § 1691.

5. . See, e.g., 15 U.S.C. § 45(a); 15 U.S.C. § 1607.

6. . A number of the remarks in this testimony are based on the Commission's administrative and enforcement experience in the area of home equity lending, including consultations with individual consumers, consumer groups, and industry.

7. . Credit to "prime" borrowers, borrowers generally with good credit histories, is referred to as "A" credit. "A" mortgage loans are those that conform to the secondary market standards for purchase by the government-sponsored entities, Fannie Mae and Freddie Mac (although Freddie Mac now is purchasing "A minus" subprime loans).

8. . See Martin Wahl and Craig Focardi, *The Stampede*, Mortgage Banking, Oct. 1997, at 26, 31. This figure

stands in contrast with an increase of 61% in the prime mortgage market for approximately the same period.

9. . See Wahl and Focardi, supra note 7, at 31.

10. . See *Top 25 B & C Lenders in 1997*, Inside B & C Lending, Feb. 16, 1998, at 2.

11. . See Wahl & Focardi, supra note 7, at 29. The number of mortgage brokers in this market skyrocketed from 500 in 1985 to 20,000 in 1996. See *The Two Faces of B&C Lending*, Am. Banker, May 6, 1997, at 2A.

12. . See *Home Loan Leaders*, Am. Banker, Oct. 7, 1997, at 16A, 20A; Timothy L. O'Brien, *Lowering the Credit Fence*, N.Y. Times, Dec. 13, 1997, at B1; Adam Zagorin, *Sub-Prime Time*, Time, Nov. 4, 1996, at 67.

13. . See Paul Muolo, *Profits Put Sizzle in Subprime Lending*, U.S. Banker, Aug. 1997, at 62. Following a recent boom, earnings in the subprime home equity market generally dipped in the fourth quarter, although many companies' profits already are back on the rise. See Heather Timmons, *Home Equity Sector Rises After Do-or-Die Quarter*, Am. Banker, Feb. 5, 1998, at 9.

14. . Many subprime lenders justify their rates and fees on this basis.

15. . See O'Brien, supra note 11, at B3.

16. . See, e.g., Norma Paz Garcia, Dirty Deeds: Abuses and Fraudulent Practices in Los Angeles' Home Equity Market, Consumers Union, October 1995, at 25; Mike Hudson, *Stealing Home*, Wash. Monthly, June 1992, at 23, 26. Congress removed federal interest rate ceilings and preempted many state usury laws on first lien mortgages with passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7.

17. . See Wahl & Focardi, supra note 7, at 29.

18. . See *Record B & C Securitization Seen in 1996*, Inside B & C Lending, Feb. 17, 1997, at 4.

19. . See Wahl & Focardi, supra note 7, at 29. Growth in subprime originations also has been facilitated somewhat by the increasing availability of warehouse lines of credit, which provide short-term funding to lenders for the purpose of loan financing. See *Warehouse Lines of Credit: Limited for B & C Lenders?*, Inside B & C Lending, Feb. 17, 1997, at 9.

20. . See *Subprime Loans Supreme*, ABA Banking J., Nov. 1997, at 77; *Freddie Mac Announces Aggressive Timetable for Full Involvement in Subprime Mortgage Business*, Inside Mortgage Fin., Oct. 10, 1997, at 3. In the letter-grade system for categorizing risk, which ranges from "A" through "D," borrowers who are the most creditworthy are "A"credit risks and those who present the worst credit risks are "D" credit risks. The subprime market generally refers to loans below the "A" level, however the criteria for each credit category are not standardized across the industry and therefore differ among subprime lenders.

21. . See Kim Clark, *Why So Many Americans Are Going Bankrupt*, Time, Aug. 4, 1997, at 24; Thomas Goetz, *Loan Sharks, Inc.*, Village Voice, July 15, 1997, at 33, 34; Michael Markowitz, *U.S. Bankruptcies At Record Level*, Bergen County Rec., Jan. 8, 1998, at A1; *Nothing Sub-Prime About These Profits*, Business Week, Sept. 4, 1995, at 98; *The Two Faces of B&C Lending*, supra note 10 at 2A.

22. . A full discussion of the entire subprime market is beyond the scope of this testimony.

23. . Attention to practices of subprime lenders also has increased due to lawsuits challenging lender payments to brokers under the Real Estate Settlement Procedures Act ("RESPA"). See generally Culpepper

v. Inland Mortgage, 132 F.3d 692 (11th Cir. 1998); Barbosa v. Target Mortgage Corp., 968 F. Supp. 1548 (S.D. Fla. 1997); Mentecki v. Saxon Mortgage Inc., Civ. No. 96-1629-A, U.S. Dist. LEXIS 1197 (E.D. Va. January 10, 1997); see also Carol M. Cropper, *Even With Mortgage Brokers, Let the Borrower Beware*, N.Y. Times, Sept. 8, 1996, § 3, at 8.

24. . See Complaint at 6, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998); Goetz, supra note 20, at 33; Anastasia Hendrix, *Oakland Widow: They Stole My House*, S.F. Examiner, Apr. 13, 1997, at A-1; O'Brien, supra note 11, at B3; Kay Stewart & David Heath, *High-Cost Loans Trap Those Least Able To Afford It*, Louisville Courier-Journal, Feb. 16, 1997, at 16-17; Lucille Renwick, *Wolf at the Door*, L.A. Times, Mar. 14, 1993, at 16.

25. . For example, the Department of Justice announced a settlement in September 1996 with Long Beach Mortgage Company addressing allegations, inter alia, that the company discriminated against the elderly, African Americans, Latinos, and women by charging higher rates than were offered to other similarly-qualified borrowers. The combination of these factors was alleged to be crucial. For example, African American females over the age of 55 were 2.6 times more likely than white males under age 56 to be charged fees and points that amounted to 6% or more of the loan amount. See Complaint, United States v. Long Beach Mortgage, Civ. No. 96-6159DT (CWX) (C.D. Cal. filed Sept. 5, 1996).

26. . See Goetz, supra note 20, at 34.

27. . Fifty-eight percent of seniors living below the federal poverty level own their own homes. Derived from U.S. Dept. of Commerce & U.S. Dept. of Housing and Urban Development, American Housing Survey of the United States, 1993. Thirty-nine percent of all families below the federal poverty level own their own homes. Derived from U.S. Dept. of Commerce & U.S. Dept. of Housing and Urban Development, American Housing Survey for Selected Metropolitan Areas, 1991-94.

28. . *Hearings Before the Federal Reserve Board on the Effect of Truth in Lending Act Provisions Enacted in 1994 on the Home Equity Loan Market*, June 17, 1997 (testimony of Elizabeth Renuart, National Consumer Law Center).

29. . While the TILA, as amended by the Home Ownership and Equity Protection Act, prohibits a pattern or practice of asset-based lending, this proscription only applies to the narrow set of high-rate and high-fee loans covered by the statute and does not apply at all to purchase-money loans. See 15 U.S.C. § 1639; 12 C.F.R. § 226.32. For a discussion of HOEPA's requirements, see infra note 43.

30. . See The Money Tree, No. C3735 (F.T.C. Apr. 28, 1997) (settling allegations that credit insurance and other "extras" were required but not included in finance charge and APR disclosures in violation of the TILA and, in certain instances, the FTC Act); Tower Loan of Mississippi, 115 F.T.C. 140 (1992) (same).

31. . The guidelines established by the National Association of Insurance Commissioners suggest that lenders and insurers may retain up to 40 cents on the dollar from premiums paid by borrowers, with 60% of premium payments paid out for claims. In most states, however, lenders and insurers retain more than 40% of premium monies; in some states, they keep up to 70% or 80% of the proceeds. See Jane Bryant Quinn, *Credit Life Insurance Often Overpriced*, Wash. Post, Feb. 9, 1997, at H2.

32. . See Mike Hudson, *Credit Insurance: Overpriced and Oversold*, N.Y. Times, July 3, 1994, at 8 (discussing overcharging for credit insurance policies). Concerns regarding the value and marketing of credit insurance date back to the 1970's. See Charles Hassell, *Credit Insurance Problems*, National Association of Attorneys General Consumer Protection Newsletter, May 15, 1975, Vol. 3, No. 5, at 11 (finding that lenders often do not disclose to borrowers material facts about policy provisions and exclusions); Phillip Stern, *Debt Insurance Charges*, Wash. Post, Nov. 12, 1974, at A9 (asserting that purchasers of credit life insurance were

overcharged a total of $615 million in 1973).

33. . This scenario is known as "bait and switch," because the closing papers differ from the loan package previously discussed with the borrower.

34. . See 12 C.F.R. § 226.4(b)(7). Typically, lenders can easily induce borrowers to sign a line in the thick package of complex loan closing papers indicating that the purchase of insurance is voluntary when, in fact, they have little choice if they want to close the loan at that time. Whether credit insurance is in fact required or optional is a factual question. See Federal Reserve Board, Official Staff Commentary to Regulation Z, § 226.4(d)(5).

35. . Lenders have incentives to omit required credit insurance premiums from the disclosures of the annual percentage rate and finance charge. First, the appearance of a lower rate may induce the borrower to follow through on the transaction. Second, the lower figure may cause the lender's annual percentage rate to appear to fall below state rate ceilings, which it may in actuality be exceeding.

36. . One method of inducing a borrower to refinance is by issuing a balloon note -- particularly one in which the borrower is paying only interest -- where the note comes due in a relatively short period of time. When the note comes due and the borrower owes a substantial lump sum -- sometimes equal to the entire principal of the original loan-- the borrower must again obtain a loan in order to finance the balloon payment that is due at that time.

37. . See, e.g., Kay Stewart, *Widow Sold Her House To Pay Loan She'd Hoped Would Ease Her Debts*, Louisville Courier-Journal, Feb. 16, 1997, at 16 (lender refinanced borrower's loan four times in nine months). Lenders in the consumer finance industry have long relied on refinancing, and sometimes repeated refinancing, as a source of business. See W. Artz & R. Neihengen, Jr., *Analysis of Finance Company Ratios in 1994*, 78 J. Commercial Lending 33, 37 (Sept. 1995) (showing that, from 1990 to 1992, companies refinanced existing loans to present borrowers in a range of 63% to 66.8% of the cases); Report of the Presiding Officer on Proposed Trade Regulation Rule: Credit Practices, Federal Trade Commission, Aug. 1978, at 43-44 (creditors self-reported refinancing loans for existing customers in a range of 35% to 75% of accounts, with an average of 56.5%).

38. . See, e.g., Emery v. Am. Gen. Fin., 71 F.3d 1343 (7th Cir. 1995) (noting that disclosures do not wholly protect a vulnerable borrower from misrepresentations in connection with loan refinancing and holding that flipping can present a civil cause of action under RICO).

39. . See Complaint, Newton v. United Cos. Fin. Corp., Civ. No. 97-CV-5400 (E.D. Pa. filed Sept. 2, 1997) (class action suit on behalf of low-income borrowers who paid fees and charges of up to 50% of the cost of the home improvements); Complaint, Harris v. Green Tree Fin. Corp., Civ. No. 97-CV-1128 (E.D. Pa. filed Feb. 14, 1997) (class action suit challenging deceptive home improvement loan contracts); see also Stuart L. Ditzen, *From Home Loans to Lawsuits*, Phila. Inquirer, Dec. 17, 1997, at B1.

40. . Although a consumer targeted by a home improvement contractor often has no direct contact with the lender, the consumer generally still can bring an action against the lender. The contractor, pursuant to the Commission's Trade Regulation Rule on Preservation of Consumer Claims and Defenses, known as the Holder Rule, is obligated to include in the consumer's loan documents a provision stating, in part, that "any holder of [that] consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services . . . ." See 16 C.F.R. § 433.2. Therefore, depending on the facts of a particular case, the lender could be subject to any claims that the borrower could have brought against the contractor. If the contractor omits this language from the loan documents, the omission itself would constitute a violation of the Holder Rule.

41. . Lenders have several incentives to refinance a homeowner's existing mortgage rather than to merely

originate a new loan for the home improvements. First, lenders generally seek to originate one combined loan rather than only a second mortgage for the smaller cost of the improvements. This allows the lenders to maximize fees that are obtained based on the loan principal. Second, lenders generally prefer the initial lien position because of the benefits that would accrue to them in the event of a borrower's bankruptcy. Third, under current federal law, state usury caps do not apply to first liens. See 12 U.S.C. § 1735f-7.

42. . See Complaint at 11-13, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998). See infra note 45 and accompanying text for a discussion of this case.

43. . A borrower also may be tied to a lender if the lender's appraisal intentionally and significantly overvalues the property because the borrower's loan-to-value ratio may be too high for refinancing. This is known as a "bumped appraisal."

44. . HOEPA prohibits various practices and requires that certain material disclosures be provided in advance for certain home equity loans. HOEPA applies only to loans where the APR exceeds the comparable Treasury security rate by more than 10 percentage points or where the total fees and points exceed the larger of $435 or 8 percent of the total loan amount. (The $435 figure is applicable to 1998 and is updated annually by the Federal Reserve Board.) If a loan meets this considerable threshold, a lender must provide several special disclosures of loan terms and conditions. In addition, the loan may not be based solely on equity and may not include, inter alia: negative amortization, most pre-payment penalties, balloon payments for loans with less than five-year terms, and default interest rates higher than pre-default rates. HOEPA does not apply to purchase money, reverse mortgage, or open-end mortgage loans. See 15 U.S.C. § 1639; 12 C.F.R. § 226.32.

45. . See supra note 24 for a discussion of the Department of Justice's settlement with Long Beach Mortgage.

46. . See Complaint, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998).

47. . See 15 U.S.C. § 1692.

48. . See also Complaint, F.T.C. v. Nationwide Mortgage Corp., Civ. No. 85-0976 (D.D.C. filed Mar. 26, 1985); Complaint, F.T.C. v. R. A. Walker and Assoc., Civ. No. 83-2462 (D.D.C. filed October 5, 1983). In Nationwide, the Commission alleged that Nationwide solicited consumers whose mortgages were in default and offered them one-year, interest-only loans with balloon payments of the entire loan balance due at the end of the year. The complaint alleged that Nationwide's practices were deceptive and violated Section 5 of the FTC Act because Nationwide told consumers falsely that they would be able to obtain refinancing at the end of the year. The complaint also alleged violations of the TILA based on Nationwide's alleged failure to disclose the balloon payment and the company's alleged practice of inducing some consumers to sign statements indicating their loans were for business purposes, which are exempt from TILA protections, when in fact they were consumer loans. In R. A. Walker, the complaint alleged that Rita Walker solicited consumers whose mortgages were in default, persuaded them to transfer title to their property to Walker, and engaged in unfair and deceptive practices in violation of Section 5 by falsely claiming that the transfer of title was a temporary measure to avoid foreclosure and that Walker would obtain financing for the consumers that would allow them to remain in their homes.

49. . See The Money Tree, No. C3735 (F.T.C. Apr. 28, 1997).

50. . See Tower Loan of Mississippi, 115 F.T.C. 140 (1992).

51. . See, e.g, Commercial Credit Co., 82 F.T.C. 1841 (1973), *order reopened and modified*, 98 F.T.C. 783 (1981).

52. . States also have authority to enforce HOEPA. See 15 U.S.C. § 1640 (e).