February 12, 2001

Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: FDIC Staff Memorandum: How to Avoid Purchasing or Investing in Predatory Mortgage Loans

Dear Mr. Feldman:

In November 2000, the Federal Deposit Insurance Corporation ("FDIC") posted on its website a draft Staff Memorandum ("staff memo") containing "suggestions on how to avoid purchasing or funding predatory mortgage loans and investing in securities backed by such loans." The FDIC stated that "[t]hese activities may be the most common means by which financial institutions and other investors unknowingly help to fund predatory loans, incurring several risks." The FDIC invited comment from bankers to refine the suggestions put forward by the FDIC in the staff memo. The American Bankers Association brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and bank holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest bank trade association in the country.

The American Bankers Association condemns predatory lending. ABA has formed a banker-led Lending Practices Working Group to educate bankers and local communities on combating illegal loans and to act in an advisory capacity on consumer education initiatives and partnerships to help end predatory lending. ABA is concerned not only about the risks to banks posed by predatory lenders mentioned by the FDIC in its staff memo but also about the risks to banks' communities as well as customers or potential customers. Therefore, ABA welcomes the FDIC's efforts at providing education guidance to bankers on how to avoid purchasing or investing in predatory loans. As ABA has stated in other forums and other comments, the keys to ending predatory lending are better enforcement of the laws against financial fraud and better consumer education. For the sad truth is that every predatory loan was consented to by a borrower who, if more financially knowledgeable, would have not been victimized by that predatory lender. As Federal Reserve Board Governor Gramlich said in a speech on December 6, 2000:

"[W]e should all recognize that the best defense against predatory lending is a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and know how to exercise those rights can thwart predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes. Unfortunately, as is usually the case, the best solutions are often the most difficult to implement. A massive educational campaign is needed to bring about this expanded consumer knowledge."[1]

However, while favoring stricter and broader enforcement of the law and better consumer education, ABA has been concerned about state and local attempts to prevent predatory lending through overly broad lending restrictions. Because predatory lenders cleverly try to mask themselves as legitimate lenders, a number of attempts to ban predatory loans appear to confuse legitimate subprime loans with predatory loans, resulting in less credit being available in the subprime market. Some of these proposals to ban predatory lending, if adopted, will have a negative impact on banks' CRA lending. The FDIC itself is aware of this problem of confusion between predatory and subprime lending, as shown by the following statement taken from the memorandum:

"This memorandum is not intended to discourage the purchase of properly underwritten and appropriately priced subprime loans or securities backed by such loans. On the contrary, the FDIC believes safe and sound, well-managed subprime lending programs, with appropriate capitalization and loan pricing, provide an important source of credit for borrowers whose credit history may not permit them to qualify for the conventional "prime" loan market."

It is with all of these concerns in mind that the American Bankers Association submits these comments in response to the FDIC's questions about its draft staff memorandum on avoiding purchasing or investing in predatory loans. These comments follow the FDIC's organization of questions about the staff memo.

GENERAL COMMENTS

Question No. 1. Is the approach suggested appropriate for institutions of all sizes?

Some bankers thought that the FDIC's approach was more appropriate for smaller banks doing few purchasing or investment transactions. One large bank said that their mortgage investment business pooled loans from such a wide variety of sources, including from different parts of the bank and different bank affiliates that the suggestions by the FDIC (such as consulting with Better Business Bureaus, state Attorneys General, and local affordable housing groups) was impractical, given the volume and pace of the mortgage securitization market. Even in purchasing loans, high volume purchasing programs would find it impractical to review title insurance policies for the date of the last recording of a mortgage or to ensure that collateral was appraised fairly and accurately. In fact, one banker asked, with respect to the appraisal suggestion, "how does one do that on an out-of-market purchased loan?")

Also, some of the recommendations appear more appropriate as due diligence before forming an agency relationship with a broker rather than just purchasing or investing in loans. Obviously, the closer the relationship of the bank to the broker or originator, the more due diligence would be required. The FDIC comes close to recognizing this when it writes in the staff memo that:

Even the best-intentioned banks can become associated with predatory lending, inadvertently, through involvement in the mortgage and securities markets. Some banks purchase loans from loan brokers. Others have lending subsidiaries, form joint ventures with other lenders, or provide warehouse lines of credit, liquidity facilities, and dealer or broker lines. Some banks or their subsidiaries may service loans. In addition, some banks might invest in asset-backed securities or participate in the securitization process by providing trust services or acting as an underwriter….

The advice in this memorandum focuses on loan purchases and investments in securities, those parts of the mortgage market that pose the most common risk to institutions. However, the underlying principles also apply to other ways banks may be involved in the mortgage market. Each bank needs to decide for itself precisely how and to what extent it will undertake due diligence to minimize the risk of involvement in predatory loans.[2]

While ABA concurs with the FDIC that appropriate due diligence is a decision to be made by each bank, as noted above, ABA believes that the FDIC has actually provided guidance for due diligence beyond that necessary for banks just purchasing or investing in loans. In fact, the FDIC's guidance appears more focused on closer relationships than being just a purchaser or investor, relationships such as joint ventures, providing warehouse lines or forming exclusive funding or purchasing agreements.

Question No. 2. What other steps or alternatives might we consider?

One step that would be consistent with better enforcement and with the federal banking regulators' (the "Agencies") just released (January 31, 2001) Examiner Guidance on Subprime Lending would be to refer suspected instances of predatory lending by nonbank lenders or brokers to the appropriate enforcement agencies. (Obviously, if examiners find that the examined bank is directly engaging in predatory lending, the Agency will refer the violations to its own enforcement staff as well as referring fair lending violations to the Department of Justice.) Since the Examiner Guidance clearly calls for greater scrutiny of subprime loans during examinations and provides some guidance on examiners detecting abusive or predatory lending, perhaps the Agencies should increase the Guidance on detecting predatory loans and refer suspected instances to the appropriate enforcement authorities.

Question No. 3: What effect, if any, would the approach suggested have on the subprime market? On under-served markets?

Question No. 4: What part, if any, of the suggested review process may lead to unintended consequences? What are the unintended consequences and how might we avoid them?

ABA and the Agencies are all concerned that too hasty steps taken to combat predatory lending may reduce credit availability to less-than-prime-creditworthy borrowers. For example, Federal Deposit Insurance Corporation Chairman Donna Tanoue, in her testimony before the House Banking Committee on May 24, 2000, said:

"As you know, several proposed predatory lending bills are aimed at providing consumer protection against abusive practices in connection with mortgage loans. Some proposals ban such practices as balloon payments and prepayment penalties while others prohibit the charging and/or financing of certain fees. While well-intended, outright prohibitions of such practices could unduly limit credit availability or increase the cost of credit to the same consumers that we are trying to protect."

In the course of soliciting comments from our members on the FDIC staff memo, ABA staff were told by some bankers that the lack of clarity in the fair lending law on the responsibilities and liabilities of a third-party purchaser of consumer or mortgage loans had caused them to stop buying auto loans or subprime loans. New concerns (discussed below in more specific detail in Questions Nos. 7, 8 and 12) raised by the FDIC in its staff memo on avoiding buying or investing in predatory loans could have a similar effect on sales of third party paper. ABA is particularly concerned that the FDIC staff memo not be accepted as setting an absolute legal standard of due diligence with respect to buying mortgage loans. ABA does believe that such a result would add costs to consumers and reduce liquidity in the secondary mortgage market. And ABA believes that creating such a due diligence standard for identifying predatory loans is virtually impossible. As Governor Gramlich has said:

"[O]ne distinguishes predatory lending from subprime lending by the features of the loan **and, importantly, by whether the borrower understands the terms of the loan. Thus, there is no ready way to distinguish predatory from subprime lending**, to identify predatory lenders, or to measure amounts."[3]

To the extent that the FDIC staff memo purports but fails to define predatory lending distinguishably from subprime lending, ABA believes that the FDIC inadvertently may be discouraging banks from engaging in subprime lending, which the FDIC has already stated that it does not wish to do.

Another concern is whether the FDIC staff memo is addressed just to state nonmember banks that have the FDIC as their primary federal banking supervisor or to all FDIC-insured institutions. ABA notes that a number of bankers ABA consulted on the staff memo indicated that their institutions were not filing comments since the FDIC was not their primary supervisor. As the FDIC suggests in the staff memo that predatory lending raises fair lending concerns, ABA is surprised that the FDIC's staff memo was not prepared in coordination with the other banking supervisors or even with all of the federal agencies party to the Joint Policy Statement on Discrimination in Lending. Further failure to coordinate with the other fair lending enforcement agencies on a common approach to predatory lending will only increase lender and borrower confusion. Adding to potential confusion, on the day comments were due on the FDIC staff memo the four banking Agencies released an Examiner Guidance on Subprime Lending that gave a different definition of predatory lending than that found in the FDIC staff memo, suggesting that there is considerably more difficulty in identifying predatory loans than the FDIC acknowledges in its staff memo. At a minimum the relationship between these two documents and the identity of the target audience of the FDIC staff memo need to be clarified.

Question No. 5: General comment on all aspects of the memorandum.

ABA believes the FDIC's proposal could substantially increase the vast majority of legitimate creditors' risks and costs of doing business and would do little to curb predatory lending. Any guidelines adopted by the FDIC should be narrowly drawn to focus only on high risk purchases. If the effect of the proposal is to drive away depository institutions from the legitimate subprime lending market, the consequences may be to dry up the availability of credit to individuals who already have limited access to it.

SECTIONS OF THE MEMORANDUM

I. Purpose and Introduction.

Question No. 6: How can we better describe predatory loan characteristics?

In the staff memo, the FDIC states:

"Predatory loan characteristics and practices are well known:

- Misleading or fraudulent marketing
- Loan fees and interest rates higher than necessary to cover profit and risk
- Excessively priced products, such as single premium credit life insurance
- Large prepayment penalties that make it difficult to refinance affordably
- Balloon payments likely to result in default and foreclosure
- Abusive collection and aggressive foreclosure practices
- Mandatory arbitration provisions

This guidance suggests steps to identify some of these characteristics. While a few occurrences of these characteristics in a package of loans may not indicate a pattern of predatory lending, several occurrences may raise concern, depending on the circumstances surrounding the loans."

Unfortunately, the FDIC's list of characteristics is so judgmental or requires knowledge unavailable to a purchaser or investor so as to invite confusion of predatory loans with legitimate loans. For example, loan fees and interest rates higher than necessary to cover profit and risks is extremely subjective, and suggests that the FDIC has predetermined what is a fair profit. There is a similar problem with determining when products are "excessively priced." "Large prepayment penalties that make it difficult to refinance affordably" is extremely subjective, given that the purpose of a prepayment penalty is in fact to reduce the likelihood of refinancing, partly as a way to protect the bank from prepayment risk, a risk that the FDIC expects banks to anticipate for safety and soundness reasons.

While the FDIC states that these characteristics of predatory loans are well-known, ABA notes that in the January 31, 2001, examiner guidance on subprime lending, this list was not given to examiners. Instead, examiners were advised that predatory or abusive loans typically involve:

"at least one, and perhaps all three, of the following elements:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;

- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower."

Interestingly, this definition is taken virtually word for word from that same speech by Federal Reserve Board Governor Gramlich in which he declared an educated consumer the best defense to a predatory lender. After giving these three characteristics of a predatory loan, Governor Gramlich pointed out just how predatory lending mimics good lending:

"Some of these practices are clearly illegal and can be combated with legal enforcement measures. But <u>some are more subtle, involving misuse of practices that can improve credit market efficiency most of the time</u>. For example, the freedom for loan rates to rise above former usury law ceilings is mostly desirable, in matching relatively risky borrowers with appropriate lenders. But sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. Most of the time balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. But sometimes balloon payments can ruin borrowers who do not have a rising income stream and are unduly influenced by the up-front money. Most of the time the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates, but sometimes easy refinancing means high loan fees and unnecessary credit costs. Often mortgage credit insurance is desirable, but sometimes the insurance is unnecessary, and sometimes borrowers pay hefty premiums up-front and often as their loans are flipped." [Emphasis added.] [4]

Therefore, ABA recommends that the FDIC should rewrite its list of characteristics of predatory loans to recognize how difficult it is for a purchaser or investor to distinguish between a predatory loan and a good loan, because predatory lenders actively mimic good lenders. The examples should clarify that the determination that an interest rate covers more than profit and risk or that a balloon payment is likely to result in default and foreclosure is very hard to ascertain from loan documents available to a purchaser or investor.

Question No. 7: How can we better describe the risks to banks and the communities they serve?

The FDIC only generally describes the risks to banks as follows:

"Predatory loans harm individuals and communities, raising compliance concerns for financial institutions. Predatory loans can have a negative impact on a bank's Community Reinvestment Act evaluation. The loans may violate fair lending laws and other consumer protection laws, resulting in legal or regulatory action. Questionable loan underwriting and the risk of litigation also raise safety and soundness concerns."

As the FDIC staff memo is limited to addressing concerns of purchasers and investors, ABA recommends that the FDIC more specifically address the fair lending legal or regulatory concerns of banks as third-party purchasers. ABA notes that the 1994 Interagency Policy Statement on Discrimination in Lending failed to address secondary market activities except in the answer to its Question No. 11 on the role of secondary market guidelines in determining whether the primary lender has committed lending discrimination. Review of Department of Justice fair lending settlements involving secondary market activities (such as the Long Beach settlement) and of the banking agencies' settlements (such as the Federal Reserve Board's enforcement action against Foxdale) provides little guidance to the *bona fide* third-party purchaser or investor that is the subject of this FDIC guidance. While assignees may be held liable for violations by primary lenders of the HOEPA provisions, such violations are observable from the documents presented to the purchaser. As noted above, the fraudulent and deceptive practices of the predatory lender or the lack of understanding of the borrower are not so discoverable from the loan documents before a third-party purchaser. As to litigation risk, this is extremely hard to quantify, particularly with respect to legal products and practices (such as arbitration, credit insurance, balloon payments, prepayment penalties) that may be abused by a predatory lender.

One risk not mentioned by the FDIC but bearing heavily on the minds of bankers is the risk to reputation of being labeled a predatory lender. As noted above, fear of being unfairly labeled a predatory lender or a violator of fair lending laws is causing some bankers to withdraw from some secondary market or third-party paper purchases and investments. ABA believes that because the legal liability under the fair lending laws for such purchases and investments continues to be unclear, banks are avoiding some legitimate banking activities in order to be sure that they have minimized their risks of litigation and to reputation. ABA believes that the Agencies need to clarify the law in this area and thus more clearly delineate the risks.

The FDIC might better define the risk focus of this guidance by limiting its recommendations to purchases and investments in subprime mortgages. As the FDIC states in the staff memo, predatory lending occurs mostly within the subprime lending market. HUD and Treasury in their joint report on predatory lending issued earlier this year conclude the same. Yet the staff memo appears to apply to all mortgage loan purchases or mortgage-backed securities. ABA believes that predatory practices in the "prime" market are rare and appear to be less common in first lien originations. The FDIC might then better risk focus its staff memo on subprime mortgages that are junior liens. In fact, the FDIC appears to approach such a risk focus in its Three Step Process in reviewing loans for purchase. ABA encourages the FDIC to more clearly target the staff memo to only known high-risk situations, such as in areas highlighted in the HUD/Treasury report involving loans originated in connection with home improvement contractors and mortgage brokers originating second and third mortgages.

Question No. 8: General comments

ABA believes that the vague discussion of possible risks and the subjective, judgmental guidance on identifying predatory loans in connection with the broad application of the guidance to all mortgage purchases and investments may actually increase banks' risks in purchasing or investing in mortgages. ABA believes that the staff memo will be read by banks' and plaintiffs' attorneys as establishing an industrywide standard of care for secondary market purchasers and investors: a "standard of care" that does not in fact provide the certainty and clarity that a standard of care must to be of benefit to its users.

II. How to Avoid Purchasing Predatory Loans

Question No. 9: What additional information would make the review easier to undertake?

The FDIC suggests a Three Step review, with each stage designed to develop information that would either lead to the next stage or be sufficient to stop the review process. While theoretically useful, bankers are skeptical that the steps are likely to lead to revealing predatory lenders. For example, review of sales and marketing activities by a purchaser will not uncover the actual behavior of a predatory originator's sales and lending personnel. As so many of the anecdotes of predatory loans reveal, borrowers are often told different things than appear on the loan documents, and yet these borrowers sign the documents anyway, trusting in the "word" of the lender's representative. Bankers also report that state's Attorneys General often do not discuss companies and persons under active investigation.

Determining whether an originator has complied with the applicable banking regulations in Step Two is more like a compliance audit than a purchaser's due diligence. In reviewing a sampling of loan files in Step Three, verifying appraisals also appears impractical. The loan file sampling procedures recommended in Step Three appear to require resources that are simply not available to most institutions. File sampling itself is a common precautionary measure, but the extent of procedures listed is inconsistent with commercial practices. A purchaser may inspect a file for terms in the Good Faith Estimate and documentation of required disclosures, but it would be difficult to detect steering or whether adverse actions are mailed in a timely manner. Finally, as discussed above, that the guidance from the FDIC explicitly suggests such review appears to substantially increase the risk that banks will be held accountable in the future for originators and sellers' actions for which they would not currently be held. As stated above in Question No. 1, the FDIC's suggestions appear to be addressed to appropriate due diligence for relationships more like principal and agent rather than just purchaser and seller.

Question No. 10: General comments

ABA has no additional comments.

III. How to Avoid Investing in Securities Backed By Predatory Loans

Question No. 11: What other information about the securitization process should we consider?

ABA received no recommendations for additional information. Some bankers did tell ABA that if they did request some of the additional information suggested by the FDIC, they would be unlikely to receive it. In that case, the FDIC seems to be implying that the bank should not invest in the securities, absent receiving the additional information. Again, such a result may diminish the available credit for subprime mortgages, while not really stopping predatory lending.

From the perspective of protecting the investing bank from risk, the FDIC points out that standard representations and warranties on securitized loans include a provision that the underlying loans were made in compliance with all applicable federal and state consumer protection and fair lending laws and regulations, including TILA, HOEPA, RESPA, FHAct, and

ECOA. The FDIC seems to be suggesting that this is inadequate protection for the investor. On this issue, bankers would like more certainty.

Inquiries as to past performance and any changes in ratings for previous securitizations of a particular originator seem to be relatively common for investors to make. However, some of the other inquiries suggested are more problematic. For example, what is a "high percentage" of refinanced loans such that it would trigger an inquiry to the underwriter to explain? What are "excessively above-market interest rates" and what loan distribution of "excessively above-market interest rates" would trigger review of the underlying loans and how would the investor review those loans? Similar judgmental problems are presented by the FDIC's suggestions with respect to the percentage of loans with prepayment penalties or with negative amortization.

In line with ABA's recommendation in Question No. 7, the FDIC does focus the risk review on securitizations of subprime loans or securities targeted to areas with populations at risk. The FDIC suggests looking for disparities in amounts of credit enhancements of subprime loan securitizations, as a possible red flag for predatory loans. Bankers suggest this may be problematic, since securitizers may get cost breaks for credit enhancements if they are willing to over-collaterize some of the securities tranches or if they are willing to keep deeply subordinated tranches in order to credit enhance the higher priority securities.

Question No. 12: General comments

The FDIC's suggestions for review of mortgage-backed securities again raise the question as to whether the FDIC is establishing a new legal standard for liability for banks (but not nonbank lenders and investors not subject to FDIC supervision) or even just for some banks (state nonmember banks but not for national banks, state member banks, and savings associations under the jurisdiction of the Office of Thrift Supervision). ABA believes that the FDIC must clearly answer this question in the negative in any final version of this draft staff memo.

IV. Conclusions

Question No. 13: General comments.

Unquestionably, banks, regulators and communities should be concerned about stopping predatory lending. ABA appreciates that the FDIC is trying to offer helpful guidance to banks on how to avoid purchasing or investing in predatory loans. Bankers know the damage done to their borrowers and communities by home equity strippers and other predatory lenders. And no bank wants its reputation damaged from being seen as aiding and abetting a predatory lender. To the extent that the FDIC can successfully clarify the risks posed to banks from the third-party purchase of loans and investment in securities (without adding to the risk), so that legitimate lending is not made less available out of a fear of inadvertently buying or investing in predatory loans, the FDIC is to be applauded for its efforts. To achieve this, ABA believes that the FDIC needs to rewrite the guidance so that it is less a warning about legal or litigation risk and more about banks performing extra steps to protect their communities and be good corporate citizens. Every banker with whom ABA discussed this FDIC draft staff memo was truly concerned about protecting his or her community from predatory lenders. Perhaps the FDIC should focus less on the risks to banks in its guidance and more on the opportunities for banks to perform valuable community service in ending predatory lending.

Nonetheless, as pointed out so cogently by Governor Gramlich, the best place to stop predatory lending is at the table where the borrower signs the loan documents, not at the foreclosure auction. And that requires considerable consumer education. In fact, all of the Agencies and many banks are doing consumer education, but reaching the most vulnerable consumers will require a continuing process from schools, lenders, community groups and governmental agencies. ABA's new Lending Practices Work Group is not the first nor will it be the last effort by ABA and its members to provide consumer education, but it is efforts like it that will really shut down predatory lending.

If the staff of the FDIC have any questions about this comment, please call the undersigned.

Sincerely,
Paul A. Smith

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[1] Remarks by Governor Edward M. Gramlich, Community and Consumer Affairs Department Conference on Predatory Lending at the Federal Reserve Bank of Philadelphia, December 6, 2000

[2] Draft FDIC Staff Memorandum, 'How To Avoid Purchasing Or Investing In Predatory Mortgage Loans", November 2000, p. 2.

[3] Speech to the Fair Housing Council of New York, Syracuse, New York, April 14, 2000

[4] Remarks by Governor Edward M. Gramlich, Community and Consumer Affairs Department Conference on Predatory Lending at the Federal Reserve Bank of Philadelphia, December 6, 2000