Testimony of the

NATIONAL CONSUMER LAW CENTER

before the

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND REGULATORY RELIEF

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

regarding the

Rewrite of Truth in Lending Act and Real Estate Settlement Procedures Act

and Proposed Moratoria on
HUD Employee Compensation Rule and
Class Action Suits Challenging Lender Paid Mortgage Broker Fees

July 9, 1997

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Mr. Chairman and Members of the Subcommittee, on behalf of our low-income clients, the National Consumer Law Center[1] thanks the committee for inviting us to testify today regarding the rewrite of the Truth in Lending Act and the Real Estate Settlement Procedures Act. We agree with the premise of these hearings that these two laws are not perfect and could be improved, and to that end we have been participating in the meetings among industry groups and consumer representatives to discuss how these improvements might take place. At this point in time, we cannot even speculate as to the success of these meetings in creating a resolution in which all interested parties will agree.

When considering a rewrite of the basic federal laws governing the home mortgage process, we should first consider what protections and disclosures consumers really need the government to ensure that lenders provide. Despite the considerable amount of resources devoted to enabling Americans to obtain homeownership, an amazingly inconsequential amount of resources are provided to ensuring that people maintain that homeownership. One of the results of this lopsided approach to encouraging homeownership is the high rate of foreclosures, especially among low income and minority homeowners. **Between the years 1980 and 1995, the number of foreclosures executed each year rose from 150,000 to over 450,000.** (See Table 1.) It does not help Americans to tantalize them with the dream of homeownership without providing the support to allow them to maintain that homeownership. A tripling of the foreclosure rate in 15 years is an indication that the mortgage marketplace is working *against* the maintenance of homeownership. Something is wrong. The mortgage industry may want regulatory reform, but homeowners need help as well.

A federal legal structure which would significantly assist people in maintaining homeownership, without diluting the strength of the home finance industry would include the

[1] The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with thousands of legal services, government and privates attorneys around the country, representing low-income and elderly individuals, who request our assistance with the analysis of credit transactions to determine appropriate claims and defenses their clients might have. As a result of our daily contact with these practicing attorneys we have seen examples of predatory lending to low-income people in almost every state in the union. It is from this vantage point--many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities--that we supply this testimony today. *Cost of Credit* (NCLC 1995), *Truth in Lending* (NCLC 1996) and *Unfair and Deceptive Acts and Practices* (NCLC 1991), are three of twelve practice treatises which NCLC publishes and annually supplements. These books as well as our newsletter, *NCLC Reports Consumer Credit & Usury Ed.,* describe the law currently applicable to all types of consumer loan transactions.

following elements:

- **Disclosure of all costs associated with obtaining a home loan in an easy to understand and uniform manner prior to application for the loan** (or at the least prior to the payment of non-refundable fees). This would facilitate true shopping for all of the various loan terms which contribute to the costs of the loan. All of these costs should then be disclosed in the same format at closing, so the homeowner can see that the loan costs are as promised. Some homeowners -- those who are sophisticated and savvy -- may be able to reduce their mortgage costs in this way. Reducing the costs on mortgages will reduce foreclosures.

- **The requirement that the actual costs of the loan (in terms of closing costs and interest rate) be the same as those disclosed earlier,** unless there is a very good reason why they should be different.

- **Prohibitions against abusive loan terms**. This might take the form of a "suitability" standard, which would hold lenders accountable for making loans which were unsuitable for the borrowers at the time the loan was made, in the same way that sellers of securities are responsible to their buyers for ensuring that their product is not unsuitable for their needs.

- **Protections to facilitate the avoidance of foreclosures**. Loan modifications, loan extensions, reductions in contract interest rates to current rates, are all tools currently employed by the major lenders to avoid foreclosure. Homeowners should have uniform access to these mechanisms.

Along with appendices, this testimony has several parts:

Part I. **The Role of the Marketplace** -- which describes the role the marketplace plays in regulating as well as failing to protect against abuses. This section also discusses the alarming increase in the rate of home foreclosure in the United States.

Part II. **Our Proposal on Amending RESPA and TILA Disclosures** -— describing our specific recommendations for changing the format for disclosures required under these two important statutes.

Part III. **Rationale** — explaining the reasoning behind the proposed format for RESPA and TILA disclosures.

Part IV. **Proposed Substantive Protections to be Included in any Mortgage Reform Legislation** -- explaining our recommendations for three types of substantive protections which must accompany the major changes contemplated to RESPA and TILA.

Part V - **Lender-paid Mortgage Broker Fees and Implementation of the Employee Compensation Rule under RESPA** — explaining why we oppose any moratoria on class action suits regarding lender paid mortgage broker fees and on HUD's employee compensation rule.

I. The Role of the Marketplace.

The single most expensive, complicated, and important investment most Americans make in their lifetime is thinly regulated in this nation. There are no federal or state laws that govern the maximum rates or fees that lenders can charge for loans used to purchase or refinance a home. Also, states cannot set limits on the terms lenders can impose on these loans. Other than prohibitions against discrimination in the granting of credit, the Truth in Lending Act and the Real Estate Settlement Procedures Act are the only federal or state laws that apply to these loans. These two laws are thus the only significant way in which Congress has ensured that the needs of homeowners are protected and balanced against the interests of the lending industry. As a result, it is crucial that any changes to these laws -- even recognizing their current imperfect condition -- should be made only after extremely careful consideration.

Many homeowners go through the home purchase, financing and refinancing process without any problem. Many others, however, find themselves confused, feel deceived, or worse: lose their home as a result of abusive or improper loan terms. This latter group is much larger then it should be. Indeed, according to the mortgage industry's own analysis, 39-40%[2] of all mortgage borrowers were confused by the process. Moreover, while we do not have explicit statistics, we know that the number of homeowners who are exploited in refinancing transactions is far too high. These abusive loans are an indication of a failure in the marketplace; competition and self regulation do not stop bad loans from being made. The message is, therefore, that the efforts by industry to further deregulate the home mortgage transaction will only hurt consumers. Reform of the mortgage transaction on a federal level should mean improvement for consumers, not simply repeal of current laws.

The marketplace does work to keep interest rates down and loan terms fairly even handed for the majority of middle class borrowers who qualify for "A" credit. It is clearly not working, however, for too many American homeowners who do not qualify for the best credit rating; all too often these homeowners are elderly, or minority. Nationally, 39% of households with incomes below the federal poverty level[3] own their own homes. (See Table 2.) More dramatically, 58% of older Americans who are below the federal poverty guidelines own homes. Too many of these low-income, elderly homeowners have lost equity in their homes, or their homes altogether as a result of abusive lending.

[2]Given the proclivity of many of us to want to minimize our weaknesses, we can safely assume that some additional number of mortgage borrowers were also confused, but were embarrassed to admit it.

[3]In 1997, the federal poverty level for a family of four was set at $16,050.

Abusive home equity lending, in particular, is a longstanding problem that exploded in the early 1990's. Vulnerable homeowners who could not access mainstream forms of credit were the focus of these abusive practices.[4] Many were forced to rely on equity loans with high rates of interest in order to finance home repairs, credit consolidation or other crucial credit needs. Refinancing low rate purchase money first mortgages with high rate first mortgage loans has become a serious problem in the low income community leading to the escalating loss of homeownership. The terms of these high rate loans are not necessary to protect the lenders against loss; indeed the terms are generally so onerous that they precipitate default and foreclosure. With these equity based loans, even foreclosure does not pose actual risk of loss to the lender. The Home Ownership Equity Protection Act passed by Congress in 1994 to address these abuses, while helpful, has not significantly reduced the abuses faced by many low-income, minority and elderly homeowners.

Mortgage Crisis for Low-Income Homeowners. A number of factors coalesced in recent years to create an ongoing mortgage crisis for low-income homeowners:

- In 1986, Congress changed the tax code to establish a tax preference for interest on second mortgages over interest on other consumer loans. This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. The message was delivered to and received by low-income homeowners even though they benefit less, or not at all,[5] from the deductibility of mortgage interest.

- Mainstream banks nearly abandoned low-income neighborhoods across the country, especially minority low-income neighborhoods. This created a vacuum for finance companies charging high rates of interest to fill. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders.[6]

- Given appreciating real estate values throughout much of the country, finance companies are able to make loans at high rates with very little risk. Many finance companies target homeowners who have substantial equity in their homes in order to protect their investments if the borrowers do not pay. Elders are a common target for this equity based lending, because many have built significant equity in their properties over time. Based on equity, a

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[4]Dozens of examples were raised in the variety of Congressional hearings held on these issues. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 258, 260 (Feb. 17, 1993); *Hearing on S.924 Home Ownership and Equity Protection Act, Before the Senate Banking Committee,* 103d Cong., 1st Sess. (May 19, 1993); *The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs,* 103d Cong., 2d Sess. (March 22, 1994); *Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance*, 103d Cong., 1st Sess. (Feb 2-4, 1993).

[5]Many low-income homeowners are working poor, with no tax liability, because of the earned income tax credit. Others are paying at the tax system's lowest tax rates.

[6] The term "reverse redlining" has been coined to describe a practice wherein banks make loans at one rate in white communities through their banking arm and at another higher rate in communities of color through separate finance company subsidiaries. Evidence in a case brought in Atlanta, for example, established that black borrowers were charged 11.06% in up front fees by Fleet Finance Co. (a subsidiary of Fleet Bank). White borrowers were charged 8.26%.

lender is in an advantageous situation: either the borrower pays the loan back with high interest or foreclosure on the home permits a recovery from the property directly. In fact, when foreclosure occurs and the borrower's property is sold to the lender for less than fair market value (as it generally is), the lender can resell the property after foreclosure and realize the homeowner's equity. These anticipated windfalls encourage some lenders to make loans designed to result in foreclosure.

- Deregulation has allowed a wide range of marginal players into the lending and loan brokering business. Many of the historic protections against unfair lending practices, such as state ceilings on interest rates and licensing requirements, were removed or eviscerated during the 1980's. Even where licensing requirements remain, inadequate funding has led to inadequate policing of abusive lenders. A significant secondary market then developed during the 1980's creating liquidity for finance companies marketing loans with high interest rates.[7]

Rising Foreclosure Rate. It is significant that foreclosures have increased by approximately three times since 1980, and that on any given day there are almost half a million foreclosures going on in the United States.[8] (See Table 1.) There are a number of reasons for this. Data shows that most foreclosures are caused not by homeowner mismanagement, but rather by unexpected life events which are beyond the homeowner's control such as loss of job, illness, death or divorce.

Census data establishes that more than 1/3 of households in the lowest 40% of income range will experience a loss of income of at least 33% for one month in a given year. Income disruptions obviously increase the likelihood of mortgage defaults especially since the same lower income households also have low savings rates and high debt to income ratios. As family debt increases as a percentage of income,[9] families are increasingly vulnerable to the exigencies of unforeseen income decreases or increases in expenses. Problems which would be manageable for a family whose housing costs constitute 20% of the monthly budget are unmanageable when those costs are 40% of the total household expenses.

Additionally, there has been a major expansion of home equity lending, thus creating an additional pressure on the homeowner's budget. The median amount outstanding on mortgage debt for a typical family rose 30% between 1989 and 1995.

Increases in Foreclosures Exceeds Increasing Homeownership In May of 1995, the Clinton Administration announced its goal of achieving a homeownership rate of 67.5% by the year 2000. This new initiative is an addition to the decades of homeownership strategies employed and supported by the United States Government through HUD guarantee programs and other government

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[7] *See* examples referred to in Footnote 4.

[8]Compiled from information in the *Statistical Abstract of the United State States, 1996.*

[9]The Federal Reserve Board concludes that one in nine families face debt payments that are higher than 40% of annual income. The rate rises to one in six families among those earning less than $25,000 per year. "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances" at 21, Table 14, *Federal Reserve Bulletin,* January 1997. *See* Pearlstein, "Trendlines: The Fed's Knowledge of Wealth", *Washington Post,* p. E1 (1/23/97).

backed institutions.

The problem is that despite decades of sincere and concentrated efforts to improve homeownership, the *rate* of homeownership has not increased nearly as dramatically as the rate of foreclosures. In 1980 there were 52 million homeowners in the United States. By 1995 that number had increased to slightly less than 65 million. The number of homeowners thus increased by 124% in those fifteen years. Yet the number of foreclosures executed on American homes increased by 300% in the same time period. (See Table 3.)

It is important to recognize that these new first time homebuyer opportunities, while creating important housing options, nevertheless have significant risks for the participants. A key feature of most programs is low down payment requirements, usually 5%, but, in some instances, 3% or less. High debt to income ratios (40% and above) are usually also required to make programs accessible to families with very low incomes.

A correlation between low down payments and high foreclosure rates was identified in a study conducted by Freddie Mac officials, which found that loans with a 95% loan to value ratio made under their affordable housing programs, such as Affordable Gold, have delinquency rates 50-100% higher than conventionally underwritten loans with the same loan-to-value ratio.

Another distressing trend is a diminishing federal commitment to working with troubled borrowers who have financial problems in the FHA loan guarantee program. Until April, 1996, homeowners who had a default for reasons beyond their control and who could show an ability to get back on track within 36 months were able to obtain forbearance in the HUD assignment program to prevent foreclosure. With termination of that program by Congress in 1996, that option is no longer available. The private market loss mitigation options with which HUD has replaced the assignment program may well result in more and quicker foreclosures.

For these reasons, the federal government cannot rely on the marketplace -- or self-regulation by the mortgage finance industry -- to police lending secured by the home. While Americans enjoy a strong home lending industry, the appropriate degree of regulation should not hamper legitimate lenders, while it will serve to protect the most vulnerable homeowners from losing their homes.

II. Our Proposal on Amending RESPA and TILA Disclosures.[10]

Enacted in 1974, the purpose of RESPA is to provide consumers with timely information about the real estate settlement process as well as to protect consumers from high settlement charges. 12 U.S.C. § 2601(a). TILA was created in 1968 to bring honesty and accuracy to the consumer credit marketplace and to standardize the cost of credit so that borrowers could comparison shop. To that end, TILA's "price tag" disclosures of the APR and the finance charge were defined to include, in the first instance, all the costs attendant to the credit that the borrower would have to pay. As discussed below, TILA's exceptions to this definition are taking the *truth* out of the lending. Neither the interests of consumers nor the industry have been served by that development.

[10]Please note that to truly protect consumers, amending the disclosures under these two laws without also including the substantive provisions also recommended herein, would not provide the appropriate structure of protections for consumers under federal law.

We propose the following changes:

1) that RESPA's post application and settlement disclosures be provided in a format that also includes disclosures required by TILA;

2) that TILA disclosures provided at closing be in the same format, using the same terminology as the early RESPA disclosures;

3) that the finance charge disclosure include all costs associated with the loan, regardless of whether the lender benefits from the charge;

4) that the post application disclosures should list actual charges rather than estimated charges except in limited circumstances; and

5) that open end credit loans include a disclosure of the finance charge, which in turn includes all closing costs and anticipated interest payments to be paid during the course of the loan.

The key change here is actually the change in the definition of finance charge under TILA. To accomplish the goal of encompassing the RESPA-type disclosures as part of the finance charge disclosure, the finance charge itself should be disclosed as one number, which is derived from the sum of two other numbers: 1) the "interest" to be paid during the course of the loan, and 2) all of the charges to be paid "up front" or before the loan is closed, such as any points, the settlement charges, the appraisal fees, and the like. For example, RESPA/TILA disclosures required to be provided three days after application and again at settlement for closed-end loans should look like the example in Appendix 1. Similar disclosures, with minimal but appropriate distinctions would be made at closing.

Combined TILA/RESPA disclosures for open-end variable rate loans would be essentially the same, with additional information about variability of the annual percentage, the change in the monthly payments, and historical and worst case scenarios. For example, information on rate, monthly payments and potential total of payments, should be provided on the current annual percentage rate, the historical example, and the application of the most expensive rate allowed under the agreement. See Appendix 2 for an example of this disclosure.

III. Rationale.

A. Combining RESPA and TILA Disclosures into One Format

Currently RESPA requires the disclosure of all closing costs as part of the good faith estimate provided within three days after application. Some of these costs are included in the TILA disclosure of the finance charge but many are not. At closing (or a day in advance if requested by the borrower), RESPA also requires that the borrower be given a HUD-prescribed settlement statement, which details all costs imposed on the borrower and the seller in connection with the settlement.

On the other hand, TILA requires the disclosure of the annual percentage rate, amount financed, finance charge, total of payments, monthly payment and loan term. These disclosures are totals and do not include any itemizations of the amount financed and the finance charge.

Our proposal eliminates the differences between TILA and RESPA disclosures and creates one easy form for closed-end loans and one easy form for open-end loans to be completed by the lender at application (or at least before non-refundable fees are paid) and at settlement that will fulfill the goals of both statutes. This proposal will greatly increase a borrower's understanding of the true cost of credit before the loan is signed. It will also reduce the disclosure headaches of lenders because only one form will now be necessary.[11]

B. Including ALL Costs of Credit in the Finance Charge

The problem is that the "truth" has gone out of the Truth in Lending Act. There are too many exceptions to what should be hard and fast rules. The disclosures provided to borrowers at closing, which purport to disclose the "cost of the credit" include some costs but exclude others. The annual percentage rate (which is supposed to represent the cost of the credit in terms of a yearly rate) is equally confusing and it does not reflect the true cost of credit because of all the exceptions allowed to the finance charge. The APR is always more than the *interest* rate that the borrower understood would be charged on the loan, but the reasons why it is higher are never explained.

The extensive, and increasingly complicated, list of exceptions to the fees which are included in the finance charge creates compliance problems for lenders, and more seriously, undermines the purpose of TILA. Fees for preparation of loan related documents, credit reports, attorneys' fees, are all fees which are only incurred because there is a loan being made. They are clearly a cost of obtaining credit to the borrower. However, under current law, they are excluded from the finance charge; presumably on the rationale that they do not represent a source of profit to the lender. Regardless of the reason for the exclusions-- whether profit or not to the lender--these fees are a cost of credit to the consumer. Indeed, often these fees are a very significant percentage of the initial closing costs for the loan.

Requiring the inclusion of all of the costs of credit in the finance charge will advance the ability of consumers to actually shop for the best credit available. Competition in the marketplace for the best loan products, as well as the best settlement service providers will be advanced by this change in the definition of the finance charge.

In the marketplace of the 1990s, disclosure of the real costs of the credit is very often the only real tool that homeowners have to protect themselves from unaffordable, or unreasonable credit terms. The deregulation of interest rates on most loans secured by homes has further increased the importance of full disclosure.

Moreover, competitive forces now work against, not in favor, of consumers. Those lenders who would have been inclined to fully and accurately disclose the costs find themselves at a

[11] It is important to note that this proposal encompasses the combination of only the RESPA and certain of the TILA disclosures into one simple format. We are not suggesting that these proposed forms substitute for the heightened disclosure rules required by the Home Ownership and Equity Protection Act of 1994 (HOEPA). 15 U.S.C. § 1639.

competitive disadvantage with those lenders who are not so inclined. The general standards, then, have begun to sink to that of the lowest common denominator. Because of the failure of TILA to require full disclosure of all of the costs of the loan to be included in the finance charge -- and thus the APR -- most creditors have no incentive to keep their closing costs down. Indeed, the competitive pressure, again, perversely hurts the consumer, because it does nothing to encourage efficiency or keep closing costs competitive.

It is mere rationalization to say that third-party costs could not practically be included because they "may not be within the creditor's knowledge or control." It is the creditor which makes the decision as to whether to utilize third parties, how many to use, and which ones to use. With one very narrow exception, the third parties involved in a loan are there for the convenience and benefit of the creditor. The lending industry, therefore, has tremendous leverage with those ancillary segments of the market who serve them -- the title companies, real estate closing attorneys, mortgage brokers, etc. In any other aspect of their business, if a lender finds a supplier to be too expensive, or too inefficient in delivering the goods or services, it looks to decrease its costs and increase its efficiency by finding a cheaper, more reliable provider. But since, under TILA rules, the lender can pretend these costs are completely outside the price tag, it has no incentive to pressure the providers to keep costs down. Quite to the contrary, where the costs are being financed, the lender has an incentive to use more costly ones, because that increases the lender's interest income from the loan due to higher capitalized closing costs -- yet another example of reverse competition, and how far the practice has strayed from TILA's goals.

Some lenders may complain that an all inclusive finance charge would “inadvertently” trigger the provisions of HOEPA. This is unlikely to be a real problem. The current trigger on a 30-year mortgage is approximately 16.77%. The current market rate on a fixed-term 30-year mortgage loan is approximately 8.25%. The points and prepaid finance charges would have to be extraordinarily high to generate an APR that exceeds 16.77% if the contract rate is 8.25%.

In sum, the current patchwork system has served neither consumers nor the industry well. Twenty-five years of experience under TILA suggest that all concerned would be better served by a bright line, clear-cut, easy to understand and implement, all-inclusive price tag rule. Including all the costs of credit would provide benefits to consumers and creditors alike:

- Consumers would get the accurate and full price tag disclosures that were originally envisioned, to give them sufficient information to decide whether to forego credit when it is too expensive, or to comparison shop for the credit they decide they want or need.

- Creditors would get certainty about the rules, which would significantly reduce the potential exposure to legal liability for errors and the concurrent cost of legal advice. The FRB and the industry have raised the concern that an all-inclusive definition would appear to raise the APR. The feared "sticker shock" among consumers should in no way stand as an obstacle.
- The market would benefit. If TILA is to effectively work as a market perfecting mechanism, it must not be a tool which readily lends itself to manipulation and deception. It must not be a law which perversely encourages competitive pressures to move toward lower standards and higher prices for consumers, rather than rewarding honest and efficient providers. Perhaps most critically, if disclosure is to be the justification for substantive deregulation as a matter of public policy, it must be consistent, uniform, and above all,

accurate. Otherwise, consumers get the worst of all worlds.

- The economy would benefit: Even assuming a more accurate, fully-loaded APR would lead to market resistance, that would not necessarily be a bad thing. The purpose of TILA is, after all, not to help the financial services industry to log record profits, nor to create a national economy based on debt. Rather its purpose is to facilitate honesty and accuracy, efficient business operations, and, to serve the economy as a whole, to encourage consumer restraint when the price of credit is too high.

C. Using Actual Costs on the Post Application Disclosure Except in Limited Circumstances

Currently, RESPA allows "good faith estimates" of the settlement costs to be disclosed within three days following application. Similarly, TILA allows “estimated” APR, finance charge, amount financed, and total of payment disclosures to be given with the RESPA “good faith estimates.” The problem is that these good faith estimates view all settlement costs as merely estimates which can legitimately be adjusted later. With few exceptions discussed below, credit charges are known with certainty since, like the interest rate, they are part of the price of credit to which lenders expect to be held. By viewing credit charges as estimates, however, these disclosures provide an open invitation to less scrupulous lenders and brokers to "accidentally" omit a charge on the estimated disclosures only to include it at settlement when the borrower is in too deep to back out.

Even third party charges are known to the lender at this time. The lender, in most instances, requires the use of certain third parties who appear on lender-approved lists. Lenders, however, may not know the actual cost of a charge by a third party not on an approved list who is independently selected by the borrower. In this limited circumstance, the lender need only disclose the cost of the lender's approved provider.

The only item listed on the proposed form that by necessity must be an estimate is the per diem interest charge. This is so because the lender will not know within three days after application when the settlement will occur. Since the amount of per diem interest is never large enough to distort the annual percentage rate to any degree, allowing this to be an estimated charge will not affect the information upon which the borrower relies to comparison shop.

D. Changing Disclosure Rules for Open End Home Loans

Lenders primarily object to including all closing costs in the finance charge because they say that this makes closed end credit appear to be more expensive than open end credit. This is because currently TILA does not require any closing costs to be included in the calculation of the annual percentage rate for open end extensions of credit. Thus, if only closed end disclosure rules were changed, the fees included in the calculation for the annual percentage rate would be higher for closed end loans than the fees included for open end loans. The fair and appropriate way to resolve this for lenders and consumers alike, is to require all fees to be included in both open and closed end credit transactions secured by the home.

When the current TILA rules for open end credit secured by the home were being designed, both the fluid nature of the product and the state of technology as it then existed had to be taken into account. For example, authorizing the use of historical tables and hypothetical $10,000 loan examples reflected an attempt to balance the need to explain how an open end line credit might work to the consumer with the industry's desire to save the costs that personalized predictions would incur. Because the information in this hypothetical is so unrelated to the actual loan contemplated, however, most borrowers find very little that is useful in the information provided.

Technology has now developed to the point that an individualized disclosure is possible and reasonable. In weighing the costs and benefits of more personalized, more predictive disclosures in light of more sophisticated technology, the actual comprehensibility of the disclosures must be considered. If consumers are to be legally held to their contracts, then it is vital that we do as much as possible to make sure that there is some reality to the legal premise that contracts are binding because the parties knowingly agree to the terms.

The essence of the problem for determining rules for open end credit is how to calculate the time and price for the outstanding extensions of credit. This is a problem for open end lines of credit where it is not for closed end credit because of the revolving nature of these loans. Once some money is borrowed, and some paid back, some more money can be borrowed again. It is indeed impossible for the lender to predict the amount of money which will actually be extended to the borrower, the time period and amount of repayment by the borrower, and - in most cases because open end loans are generally also variable rate loans - the applicable interest rates throughout the term of the loan.

Lenders, however, make a series of assumptions when they make disclosures on closed end loans, and on variable rate loans in particular: they assume an interest rate, and they assume that the loan will be paid back at the times and in the amounts contemplated in the loan contract. There is no reason that the Federal Reserve Board could not choose a series of reasonable assumptions to be applicable to open end credit disclosures which would then be used as the basis for the disclosures provided at the inception of the open end loan. For example, lenders could assume the following:

a) The maximum amount of the line of credit would be borrowed immediately (a fairly typical occurrence) rounded up to the nearest $5,000. For example, when a borrower is contemplating a line of credit of $37,500, information provided for a $40,000 loan is far more relevant than it is for a $10,000 loan.

b) Only the minimum required payments would be made by the borrower (also, a fairly standard scenario).

c) The interest rate over the term of the loan would be what it would have been had the loan been taken out the same number of years ago as the term is long. (In other words, if the loan term is for fifteen years, for the purposes of the initial disclosure, the interest rates for the next 15 years would be assumed to be what they had been the past 15 years.)

Part IV. Proposed Substantive Protections to be Included in any Mortgage Reform Legislation.

The government, and the housing and lending industries have done an excellent job in recent years in expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth.

Suggested Remedies. As illustrated in Part 1 above, the market does not work to provide protections for consumers from abusive mortgage loans, because too often it is financially remunerative for lenders to encourage foreclosure. Foreclosing on a home will force a sale which almost always yields less than the home's true value, allowing the creditor to purchase the home at a discounted rate and realize yet another profit when the home is sold at full value at a later date. Not only is there always significant collateral protection on home loans, there is the very real emotional attachment that homeowners have in their homes, making the home loan the first to be repaid, and the last to be defaulted upon. There is thus generally very little risk in any loan which is secured by a home.

Should not lenders who persist in making loans which are clearly not affordable to the homeowner, and are thus designed to lead to default, refinancing, and eventually foreclosure, be held responsible for their improvident extension of credit? For example, consider the real case of a lender who makes a low-income disabled homeowner a first mortgage loan of $102,000, charging over $7600 in settlement charges. Although the homeowner's only income is $500 a month from SSI, the payments required under the loan are $914 a month for thirty years. Shouldn't a lender in this situation be held responsible for this bad judgment, and not be permitted to profit from the deliberate attempt to take the homeowner's home by way of foreclosure?[12]

If the TILA rules are changed to improve disclosures and make it easier for lenders to comply with the law's requirements, homeowners like the one in this example will have even fewer protections from abusive lenders. TILA rescission will no longer be a viable remedy because the disclosure rules will be so simple to comply with, even the most abusive lenders will find it easy to meet the requirements. In the stead of the rescission remedy under TILA, Congress should establish tools designed to prevent abuses, rather than one used because of its convenience and the fact that there are no others.

We propose, that along with the disclosure amendments to TILA and RESPA, three substantive provisions along the following lines be added to the new law:

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[12] The facts of this case are those of Mrs. Rodash in *Rodash v. AIB Mortgage Co.,* 16 F.3d 1142 (11th Cir. 1994). Mrs. Rodash was able to rescind her loan because of the non-compliance with the disclosure rules under TILA. These rules have now been changed, thereby preventing many homeowners like Mrs. Rodash from using TILA's compliance rules to prevent foreclosure.

- **A federal standard of loan suitability**. Home mortgage lenders generally have more information about borrowers' finances than do the borrowers' closest relatives and friends. Using generally accepted principles in the industry, these lenders know when the payment schedule required in a mortgage can be reasonably met by the borrower. Indeed with the increased use of credit scoring and computer based underwriting, legitimate lenders can reasonably anticipate risk of non-payment. Also, loans which contain unfair terms, such as requiring a balloon payment -- unless the borrower wins the lottery, are often a recipe for foreclosure. Thus, when loans are made to borrowers which are clearly unaffordable, or which contain unfair terms lenders should be held responsible for their poor judgment. <u>Lenders who make unsuitable loans or who commit unfair practices in the making of home loans should not be permitted to profit from those practices.</u>

- **Increased support for housing counselors and mandatory notice regarding their availability**. Good housing counselors can facilitate loan workouts that preserve homeownership, prevent foreclosure, and reduce costs for lenders. Fannie Mae, Freddie Mac, and the FHA have implemented loss mitigation tools to avoid foreclosure and housing counselors are an essential part of that process. <u>All mortgage lenders should be required to provide some support for housing counselors and notice of the availability of housing counselors should be required before any foreclosure can proceed.</u>

- **Lenders should provide homeowners with the opportunity to pay off the arrearages and avoid foreclosure.** Although this seems obvious, and in the best interest of both parties, this is not always done. Lenders should be required to give notice to defaulting homeowners of the amount past due and the amount needed to avoid foreclosure prior to the addition of fees.The notice should list the various workout options available. These options have been accepted by Fannie Mae, Freddie Mac, and the FHA as appropriate loss management tools in the industry. <u>Lenders should also be required to attempt to avoid foreclosure through various loan workout mechanisms. Further, a lender should not be permitted to unreasonably reject a workout proposal.</u>

Part V - Lender-paid Mortgage Broker Fees and Implementation of the Employee Compensation Rule under RESPA.

Congress Must Protect Consumers from Improper Yield Spread Premiums. The mortgage industry seeks a moratorium on the class action suits currently proceeding under RESPA which challenge the payment of a yield spread premium to a mortgage broker by a lender. We strongly oppose any Congressional action on this issue, as it is would cause significant harm to consumers. Further, it would do little to provide assistance to the mortgage industry unless Congress also passes a statute providing retroactive immunity to the industry for illegal kickbacks. There would be simply no justification for retroactive relief to the industry. Consumers have been truly hurt by the payment of yield spread premiums; paying thousands of dollars more for their loans than their lenders required.

The mortgage broker fee *brouhaha* is only analagous to the *Rodash* fuss in one way: the mortgage industry is facing judicially imposed liability for blatantly violating one of the two federal consumer protection statutes governing mortgage loans. Unlike *Rodash*, we are *not* talking about windfalls in the tens of thousands of dollars for the failure of the lender to place the disclosure of a specific fee -- which the borrower had to pay anyway -- in the proper column. This issue is whether a yield spread premium, which significantly increases the cost of the loan to the borrower without providing any benefit to the borrower, should be legal.

A yield spread premium is a lender's fee paid to the broker for increasing the loan rate. Yield spread premiums benefit lenders and brokers. They generally provide no benefit whatsoever to borrowers. Yield spread premiums only increase the cost of the loan -- inflating the cost of the home -- to the borrower without providing any benefit to the borrower. The entire practice of paying yield spread premiums thrives because of reverse competition in the market: the lender with the costliest loans to the borrowers -- those paying the highest yield spread premiums -- do the best.

Lenders and brokers have been saying that yield spread premiums are justified, and indeed are good for consumers. Yield spread premiums, the industry maintains, are justified because they are typically paid to compensate brokers for covering closing costs borrowers do not otherwise need to pay. Representatives of consumers do not dispute that a consumer might decide that a higher interest rate on the loan is a good idea, if the consumer could cover closing costs in this way. However, we have never seen these types of loans. This argument is a red herring: it is the industry's way of justifying yield spread premiums as providing benefits to the borrowers. Nevertheless, we agree with the idea that in limited circumstances yield spread premiums are legal under the statute, when they actually provide a benefit to the borrower equivalent in value to the cost incurred.

The disagreement is not over whether all lender paid broker fees are always illegal. The disagreement is about whether yield spread premiums can be legal based on the value of the services provided to the lender rather than the borrower. One must look to the person who bears the burden of the fee in dispute. If the borrower is paying the fee then the borrower must receive the benefit. If it is legal for lenders to obtain the benefit of a fee which is essentially borne by the borrower, then as yield spread premiums always provide a benefit to the lenders, they will always be legal. RESPA's prohibition against referral fees would become meaningless.

To date there have been four federal district court opinions on the issue of whether a lender paid mortgage broker fee is illegal under RESPA. Two decisions were in the industry's favor, two for consumers.

- **Briggs.** In 1996 an Alabama district court held that a yield spread premium "could well be classified as an illegal kickback under RESPA where the borrower has also paid the broker for services rendered."[13]

- **Mentecki.** In January, 1997 a federal court in Virginia squarely held, in the context of denying the lender's motion to dismiss, that the payment of a yield spread premium is a prohibited referral fee[14] because, by its very nature, yield spread

[13]*Briggs v. Countrywide Funding Corp.,* 931 F.Supp. 1545 (M.D. Ala. 1996).

[14]Under 12 U.S.C. § 2607(a).

premiums are not compensation given for services actually performed by the broker where the broker has already charged the borrower directly for all services provided. In this case, one of the named plaintiffs paid an orgination fee of **$12,925** to the broker. Then the lender also paid the broker a yield spread premium of $2,204.30.

- **Culpepper.** Barely after the ink dried on the Virginia opinion, another Alabama district court threw down the gauntlet by finding that a yield spread premium was a permitted "payment for goods."[15] The court rationalized that because the broker was funded by the lender to make the loan, the yield spread premium was a fair market value cost paid to the broker by the lender for the broker's creation of the loan and sale of that loan to the lender. This reasoning is problematic because it measures the value to the lender, rather than the consumer. Since the consumer actually bears the burden of the cost of the yield spread premium in the form of a higher interest rate, the services justifying the fee must be provided to the consumer.

- **Barbosa.** Just a few weeks ago, a district court in Florida also ruled in the industry's favor, holding that the payment by the lender of a yield spread premium is not a "referral fee" because the lender paid the fee for the broker's procurement of the loan. In this case, the broker received total compensation worth 5.1% of the loan whereas brokers receive an average of 1.5% industry-wide. The yield spread premium on this $70,000 loan caused the interest rate to rise from 8.75% to 9.5%, bloating the homeowner's costs by over $18,000 over the life of the loan.

Consumers are being harmed by the payment of yield spread premiums. The courts around the nation are busy determining whether the payment of these fees violates RESPA. It would be outrageous for Congress to intercede in the judicial process and provide blanket immunity for lenders on this complicated issue. A moratorium on class action lawsuits only assists the industry if it is followed by retroactive protections for industry. Consumers need the protection, not lenders and brokers.

There is No Justification for Extending the Moratorium on HUD's Employee Compensation Rule. There is little doubt that implementation of HUD's rule will provide more protections for homeowners than do the current regulation. Moreover, while NCLC is participating actively in the mortgage reform process, we are less sanguine as to its eventual happy conclusion for consumers. The only way that the mortgage industry will actually consider the true needs of consumers in the mortgage reform process is if it's representatives believe that Congress will insist that consumers' requirements be included. If Congress bows to the will of the industry and protects the industry from consumer friendly judicial and administrative rulings, industry will have no reason to believe that it need pay anything more than lip service to the needs of consumers in the mortgage reform process. Moreover, the integrity of the regulatory process is at stake. It is for Congress to write laws, and for the administrative branch to write regulations implementing those laws. If it is the will of Congress to change the law, then change the law, but the delay of an administrative regulation is not appropriate.

In terms of protecting homeowners, the success of the mortgage reform process hinges

[15] *Culpepper v. Inland Mortgage Corp.*, 1997 U.S. Dist. Lexis 907 (N.D. Ala. Jan. 31, 1997).

on Congress' insistence that consumers' needs be met. The only way this can be assured is if Congress makes this industry play by the rules. Protecting the industry from consumer friendly judicial and administrative rulings would send the wrong message.

Conclusion

This testimony does not address many of the technical questions involved in changing TILA and RESPA to coordinate the two statutes: which statutes would have to be amended, in exactly what way, for example. But it does provide an outline of how both statutes can be improved and coordinated to the benefit of both consumers and lenders. Disclosures would be simplified, uniform, and far more understandable if the finance charge includes all costs of the extension of credit, and these charges are disclosed in the same format after application and at closing. Lenders will benefit because of the simplicity in complying once the new forms are developed. Consumers will benefit because protections will be provided on federal, uniform level against abusive loans, and foreclosures will be reduced.

Appendix 1

PROPOSED COMBINED TILA/RESPA DISCLOSURE FOR CLOSED-END LOANS

AMOUNT FINANCED	FINANCE CHARGE	TOTAL # OF PAYMENTS	ANNUAL PERCENTAGE RATE
Repayment terms: 1 @ $ due __________ 359 @ $ due xxx of each month			

1. The **AMOUNT FINANCED** consists of
$__________ the financed purchase price of your home/ first mortgage payoff

This includes:

$________ for the purchase of your home/or payoff of 1st mortgage.
$________ to pay off another loan secured by your home.
$________ to pay off other credit.
$________ cash to you.

(NOTE: The "amount financed" may be a lesser amount than the "principal" on your mortgage note if you are financing some of your settlement costs which are also called "prepaid finance charges.")

2. The **FINANCE CHARGE** consists of two separate kinds of charges

A. _____ Interest to be paid over the life of the loan

B. _____ "Prepaid finance charges," which include settlement "closing" costs. This amount is the total of the following:

$_________ (i) Prepaid interest;
$_________ (ii) Per diem interest;
$_________ (iii) Loan discount fee;
$_________ (iv) Loan application fee;
$_________ (v) Points, or other charges paid by you directly to the creditor at the time the credit is extended;
$_________ (vi) Finder's fee, or broker's fee paid by you;
$_________ (vii) Fee for an investigation or credit report;
$_________ (viii) Fees or premiums for title examination, title insurance, or similar purposes;
$_________ (ix) Fees for preparation of a deed, settlement statement, or other documents;
$_________ (x) Fees for notarizing deeds and other documents;

$_________ (xi) Appraisal and survey fees;
$_________ (xii) Fees for a closing agent; and
$_________ (xiii) Any other expenses related to closing.

C. **Credit Insurance Premiums** totaling $________, which includes the

following:
__________credit life
__________accident
__________health
__________other insurance written in connection with the transaction
__________GAP and debt cancellation agreements.

3. The **ANNUAL PERCENTAGE RATE (APR)** is ___________. It is the real cost of your credit, expressed as an annual percentage rate, and takes into account both the interest to be paid over the life of the loan, and the prepaid finance charges.

   (NOTE: The "interest rate" of ________% on your mortgage note is lower than the APR, because the note rate only takes into account the interest to be paid over the life of the loan; it ignores the impact of the prepaid finance charges on the total cost of this loan.)

4. Amount of the fee paid by the lender to your loan broker/correspondent: $____________.

5. In addition, you will need $__________in cash at closing to cover the following items:

   A. Any items listed above that you do not wish financed (the sum of these items is not included in the calculation of the number in this paragraph);
   B. $___________ for escrow of real estate taxes.
   C. $_________ for escrow for premiums for insurance, against loss of or damage to property or against liability arising out of the ownership or use of property.

6. Amount you will pay up-front that is not refundable if the loan does not close: $____________.

7. Points or other fees to be paid by the seller at settlement: $ ____.

8. **Security**: You are giving a security interest in your home located at ________________________.

9. **Late Charge:** If a payment is late, you will be charged $____ or _____% of the payment.

10. **Prepayment:** If you pay off early, you will/will not have to pay a penalty.

11. **Assumption**: Someone buying your home may/may not be allowed to assume the remainder of your mortgage on the original terms.

Appendix 2

PROPOSED COMBINED TILA/RESPA DISCLOSURE FOR OPEN-END, VARIABLE RATE LOANS

Assuming that you borrow the maximum you are permitted under the LINE OF CREDIT, make only the minimum payments due under the contract during the term of the agreement, and do not make further draws on your LINE OF CREDIT:

1. Your beginning **ANNUAL PERCENTAGE RATE** (APR) is _______%. [If teaser, add: It will go up to ________% after _________month/years.] This annual percentage rate is based upon the initial amount you are borrowing rounded up to the nearest $5,000. The APR is the real cost of your credit, expressed as an annual percentage rate, and takes into account both the interest to be paid over the life of the loan, and the prepaid finance charges.

   (NOTE: The “interest rate” of ________% on your line of credit is lower than the APR, because the interest rate only takes into account the interest to be paid over the life of the loan; it ignores the impact of the prepaid finance charges on the total cost of this loan.)

   a. Your minimum monthly payments would be $________. [IF TEASER, add: They would go up to _____% after ____ months/years.]
   b. If this APR does not change, it would take ____ months to pay off this loan at the minimum monthly payment, plus one balloon of _____ at the end of ________years.
   c. The total of your payments would be $_____.

4. **Historical Information About Your Annual Percentage Rate.** Your rate is based on an index. IF THE INDEX CHANGES DURING THE LIFE OF YOUR LOAN, THE SAME WAY AS IT DID THE PAST ___ YEARS (<u>There is no guarantee it will</u>):

   a. The highest annual percentage rate would have been: _____%
   b. The highest monthly payment would have been: _____
   c. It would have taken _____ months of the highest monthly payments (and some lower ones) to pay off the loan, plus a balloon payment of ______ at the end of the ____ years.
   d. The total of payments would have been $_____.

5. Worst Case (or Most Expensive) Example. IF THE RATE GOES AS HIGH AS IT COULD UNDER YOUR CONTRACT:

   a. The highest annual percentage rate would be: _____%
   b. The highest minimum monthly payment would be: ______.
   c. It would take _____ months of to pay off the loan, plus a balloon payment of ______ at the end of the ____ years.
   d. The total of payments would be $_____.