Comments to the Federal Reserve Board's Proposed Revisions to Regulation Z Truth In Lending regarding

Proposals to Address Predatory Mortgage Lending

Docket No. R-1090
March 9, 2001

I. Introduction

The **National Consumer Law Center**[1] submits these comments on behalf of its low income clients as well as the following organizations which represent low and moderate income consumers:

- the Consumer Federation of America[2]
- U.S. Public Interest Research Group[3]
- Consumers Union[4]
- the National Association of Consumer Advocates[5]

First, we want to congratulate the Board for taking these courageous steps toward addressing predatory mortgage lending. There is broad agreement on the federal level with the Board's view that there is a predatory lending crisis throughout the U.S., particularly affecting low income and minority households and neighborhoods, and that greater federal involvement is necessary.[6] The Board's publication of the proposed amendments to Regulation Z and the Official Staff Commentary is the natural extension of these various federal agency efforts. We commend the Board for its work and recommend that it continue its joint work with the other federal regulatory agencies to address predatory lending. The agencies should adopt a bold, comprehensive and specific series of regulations to change the mortgage marketplace to accomplish the following:

- Predatory mortgage practices are either specifically prohibited, or are so costly to the mortgage lender that they are not economically feasible.
- Necessary, constructive credit is made available with appropriate rates and terms to all Americans who qualify.

It is particularly appropriate for the Board to be the leader in this effort since the Board has the primary role in interpreting and applying HOEPA, the major legislation that addresses predatory lending. The broad power granted to the Board by Congress is an essential ingredient in this comprehensive strategy.

On behalf of our clients, we strongly support the Board's proposals to lower the APR trigger to 8 points and to include single premium credit insurance in the points and fees trigger. We also support most of the Board's proposals for improvements to the HOEPA notice, although we believe that the Board's focus should be on substantive protections rather than disclosures. We have serious concerns about the Board's proposals regarding flipping, refinancing of low-rate loans, and lending without regard to repayment ability, and we urge the Board to make significant improvements in the proposals regarding the notice to assignees, open-end credit, and the treatment of yield spread premiums.

II. Specific Comments - Section-by-Section

A. *Rescission for Violation of New HOEPA Rules.*

The Board's proposal to add a footnote to §226.23(a)(3) appropriately ensures that the new rules for HOEPA loans will be enforced. This simply clarifies that including improper terms in HOEPA loans is a ground for rescission.

B. *Clarifying Requirement for Redisclosure when Monthly Payments Change.*

We agree with the Board that the financing of new products offered at the loan closing triggers the requirement for a new disclosure required under § 226.32, and a new three-day cooling off period is required.

C. *Changing the APR Trigger.*

We strongly support the Board's proposal to lower the APR trigger from 10 points to 8 points. As the Board notes, this change will mean that only an additional one to five percent of subprime loans will be covered by HOEPA.[7] We also encourage the Board to seek authority from Congress to lower the trigger to 6 points.

The premise of HOEPA is that when rates or fees are charged which are considerably higher than the norm, additional regulation is appropriate. The higher the rates and fees, the more likely the loan is predatory, and the more necessary closer regulation becomes.[8] When Congress first passed HOEPA, there was little concrete information available about the number of loans that would be affected by the triggers, or the extent to which credit availability would be limited by HOEPA. That situation has changed. We now have the data supplied by the Board staff and other federal agencies, and an analysis by Professor Cathy Mansfield.[9] The available *current* information shows that while some subprime lenders charged as much as 13 points above comparable treasury rates, the *median* subprime mortgage rates are typically 4 to 5 percentage points above comparable treasury securities. Thus, the bulk of subprime lending is well below the current – or proposed – 10, 8 or even 6 point – HOEPA trigger.

Reducing the trigger to Treasury to 6 points will not substantially affect legitimate subprime mortgage credit. However, loans above the trigger are highly likely to have predatory features, or involve borrowers at very high risk of default and foreclosure, for whom HOEPA protections are especially important. Professor Mansfield's data suggest that even a reduced cutoff of 6 points would affect fewer than 25% of loans made in the 1995 to 1999 period.[10] Yet, these are the loans most in need of the protective provisions of HOEPA.

To the industry's cry of "reduced credit availability," the advocacy community responds: "Only bad credit will be reduced, not good credit." Because they fall so far outside the median, no amount of additional credit risk can justify these rates, without the added protections of HOEPA. The Board's own comment makes the point perfectly:

> A borrower does not benefit from . . . expanded access to credit if the credit is offered on unfair terms or involves predatory practices. Because consumers who obtain subprime mortgage loans have fewer credit options than other borrowers, or because they perceive that they have fewer options, they may be more vulnerable to unscrupulous lenders or brokers.[11]

We agree with the Board that access to predatory lending is not a benefit to consumers. Destructive credit is worse than no credit at all. This is evident in light of the increase in foreclosures,[12] the disintegration of many low income and minority neighborhoods,[13] and the erosion of the tax base of cities due to foreclosures.

Further, we maintain that access to credit will not be reduced if predatory mortgage lending is severely curtailed. Predatory mortgage loans have simply replaced other forms of credit that were not as devastating. For example, prior to the explosion in home mortgage lending, consumers without access to mainstream banks typically obtained credit from finance companies. Small loans – typically with interest rates around 36% – and relatively high second mortgage loans – typically with interest rates of 18% or more – provided needed credit to these households. While there were problems with these types of credit (as equated to what was available from banks, this credit was comparatively expensive) their use did not have the devastating impact on homeownership and communities that predatory mortgage lending has had in the past few years.

Many subprime lenders justify higher fees and interest rates as necessary based on the risk of loss from loans to consumers with blemished credit. However, the typical structure of subprime loans creates minimal risk of loss due to either a default or a foreclosure. When credit is secured by a home, and the loan to value ratio is more than sufficient to protect against foreclosure losses (70% or less), there is no basis for significantly increased rates and fees. Actually, the higher pricing itself *creates* more risk, and the excessive fees charged up front cause the most damage to the homeowner by stripping equity from the home.

An examination of the risks in mortgage lending supports this point. Losses to a mortgage lender can result from four events:

1. late payment and default;
2. foreclosure;
3. prepayment of the loan before the lender has recouped the expenses incurred in making the loan, or
4. litigation expenses.

Risk of Prepayment. When a lender extends considerable expenses in the making of a loan, the lender does risk loss if the loan is prepaid before the regular payments on the loan allow the recoupment of these expenses. Market forces protect prime mortgage lenders, because prepayment penalties are only included in 2% of prime loans, yet they are in 70% of subprime loans.[14] Competition works to make the loans provided to prime borrowers at the lowest possible price, protecting the lenders of those loans against immediate refinancing. Thus the typical prime mortgage loan stays on the books for an average of 5 years.

Yet, in the subprime mortgage market the brokers are generally the gatekeepers for the loans, and they operate on the reverse competition method of yield spread premiums. The higher the premium paid to a broker, the more likely the broker will match a lender up with an unwitting borrower. The hefty price paid to broker in the yield spread premium is an expense that the lender must recoup in order to avoid a loss, especially considering that the same broker has an incentive to market aggressively another loan to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by yield spread premiums.

If prepayment penalties were disallowed, unreasonable yield spread premiums would not be paid by lenders, because they could not afford the risk. This would not mean that loans would not be made – they are made every day in the prime market without hefty premiums and prepayment penalties.

Real Risk of Loss. Although lending to consumers with blemished credit does not by itself create the potential for losses sufficient to justify the increased prices and many of the practices in the subprime mortgage industry, there is still considerable risk of loss to investors. The risk of loss comes from lawsuits challenging the predatory activities, not from borrowers' failure to comply with the contract terms.[15] However, this risk of litigation resulting from the lender's own bad acts certainly does not justify higher charges, and should not be considered a valid reason to avoid regulation which might stymie this type of credit.

What Risks Justify High Costs?

According to studies by Freddie Mac,[16] and extensive analyses of the prospectuses of a variety of subprime lenders, annual losses rarely exceed 3% even in the lowest rated subprime mortgage loans.[17] Therefore, at the most the increased interest rates should be 3% higher than those charged on prime mortgages. Certainly there is no justification for the huge differential in rates and points, fees and costs currently charged by many subprime lenders. This means that if regulation stops the type of subprime mortgage lending on which higher fees and rates are charged, no harm is done – instead consumers are protected.

If the result of extended regulation is actually to reduce the numbers of mortgage loans available to homeowners with impaired credit, other avenues of credit will simply quickly open up. It does not make sense to encourage the use of home secured credit if that credit creates an increased risk of losing the home. For all these reasons, we strongly support the Board's proposal to change the APR trigger.

D. *Establishing Different APR Triggers for Junior Mortgages*.

The Board requests input on whether the it should create a different trigger for mortgages which are not in first lien position. We support this concept for these reasons. The higher trigger for second mortgages provides some incentive to lenders to make more second mortgages. When a homeowner needs to borrow only a small amount of the available home equity, federal law should encourage better loans. Current law encourages lenders to refinance existing – generally affordably priced – purchase money loans to obtain a relatively small amount of credit.

Most lenders these days prefer to be in first lien position because federal law preempts state law interest rate and point caps.[18] It is an obviously logical business decision for a lender: make a loan which has no interest rate or fee limitations rather than one specifically regulated by state law.

Having a lower HOEPA trigger for first lien loans will encourage lenders to make second mortgages. Two beneficial consequences will flow to consumers. First, the incentive of predatory lenders to refinance favorable lower rate first mortgage loans will be reduced. Second, these lenders will be subject to second mortgage loan laws in states that have retained them. These laws often contain an interest rate cap and fee limitations.

E. *Changing the HOEPA Points and Fees Trigger*

The Board proposes to include only one additional type of charge in the points and fees trigger---the cost of premiums or other charges for credit life, accident, health, or loss-of-income insurance, debt-cancellation coverage, or similar products paid by the borrower at or before closing. We agree with the Board that this is a critical cost of the loan that must be included in this trigger. We hope that the Board does not waver from this position.

One of the most important hallmarks of a truly predatory loan is the financing of a large amount of costs up front. Whether these charges are labeled credit insurance, points, or closing costs, is less material than the basic fact that they all represent a significant source of immediate income to the person who is making the loan. The financing of these charges also causes the worst problem to the homeowner because this financing strips the homeowner of precious equity in the home. Triggering HOEPA restrictions by limiting the financing of these charges will have the effect in many cases of prohibiting the combination of excessive charges. But, this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the *interest rate* charged the borrower – the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower's equity in the home will be preserved. These loans will be structured exactly the same as the low cost mortgage loans provided to prime borrowers all the time. However, in order for this analysis to work , there also must be significant limitations on the prepayment penalties that can be charged.

The following discussion addresses the Board's questions about the merits of including in the points and fees trigger 1) credit insurance, 2) prepayment penalties, and 3) points paid by the consumer for refinancing the loan with the same creditor. In addition, at the end of these comments we address the Board's decision not to suggest including any other points, fees, or charges that are paid at or before closing in the points and fees trigger.

1. *Including Credit Insurance Premiums in the Points and Fees Trigger.*

The Board appropriately recognizes the significant benefit to creditors provided by single premium credit insurance (and related products), as well as the excessive cost of these products to consumers, by proposing to include the premiums in the HOEPA points and fees trigger, when the premiums are financed. We strongly support this proposal. We set out below additional information providing the basis for this important addition to the HOEPA trigger.

In concept, credit insurance could be a product which does what it is intended – benefit borrower and lender. As it has developed, though, there are structural problems – pricing distortions and marketing abuses – which have created a gap between concept and reality.

Mortgage borrowers rarely make a separate, considered decision to purchase this product. Credit insurance sometimes provides lenders with a substantial portion of their profits.[19] Advocates report that the premiums are included in loan documents with little or no prior discussion with the consumer, who is faced with the daunting prospect of canceling a loan at a closing as the only way to avoid this expensive add-on purchase.

Advocates have also suggested that the dual market for credit insurance products has a marked disparate impact on minority homeowners. As the HUD studies amply demonstrate, subprime mortgage lending is disproportionately concentrated in minority neighborhoods of major cities.[20] The same minority homeowners are paying the high cost of single advance premium credit insurance, while predominantly white homeowners with conventional mortgages are offered the less expensive monthly premium credit insurance products, which are also offered separately from the mortgage transaction. It is hard to see what business justification there can be for not offering monthly premium credit insurance, as a separate purchase, in the subprime mortgage market.

The nature of the credit insurance marketplace, and the extent of the commissions received by creditor-sellers, also strongly support including single credit insurance premiums in the points and fees trigger.[21] In theory, credit insurance is a dual benefit insurance, which benefits the creditor as much as the borrower, as it is added security on the loan. Therefore, there is no real need to provide financial incentives to the creditor to sell the products, but that is not the way the relationship between creditors and insurers developed. Instead, there are significant financial incentives, creating "reverse competition."[22] It is the creditor which selects the insurance which will be sold to its customers, which leads the creditor to select the products most profitable for it, the full cost of which is passed on to the consumer. Some major lenders have their own insurance affiliates.

The credit insurance industry is aware of its profitability to the credit providers, and markets that feature to the creditors. At a 1994 meeting of the American Financial Services Association, at a session entitled "Credit Insurance: Current and Future Issues and Opportunities," a representative from one of the major credit insurance providers on the panel emphasized the value of the credit insurance to the creditor: start with a 12% loan; a credit life premium bumps it up to 12.5% APR, and the "full package" moves it up to an 18% loan.[23] A representative of another major credit insurance provider focused on the topic "new fee income insurance products." He noted that there is a correlation between profitability and the age of the product: in the later stages, regulation forces the rates down and the loss-ratios up, so their goal is to get 20% of their premiums every year from products started in the last 5 years.[24]

Compensation ratios on credit insurance products range from approximately 33% (for credit life) to over 50% (for credit unemployment).[25] Creditors may also benefit from claims experience. A 1999 10-K filed with the SEC by a major credit insurance provider explains how to its investors:

> The Company uses contracts which allow the Company's clients to participate in the underwriting results of policies they market to their customers. The "Retro Plan" contract links a client's overall commission to the claims experience on policies marketed to its customers, **so that low loss ratios[26] result in higher commissions for the client [i.e, the creditor] and high loss ratios result in lower commissions**. Another form of participation is a profit sharing contract under which the client earns up to 50% of the profits generated from its insurance business. The Company also reinsures premiums generated by certain clients to the clients' own captive insurance companies or to reinsurance subsidiaries in which clients have an ownership interest.[27]

This back-end stake gives creditors a financial disincentive to help consumers through a claims process, which can be especially burdensome for credit disability insurance.

A study released in 1999 included nationwide data on commissions and loss-ratios on four types of credit insurance, for the period 1995 to 1997. The figures for 1997 are given below:

	Loss Ratio	Producer (creditor) Compensation
Credit Life	41.6%	33.3%
Credit A&H	48.6%	28.5%
Unemployment	12.6%	52.6%
Property (FEC)[28]	26.3%	32.8%
Property (Other)	11.6%	45.1%
TOTAL	38.7%	34.2%

Using NAIC target loss ratios of 60% for credit life and credit disability, and 75% for unemployment and property as a reasonable benchmark,[29] this study calculates over $2 billion in excess premiums paid by borrowers in 1997.[30]

Some estimates are that half of subprime mortgages have credit insurance, compared to 6% in the prime mortgage market.[31] The predatory effects of single premium credit insurance, its predominance in the subprime market, and its high level of compensation to creditors, support the Board's decision to include it in the points and fees trigger.

2. No exceptions for Refunded Premiums Should be Permitted.

The Board also seeks comment on whether there should be circumstances under which these premiums' costs should be excluded from the points and fees trigger in the event that the consumer receives a notice advising the consumer that s/he can cancel it and obtain a refund. We strongly opposes this approach for several reasons.

First, the exception will consume the rule. Such disclosures will appear in the paperwork of every closing even if the consumer did not see it or understand it. Several subprime lenders have been notorious with finagling when, if at all, they provide the HOEPA notices.[32] There is every reason to assume that this behavior will occur regarding a credit insurance notice. Thus, the notice, no matter what it says, will not be effective.

Second, the rule for inclusion should be clear and unequivocal. The lending industry complains that it needs clear-cut standards under which it can operate so that it can effectively afford legal risk. This risk is enhanced by a regulation that allows these charges to be "sometimes in, and sometimes out" of the points and fees trigger. The stability of the market is enhanced by a clear standard.

Third, even assuming consumers receive such a notice and later decide to cancel, the mere rebate of a portion[33] of the premium does not undo the damage if the premium was financed over the term of the loan. Since the lump-sum premium is part of the principal, interest will continue to be charged on the premium, even after the consumer receives a rebate. The interest charges attributable from the premium itself can be significant. For example, assume the following loan:

Loan Amount	$60,000
Loan Term	30 years
Credit Insurance Premium	$5,000
Credit Insurance Term	15 years

In this case, even if the consumer cancels the policy *immediately*, the consumer will pay an additional $16,300 interest over the life of the loan *just to cover the $5,000 premium*. In addition, loan origination fees and other fees which are calculated as a percentage of the principal will be higher when the credit insurance is financed. These fees, in turn, are often financed which results in the collection of interest on these fees. This also increases the cost to the consumer. (Note, one cannot assume that the consumer would be permitted to apply the $5,000 premium to pay off the loan balance, because this would trigger the prepayment penalty.) But why should anyone assume that a few days after closing the consumer will suddenly read through the piles of paper that came with the mortgage and understand the significant cost of the credit insurance and take advantage of the right to cancel?

The damage to the consumer is even worse if the consumer cancels after 5 years. In this case, if state law allows the rebate of the premium to be calculated based on the Rule of 78s (which is typical),[34] only 44.57% of the premium will be refunded even though coverage for two-thirds of the term of the insurance has been cancelled.

The amount of the $5,000 rebate that will be refunded after 5 years will be $2238.

Even if the consumer takes this sum and pays down the loan balance with it (which requires an assumption that there is no prepayment penalty allowed on the loan), the consumer will have already paid **$3,555 more in payments than would have been paid without credit insurance, and the balance on the loan at this point will be $2693 higher than it would have been without credit insurance.** So the total cost to this consumer for five years of credit insurance coverage on a thirty year loan will be:

Total of higher payments over the five years	$3,555
Higher balance owed on loan (assuming rebate applied to balance) after five years	$2693
Total cost	**$6,248**

Finally, disclosure should not substitute for legal protections. By including the credit insurance premium in the HOEPA trigger, one of two consequences will follow. More loans will be subject to the substantive protections in HOEPA or lenders will no longer make higher costs loans with credit insurance products. Both results are meritorious. The Board is correct to find that the cost of these products represent a significant cost of the credit transaction. The Board said it best: "including optional credit insurance and similar products in the points and fees test would prevent a creditor from evading HOEPA by packing a loan with such products in lieu of charging fees that would be included under the current HOEPA trigger."[35]

3. *Prepayment Penalties.*

The Board asks whether prepayment penalties should also be included in the HOEPA trigger. We answer yes.

As noted above, while prepayment penalties are only included in 2% of prime loans, they are in 70% of subprime loans.[36] Yet, it is our understanding that subprime loans typically refinance in half the time that prime loans do. Clearly, market forces are not working to limit this very expensive loan term in the subprime market.

Rather than including in the HOEPA trigger the prepayment penalties charged on the loan being refinanced, we recommend that the Board include prepayment penalties that *could* be charged on the loan being made. While a lender legitimately has the right to recoup the cost of making the loan, as explained above, prepayment penalties are only necessary in loans where large yield spread premiums are paid. It is only in those loans that a lender has extended so much money up-front that there is a concern that the payments on the loan will not cover the up-front cost. But why should this practice be encouraged? Indeed, the yield spread premiums generally paid in predatory mortgages simply add to the cost of the loans, without adding value to the market or the loan. Allowing 8 % of the loan amount to be charged to the borrower before HOEPA is triggered more than sufficiently ensures that lender can charge and recoup reasonable costs to make the loan. But allowing these up-front fees along with prepayment penalties allows the lender to charge twice for the same activity. In these instances, prepayment penalties are simply another instance of abuses in the subprime market which are not found in the prime market. So to really limit the unfair impact of prepayment penalties on the loss of home equity in the subprime market, it makes the most sense to simply tie them in with the amount of up-front fees that have been charged.8 % of the total loan amount charged in up-front fees should be more than necessary to cover a non-predatory lender's costs for making the loan; any more than that is unnecessary equity stripping. In this design the lender has the option of whether to charge all or part of the 8% up front or as an early prepayment penalty if the loan is prepaid before a reasonable amount of time has passed.

F. *Disclosures*

In earlier comments, we have suggested a few improvements to the HOEPA notice, though we prefer that the Board concentrate on prohibiting specific acts associated with predatory lending. The Board has proposed changes to the advance notice. As noted in comments NCLC filed in August, 2000, the purpose of any additions to this notice should be carefully weighed against the goal of keeping the notice short and understandable. The notice does play an important role in the HOEPA scheme of protecting homeowners against the worst abuses prevalent in the high cost lending market, a market in which many find themselves a captive audience due to perception, deceptive sales tactics, reverse redlining, lack of sophistication, and other factors. But this notice will only work with some small number of homeowners. It cannot replace substantive protections. We agree with the Joint Report to Congress made by the Board and the Department of Housing and Urban Development that "it is unlikely that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and unfair practices."[37]

Total Loan Amount and Balloon Payments: The proposed addition of the "total amount borrowed," as reflected on the note, is a welcome modification, for the reasons the Board articulated in the Supplementary Information.[38] Also, moving the current requirement that the balloon payment be disclosed from the Official Staff Commentary to Regulation Z makes sense. All of the mandated information will then be located in one place in the regulation.

The Board, however, seeks input on three questions related to this early warning notice.

Regular Payments: Should consumers be required to request or affirmatively agree to purchase voluntary items in writing, to aid in enforcing the rule that creditors must include voluntary items in the regular payment if the consumer has voluntarily agreed to purchase them?

Our answer is that the burden is on the creditor to comply by obtaining actual, voluntary consent from the homeowner before calculating the regular payment that must be disclosed on the HOEPA notice. The Board should refrain from regulating how the creditors accomplish that task. The statement on this point in the proposed Commentary 226.329(c)(3)-1 is adequate.

Tolerances in the HOEPA Notice Is it appropriate to provide a tolerance for "insignificant" changes to the amount borrowed, and, if so, what is a suitable margin? As a policy matter we do not agree that sophisticated creditors, who have access to any number of computer programs to determine loan schedules and payment amounts, need any tolerances. There are several reasons for this:

First, the creditors must furnish the HOEPA notice only three days before the closing so there is little excuse for discrepancies at that late stage of the process in the amount to be borrowed.

Second, any tolerance to the disclosure of the total amount borrowed will permit creditors to pad the principal following delivery of the notice and before closing with no legal consequences. Based on our experience and review of predatory loan cases, it is clear that most such transactions involve some form of bait and switch. Homeowners often believe they are getting a loan in one amount, only to discover at settlement or later, that additional fees were added to the principal and financed over the term of the loan, adding considerably to the lender's profit. Sometimes, the lender pads by paying off debts the homeowner never wanted or needed to pay, in order to jack up the principal.

Additionally, Regulation Z currently allows a creditor to use estimates in the HOEPA notice if any information is unknown to the creditor and the creditor clearly states that it is an estimate. More importantly, the usual TILA tolerance rules already apply to the APR in the HOEPA notice.[39]

However, if the Board decides to accommodate the industry on this issue, we strongly urge the Board to adopt the same tolerance standard that Congress did when a homeowner sues for damages under TILA. In that case, TILA permits the finance charge (*and the other disclosures affected by the finance charge)* to be off by no more than $100.[40] If a judicial or non-judicial foreclosure proceeding or action has begun, the tolerance is only $35.[41] Transferring these tolerances to the HOEPA context, the total amount borrowed would be accurate if it is no more than $100 (or $35, in the case of a foreclosure) different from the true amount.

Counseling: Would a generic disclosure advising consumers to seek independent advice encourage borrowers to seek credit counseling? We believe that adding such information might be helpful but only if the Board also includes some explanation about why such counseling might be necessary. In other words, the consumer should be warned that this is "A HIGH RATE LOAN." Without such a warning, consumers will have little or no reason to obtain counseling in this particular transaction, as opposed to others, such as when they purchase a car and finance it. Our major concern, however, is that this type of pre-loan counseling is not actually available to most consumers. Most credit counseling services and non-profit providers do not assess whether a particular loan will benefit or harm a consumer. Most have not received training as to the “red flags” of a predatory transaction. Most such services conduct only a budget review and assist in working out repayment plans for current debts in default. Even if these providers existed in every community at little or no cost (which they do not), they are not equipped to provide the necessary assessment.   Worst of all, there are scam credit repair and for-profit counseling services that are available to take advantage of consumers who do not understand the dynamics of the marketplace.

G. *Substantive Protections*

Refinancings within twelve months: Loan flipping is one of the most egregious practices of predatory lenders.   The Board recognizes this in the Supplementary Information and does an excellent job of explaining the nature and effect of this abuse.[42] Unfortunately, the Board’s recommendation to address this problem will not accomplish anything to restrict the practice. The prohibition only applies for a twelve-month period. This timeframe is too short. Our experience reviewing loan documents and reports from advocates show that, while many refinancings occur within four years of the closing on the existing mortgage, few take place within one year.   A bright-line rule with such a short duration will simply encourage refinancings on the 366th day or later.

Further, the rule should not limit the prohibition to one made by the same or an affiliated creditor. It is common practice for lenders to aggressively market their products to the customers of other lenders. We have seen many homeowners who have been refinanced several times for different, unrelated lenders. Often, though not always, a broker is involved and provides the common connection among the lenders and the homeowner. The regulation will grant no protection to this situation.

Also, the proposal contains an escape hatch through which any benefit otherwise available will be lost. The same lender or an affiliate may refinance a customer within twelve months *if* the refinancing is in the borrower’s best interest. The new Commentary suggests that the totality of the circumstances must be considered.   This is a very weak standard and, we strongly urge the Board to use the "net tangible" test instead. However, if the current proposed language is retained, we suggest that the Commentary also state that it is the creditor’s burden to make this showing. We agree with the Board’s articulation of specific attempts to evade this rule and the list of examples.

In deciding upon this suggestion, the Board explicitly rejects two other concepts. First, the Board recognizes that a rule which limits the amount of fees that can be *charged* in a refinancing would, quite simply, remove the economic incentive for loan flipping. Unfortunately, the Board does not feel it has the authority to impose this limit. Second, the Board refused to adopt a “net tangible benefit” to the borrower approach as inherently subjective. But, it is really no more subjective than the test that the Board proposes as an exception to the rather meaningless limitation of refinancing within one year.

Another Approach. There is another approach to accomplish the goal of eliminating the economic incentive inherent in flipping. This concept is within the broad authority of the Board to promulgate regulations on refinancings. We strongly support a provision which prohibits lenders from *financing* more than 3% of the points and fees charged at closing. This protection is not rate regulation as it does not put a cap on the points or fees that can be charged for high rate loans. Presumably, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower – the lender will recover these costs through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower’s equity in the home will be preserved. These loans will be structured exactly the same as the low cost mortgage loans provided to prime borrowers all the time.

There are indisputable advantages flowing from limiting the financing of points, fees or credit insurance premiums, and limiting prepayment penalties:

- *There will be limits on the equity stripped from the home.* The amount of money that the borrower directly receives, or is paid on the borrower's behalf will be the full loan amount, and very little more. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will not rise with each refinancing. The equity in the home is no longer the source of financing the loan – the loan can only be financed through the borrower's income.

- The lender will have the incentive to make these loans affordable. Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the payments, the lender has a clear incentive to make sure that the borrower can afford the payments.

- *The market will work to keep the interest rate on these loans competitive.* So long as the borrower has not invested a significant amount of money in each loan – as is done when thousands of dollars in points and fees are financed – there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall – just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Consider the following high cost loan:

Borrower receives:	$70,000
Borrower pays:	
6 Points	4,200 ($4,200 all profit to lender)
Closing Costs	2,50 ($1,500 profit to lender)
Credit Insurance	2,200 ($1,000 commission to lender)
Total Loan Amount	$78,900 $6,700 - immediate profit to lender upon sale of loan to investor
Interest Rate of 12%	30 year term Monthly payment - $811.58
Consumer owes after 36 payments	$77,927.52, after 60 payments, the balance is $77,056

So long as there is sufficient equity in the home (and there generally is plenty), this lender *benefits* if the borrower defaults. A default provides the lender with reason to make a new loan, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. The refinanced loan would be for an amount at least $6,000 more to cover the new closing costs, with the same interest rate of 12%, and the consumer will have that much less equity in the house.

Even if the borrower does not default, predatory lenders typically "sell" a refinanced loan with a small amount of additional cash to the homeowner, thus taking advantage of the large prepayment penalty that can be collected.

However, if the lender could charge a higher interest rate, but could not finance more than 3% in up-front costs and fees, the same loan might look like this:

Borrower receives	$70,000
Closing Costs	2,100 ($1,100 immediate profit to lender)
Total Loan Amount	$72,100
Interest Rate of 13.25%	30 year term Monthly payment - $ 811.68

The lender makes up entire the difference in the amount that is not permitted to be financed [$8,900 - $2,100 = $6,700] in 6 years in additional interest charges paid by the consumer. So this lender has the *incentive to make this loan a performing loan, and not to encourage a prepayment.* This lender has much less incentive to flip this loan than the lender in the first example. Indeed, the lender's main concern will be to make sure that borrower can in fact repay the loan. The profit from the loan will only flow from the payments.

Moreover, the homeowner does not lose equity – thus preserving the main source of savings for most Americans, the equity in their home. After 36 payments, the consumer owes $71,415, and after 60 payments, the consumer owes $70,784.

We request that the Board reconsider its position on this issue. As the clearest way to reduce unnecessary refinancings is to limit the charges that the lender can finance up-front, we ask the Board to prohibit lenders in HOEPA loans from *financing* more than 3% of the points and fees charged at closing.

Refinancing of Certain Low-Rate Loans: To address the issue of the refinancing of low-rate or no-rate loans, the Board suggests prohibiting creditors in the first five years of a zero interest rate or other low-cost loan from replacing that loan with a higher-rate loan, unless the refinancing is in the interest of the borrower. We strongly support a prohibition on the refinancing of such loans but believe changes to this rule are necessary.

It is essential to make clear what is at stake here. The loans covered by this rule will almost always be mortgages used to purchase homes for first-time homebuyers who could not afford to buy but for a special program. Usually, these loans have below market interest rates and reasonable or subsidized closing costs. In contrast, this rule addresses the situation where these homeowners are solicited by lenders who want to make them HOEPA loans! By definition, the loan that would replace this below market rate, low-cost loan is not even a market rate loan, but a loan that is *at least 8 percentage points above market or is very costly to obtain.*

We urge the Board to eliminate the five year cap and ban the refinancing of these loans altogether so that no homeowners lose the substantial benefit of these loans.

If this provision is retained in any form, we also strongly urge the Board to change the suggested Commentary which allows the creditor to rely on a statement by the borrower regarding the current rate of interest on their existing loan. Most consumers do not know the interest rate on their current mortgage and do not know where to find it on the loan documents. Frequently, it can only be found on the loan note which is not a consumer-friendly document. More importantly, the lender should be required to verify this number by asking the consumer to provide the documentation for review. After all, the lender is going to be transforming the best loan products in the country into a very high cost HOEPA loan. The lender should have the burden to determine whether it is violating any substantive prohibition.

Repayment Ability: The Board tinkers with the current rule in HOEPA which prohibits a creditor from engaging in a pattern or practice of extending credit based on the consumers' collateral without regard to the consumer's ability to repay. The proposed Commentary is enlarged to state that whether a creditor has engaged in a pattern and practice depends on the totality of the circumstances in each case. The Commentary then points to cases decided under TILA, the Equal Credit Opportunity Act, the Fair Housing Act, and the Civil Rights Act as guides on this issue.

We urge the Board to adopt the judicial definition of a pattern under the Racketeer Influenced and Corrupt Organizations Act. The Supreme Court has defined a "pattern" to means an arrangement or order of multiple events that is reflective of relatedness and of ongoing practices, as opposed to random or isolated occurrences.[43] A "pattern" is not a term of art in the ECOA, FHA, or employment discrimination context. It is important, therefore, for the Board to point to a body of law to assist courts in defining a "pattern" in the HOEPA context.

The term "practice" has been defined in the employment discrimination context. The Supreme Court has held that the challenged practice must be the "company's operating procedure—the regular rather than the unusual practice."[44] In the HOEPA context, it may be difficult to show that the practice was a company's "operating procedure." For example, we understand from ex-employees of some lenders that the written procedures say one thing but the oral instructions say another. It is a considerable burden to obtain through discovery and then review *every one of the lender's loan files* to show that the actual practice does not match the public persona.

There are few cases decided under the FHA and the ECOA defining a "pattern" or "practice." Thus, the reference to those laws is not particularly useful. The issue of a "policy" arises under these Acts because plaintiffs must show that a specific policy caused a significant disparate effect on a protected group.[45] The concept that a specific policy must be identified goes back to the original roots of the disparate impact theory in employment cases.[46] A requirement that the plaintiff show that the mortgage lender had a "policy" of failing to consider the homeowner's ability to repay is a stringent standard that will make it difficult, if not impossible, to prove a HOEPA violation.

The Board addresses the issue of "no-doc loans" and verification requirements by creating a presumption in Regulation Z that the creditor violates HOEPA if the creditor engages in a pattern or practice of making loans without documenting and verifying the consumer's repayment ability. We support this provision as a helpful way to address the use of "no doc" loans, if the Board will not simply prohibit them.

However, the concerns we expressed regarding the "pattern or practice" requirement apply to this issue as well and we ask the Board to reconsider.

Lastly, the Board looks at the issue of how the consumer's ability to repay should be assessed when the creditor makes a variable rate loan with a low introductory rate. The Board adds Commentary which requires that the creditor consider increases to the consumers' payments based on the maximum possible increases in rates in the shortest possible time frame. This standard seems confusing. It would easier, simpler, and clearer to require the creditor to consider whether the consumer has the ability to repay the highest monthly payment that could result from the formula at any time during the course of the loan.

<u>Notice to Assignee</u>: The intent of the Board in drafting the addition to the Commentary to make it clear that assignees purchase HOEPA loans subject to all claims and defenses, not just those arising under TILA, is laudable. Two problems surface in this context. First, the Board must take pains to make it clear that this is not a change in the law. The Board should also make this addition effective immediately. Otherwise, assignees will claim that they are not liable for non-TILA claims and defenses that occurred prior to the effective date of this "change."

Witness what is happening in the payday loan context. There, the Board made clear in the Supplementary Information accompanying the Commentary change adding payday loans as an example of a "credit" transaction, that this action did not represent a change in the law. Unfortunately, the Board permitted an implementation period of six months during which "compliance" was optional.[47] The payday loan industry picked up on that and has convinced at least two judges that payday loans were not governed by the TILA before the compliance date.[48]

The Board can close any potential loopholes by adding the following to the supplementary information:

> *Section 226.34(a)(2)-3 is added for clarification purposes only. The statutory language is clear that Congress intended that the liability of assignees when they purchase HOEPA loans is expanded to include all claims and defenses that the consumer could assert against the creditor and not merely those that arise under TILA. The effective date of this provision in the Commentary is immediate. The Board is not providing an implementation period under § 104(d) of TILA since this addition does not represent a change in the law nor does it necessitate a change in disclosures previously required by the Act.*

<u>Due-on-Demand Clause</u>: The addition of these types of clauses in the list of prohibited creditor behavior in a covered loan is helpful. We support this action, though there are more serious issues and widespread abuses that merit the Board's attention.

H. <u>*Open-End Credit*</u>

The exclusion of open-end mortgage loans from HOEPA is a loophole that needs to be closed. Though the Board does not have the authority to close it on its own, it should make a strong recommendation that Congress fix this trap door through which an ever-increasing number of loans are falling.

Not only do abusive, high cost open-end loans escape HOEPA scrutiny, the disclosure information gap between open-end and closed-end mortgage loans under TILA is huge. Lenders will have more incentive to structure their home equity loans as lines of credit when the HOEPA triggers are tightened through this rule-making process.

It is laudable that the Board proposes to make it an unfair or deceptive act or practice to structure a home-secured loan as an open-end plan to evade HOEPA. The Board seeks comments on whether there should also be a rebuttable presumption that a creditor intended to evade HOEPA, if a consumer applies for a closed-end home-secured loan and, instead receives an open-end line of credit that is priced above the HOEPA triggers. We strongly support both of these suggestions.

In addition, however, the Board should re-consider its decision to withdraw the five factors to be considered in determining whether a credit plan is open-end or closed-end which the Board and Staff proposed in 1997.[49] Specific guidance to both creditors and consumers on this issue is essential given the incentives which creditors have to structure their loans as open-end.

I. *Other Matters*

Points and fees trigger: The Board decided not to suggest including any points, fees, or other charges that are paid at or before closing into the points and fees trigger, other than credit insurance premiums. In making this decision, however, the Board added a sentence to the Supplementary Information which may foreclose arguments currently being made in cases that lender-advanced broker compensation payable by the consumer at or before closing are "points and fees." The Board states: "It is not clear that an amount paid over the life of the loan and included in HOEPA's APR trigger should also be included in the points and fees trigger as an amount paid at or before closing."[50]

However, HOEPA and the structure of the mortgage transactions themselves provide strong support for the argument that these payments are "points and fees" under the statutory definition. Starting with the statute: first, the points and fees must be payable by the consumer at or before closing; second, points and fees include all items added to the finance charge except interest or time-price differential; third, points and fees include *all* compensation paid to mortgage brokers.[51]

Most lender-advanced broker fees are paid in a lump sum to the broker at or before closing. Such fees are paid or payable by the consumer because the lender advances the payment and subsequently repays itself through monthly payments made by the consumer.

This process is identical to the way that all other financed closing costs are re-paid by the consumer. Appraisal charges, settlement agent closing fees, points, credit reports costs, title insurance premiums, etc. are advanced by the lender on behalf of the consumer at or before closing. The lender then reimburses itself through the monthly payments. Thus, the advancement of money to cover these costs and the repayment over the life of the loan is the same in both cases.

Lenders, however, structure the repayment of yield spread premiums in a way different from how they structure the repayment of all other closing costs. Yield spread premiums are repaid through higher monthly mortgage payments which result from an increased interest rate. The borrower would have been entitled to the lender's "par" rate, but for the lender-advanced broker payment. However, the lender charged a higher interest rate to reimburse itself. All other financed costs are added to the principal and repaid only through higher monthly payments. The repayment of yield spread premiums and all other closing costs result in the same effect upon the consumer----an increased monthly payment. It is irrelevant whether the increased monthly payment results from a higher principal to cover financed closing costs or from a higher interest rate.

The lender sets up the game this way. While some sophisticated borrowers may understand the similarities and differences between these methods of repayment, most consumers do not. Moreover, it was lenders who created this formula to insure repayment by the consumer for certain types of broker fees. Lawsuits attacking this practice consistently allege that the purpose of structuring the repayment though an increased rate is to prevent consumers from understanding that they will, in fact, be re-paying the premium. These consumers typically paid the broker directly, expecting the broker to work on their behalf and obtain the best interest rate consistent with the consumers' credit-worthiness.[52]

The fact that a higher interest rate is the repayment mechanism should not knock out the premium payment from the points and fees definition. Points and fees include all items added to the finance charge except interest or time-price differential. These payments are not "interest" or "time price differential." Instead, they are a lump sum paid at or before closing. The method to insure repayment is to increase the APR and such increase is added to the finance charge as "interest." However, the lump sum payment is never the same amount as the interest that is generated over the life of the loan due to the increase in the rate. For example, in *Barbosa v. Target Mortgage Co.*, the consumers applied for a $70,200 mortgage loan at 8.75% with a 30-year term.[53] However, the broker obtained a loan with a 9.5% rate, even though the consumers allege they qualified for the lower rate. The consumers directly paid the broker $1,128 and the lender advanced a yield spread premium to the broker of $2,457. In contrast, the increase in the interest rate generated additional income to the lender of about $13, 680. The consumers' monthly payment increased from $552 to $590 to cover this cost. Consumers are not suggesting that the $13,680 be counted toward points and fees, as that amount is included in the finance charge as interest. Rather, the amount of the premium itself, given that it meets the definition of a fee, ought to be figured into the points and fees trigger.

The Commentary supports the consumer position on this issue. It specifically addresses mortgage broker fees: "[C]ompensation paid by a consumer to a mortgage broker (*directly or through the creditor for delivery to the broker*) is included in the calculation whether or not the amount is disclosed as a finance charge. Mortgage broker fees that are not paid by the consumer are not included."[54] Yield spread premiums meet this standard when they are paid by the lender to the broker at or before closing. This is the most common scenario. On the other hand, the Commentary recognizes that some lender payments to brokers are not counted, such as volume-based compensation. This type of payment is not repaid by the consumer but is based on the number and size of mortgage loans that the broker places with a particular lender.

For these reasons, we urge the Board to add the following language in the Commentary (or, at the very least, add it into the Supplementary Information that will accompany a final regulation):

> *Lender-paid or lender advanced payments to brokers may be counted in the points and fees trigger where the payment was payable by or on behalf of the consumer and at or before closing.*

III. Conclusion

The Board has taken admirable steps toward including more predatory loans within the protective coverage of HOEPA. We look forward to continuing to work with the Board and staff as we all struggle to curb abusive lending practices in the future.

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[1] The **National Consumer Law Center** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eleven practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (4th ed. 1999) and *Cost of Credit: Regulation and Legal Challenges* (2nd ed.(2000), and *Repossessions and Foreclosures* (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers.

NCLC has been writing about the exploding problem of predatory mortgage lending to since the 1980's. NCLC has advised legal services and private attorneys on litigation strategies to deal with such loans, and provided extensive testimony to Congress regarding necessary protections to be included in federal law, including the Home Ownership and Equity Protection Act. Since the passage of HOEPA, NCLC has continued to work with a broad coalition of consumer and community groups and with various federal agencies to create a comprehensive solution to abusive lending practices.

NCLC launched a Sustainable Homeownership Initiative several years ago. As a part of that initiative, NCLC works closely with Freddie Mac, Fannie Mae, the Neighborhood Reinvestment Corporation, banks, and housing counselors to sustain homeownership through training, coalition building, as well as specific intervention projects in some cities, such as Boston and Chicago.

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[2] The **Consumer Federation of America** is a nonprofit association of some 250 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[3] **U.S. Public Interest Research Group** serves as the national lobbying office for state Public Interest Research Groups. PIRGs are non-profit, non-partisan research and advocacy groups with offices around the country.

[4] **Consumers Union,** the nonprofit publisher of Consumer Reports, is a nonprofit membership organization chartered to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life of consumers.

[5] The **National Association of Consumer Advocates** is a non-profit organization designed to promote justice for all consumers, comprised of approximately 600 lawyers, law professors and advocates who specialize in consumer law.

[6] In 1998, the Board and the Department of Housing and Urban Development and HUD released a Joint Report to Congress, in which the Board recognized that "abusive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections." *Joint Report to Congress Concerning Reform to the Truth In Lending Act and the Real Estate Settlement Procedures Act,* July, 1998, at 51.More recently, several federal agencies have strongly supported a variety of curbs on predatory lending. For example, after HUD and the Department of Treasury held hearings throughout the country, they issued a joint report in June, 2000 recommending extensive reforms. *Curbing Predatory Home Mortgage Lending,* U.S. Department of Housing and Urban Development and U.S. Department of Treasury (June, 2000). HUD issued a regulation which prohibits Fannie Mae and Freddie Mac from counting predatory loans toward their housing goals in certain circumstances. 65 Fed. Reg. 65044, 65085 (October 31, 2000). Several bank-related agencies, the Office of the Comptroller of the Currency, Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued a joint Guidance for Subprime Lending Programs on January 31, 2001 that provides a framework for the examination of subprime lending activities. The Federal Deposit Insurance Corporation sought comments regarding a "staff guidance" directed to FDIC-insured banks on "How to Avoid Purchasing or Investing in Predatory Mortgage Loans." The Office of Thrift Supervision published an Advance Notice of Proposed Rulemaking seeking input on ways to tighten its regulations under the Alternative Mortgage Transactions Parity Act which allow certain lenders to preempt state law restrictions on variable rate loans, balloon payments, negative amortization, and prepayment penalties in certain circumstances. 65 Fed. Reg. 17811 (April 5, 2000). In addition, Senators Grassley and Breaux held hearings before the Senate Special Committee on Aging, titled "Equity Predators: Stripping, Flipping, and Packing Their Way to Profit" on March 16, 1998.

[7] The Board cites data provided by the Office of Thrift Supervision. 65 Fed. Reg. 81438, 81441 (Dec. 26, 2000).

[8] *See generally, 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. (Feb. 3, 17, 24, 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).

[9] Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C.L. Rev. 473, 536-37 (Spring 2000).

[10] *Id.* at Table 1. It should be noted that the HOEPA trigger is based on APR, which is generally higher than the interest rate. On the other hand, a significant difference between the APR and the interest rate on a long-term mortgage loan results from very high prepaid finance charges (points), which is another strong indicator of potential predatory practices.

[11] 65 Fed. Reg. 81438, 81441 (Dec. 26, 2000).

[12] Between 1980 and 1998 the rate of home foreclosures in the United States has increased by 384%. That means that even though interest mortgage rates were almost twice as high in 1980 as they were in 1998, almost four times the number of homes were being foreclosed upon in 1998 as in 1980. At the end of 1980 there were 150,165 homes in foreclosure, at the end of 1998 there were 577,566. *See* Table No. 823, Mortgage Delinquency and Foreclosure Rates: 1980 to 1998, U.S. Census Bureau, *Statistical Abstract of the United States, Banking, Finance and Insurance,* 1999. This increase in foreclosure rates *cannot* be traced to the increase in homeownership rates, which was only about 3% during the same period. The increase in home secured lending during the same period was almost twofold, from 30 million loans outstanding in 1980 to 52.5 million loans in 1998. *See* Table No. 823, Mortgage Delinquency and Foreclosure Rates: 1980 to 1998, U.S. Census Bureau, *Statistical Abstract of the United States, Banking, Finance and Insurance,* 1999.

[13] *See* Debbie Gruenstein and Christopher E. Herbert, *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area, Abt Associates Inc.* (Sept. 2000); Daniel Immergluck and Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development,* Woodstock Institute (November 1999), available at www.woodstockinst.org.

[14] *See* Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. *Also see,* North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, *Inside Mortgage Finance,* and the following articles on conforming mortgages: "*Freddie offers a new A-, prepay-penalty program,*" Mortgage Marketplace, May 24, 1999; Joshua Brockman, "*Fannie revamps prepayment-penalty bonds,*" American Banker, July 20, 1999.

[15] For example, United Companies and First Alliance Mortgage Company filed bankruptcy in recent years largely to protect themselves from litigation precipitated by predatory practices.

[16] *See* Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* (Feb. 25, 2000)(Freddie Mac study which compared the interest rates on subprime loans rated A-minus by the lenders originating these loans with the rates on prime loans purchased by Freddie Mac which Freddie Mac then rated A-minus using its underwriting model; Freddie Mac found that, on average, the subprime loans bore interest rates that were 2.15% [215 basis points] higher; the study could find no justification for such a large discrepancy).

[17] Typical subprime lenders experience annual loss rates below 1% of the their loan portfolios. For example, Banc One reported in a March, 1999 prospectus supplement that its net losses as a percentage of the average amount outstanding on all serviced mortgage loans was .78% on 3/31/99. *See* Banc One Financial Services Home Equity Loan Trust 1999-2, Prospectus Supplement at S-20. All prospectuses and supplements hereafter cited may be obtained through the SEC's EDGAR database, at www.sec.gov/edgarhp.htm. Subprime mortgage lenders concentrating on the most risky borrowers still report modest losses. For example, Aames Financial Corp. reported in February 1999 that

its actual annual losses as of 12/31/98 were 1.08% of the serviced portfolio, and it estimated cumulative (i.e. not annual, but over the life of the loan pool) losses of 2.7% of the balance of loans securitized. A more conservative lender, New Century Financial, reported in March 2000 that its current loan production was a mix of about 25% "C" category loans, 20% "B" category, and 55% "A-" or "A" categories. *See* New Century Home Equity Loan Trust Series 2000-NC1, Prospectus Supplement, form 424(b)(5) dated March 22, 2000 and filed with the S.E.C. March 24, 2000, at page S-25.

[18] In 1980, Congress preempted the ability of states to set interest rate caps on most first mortgage loans. Depository Institutions Deregulation and Monetary Control Act of 1980, §' 501 (DIDA), codified at 12 U.S.C. § 1735f-7a.

[19] *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing before the Special Committee on Aging* United States Senate, 105th Cong. 2d Sess. 33-34, Serial No. 105-18 (Mar. 16, 1998)(statement of Jim Dough, former employee of predatory lender).

[20] *See e.g.* HUD, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (April 2000) in which HUD discusses the results of studies conducted in Atlanta, New York, Baltimore, Los Angeles, and Chicago. Key findings of the Department of Housing and Urban Development analysis show that: 1) From 1993 to 1998, the number of subprime refinancing loans increased ten-fold. 2) Subprime loans are three times more likely in low income neighborhoods than in high-income neighborhoods. 3) Subprime loans are five times more likely in black neighborhoods than in white neighborhoods. 4) Homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans.

[21] Much of this section on credit insurance is extracted, with permission from the author – Kathleen Keest – from materials prepared for the PLI Consumer Financial Services Litigation 2001 (forthcoming).

[22] *See generally* NCLC, *Cost of Credit: Regulation and Legal Challenges* (2nd ed. 2000) § 8.2.3.2

[23] Remarks of a panelist from American Security Group (78th Annual AFSA meeting, October 16-18, 1994).

[24] Remarks of a panelist from American Bankers Insurance Group, at the same conference.

[25]*See* Mary Griffin and Birny Birnbaum, *Credit Insurance: The $2 Billion A Year Rip-Off,"* p. 3 (1997 figures) (March, 1999 Consumers Union and the Center for Economic Justice)[hereafter Griffin and Birnbaum]. The report notes that in Texas, commissions for auto dealers averaged around 50%, compared to an overall average of 35% for credit life and disability. *Id.* p 15. A 1999 SEC 10-K filed by American Bankers Insurance Group (now part of Fortis, Inc.) listed the following data for 1998: Operating expenses: 13.9%; <u>Commissions 43.7%</u>; benefits, claims, losses & settlement expenses, 35.5%. For the 5 year period between 1994 and 1998, commissions ranged from 40% to 43.7%.

[26] The loss-ratio is the ratio of benefits paid out by the insurers to the premiums paid by the borrowers purchasing the insurance. The higher the loss ratio, the more benefits are paid out to insureds from each premium dollar, indicating efficient pricing. The National Association of Insurance Commissioners recommends a 60% loss ratio for credit life and disability, but has not set target loss ratios for credit unemployment and property insurance. Griffin and Birnbaum, supra note 24, p. 2. State law may incorporate target loss ratios for credit life and disability, and perhaps others. *See, e.g.* Iowa Code § 537.2501(3)(b), setting a target loss ratio of 50% for credit unemployment insurance.

[27] Excerpt from American Bankers Insurance Group's 1999 10-K filing with the SEC.

[28] Credit property (FEC) is that typically sold with closed-end loans, while credit property (other) is typically sold on credit card accounts. Griffin & Birnbaum, supra, note 24 , p. 3, note 5.

[29] *See* Griffin and Birnbuam study cited in note 24, *supra.*

[30] nd

See also, NCLC, Cost of *Credit: Regulation and Legal Challenges* (2 ed. 2000) § 8.1.

[31] The Coalition for Responsible Lending reports that estimate from a person knowledgeable about the industry in its comments to the Board on the proposed HOEPA revisions. *See* Comments of Self-Help and the Coalition for Responsible Lending on Docket #R-1090 (Feb. 20, 2001).

[32] *See Jackson v. US Banki Nat'l Assoc. (In re Jackson)*, 245 B.R. 23 (Bankr. E.D. Pa. 2000); *Williams v.Gelt Fin. Corp.*, 232 B.R. 629 (Bankr. E.D. Pa.), *aff'd*, 237 B.R. 590 (E.D. Pa. 1999); *Newton v. United Companies Fin. Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998). Advocates report that this is one of the most widespread violations of HOEPA.

[33] The insurance premium will not be refunded in full. The amount of the rebate will be calculated by one of several formulas which, depending on the formula that is used, can result in a windfall to the lender or insurance company. *See* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* Chapt.5 (2nd ed. 2000).

[34] *See* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2nd ed. 2000) Section 8.6.

[35] 65 Fed. Reg. 81438, 81442 (Dec. 26, 2000).

[36] *See* Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. *Also see*, North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, *Inside Mortgage Finance*, and the following articles on conforming mortgages: "*Freddie offers a new A-, prepay-penalty program,*" Mortgage Marketplace, May 24, 1999; Joshua Brockman, "*Fannie revamps prepayment-penalty bonds,*" American Banker, July 20, 1999.

[37] Department of Housing and Urban Development, Board of Governors of the Federal Reserve, *Joint Report to Congress Concerning Reform to the Truth In Lending Act and the Real Estate Settlement Procedures Act,* July, 1998, at 51.

[38] 65 Fed. Reg. 81438, 81443 (Dec. 26, 2000).

[39] Regulation Z § 226.31(g). The tolerances are .125% for a regular transaction and .25% for an irregular transaction.

[40] 15 U.S.C. § 1605(f)(1)(A).

[41] 15 U.S.C. § 1635(i)(2).

[42] *Id.* at 81444.

[43] *H.J., Inc. v. Northwestern Bell Tel. Co*., 492 U.S. 229 (1989). *See also Tabas v. Tabas*, 47 F.3d 1280 (3rd Cir. 1995).

[44] *United Bhd. of Teamsters v. United States*, 431 U.S. 324, 336 (1977).

[45] *See Mountain Side Mobile Estates P'ship v. HUD*, 56 F.3d 1243, 1251 (10th cir. 1995).

[46] *See Watson v. Forth Worth Bank & Trust*, 487 U.S. 977, 994 (1988); *EEOC v. Steamship Clerks Union, Local 1066*, 48 F. 3d 594, 601 (1st Cir. 1995) (the plaintiff must identify the challenged employment practice or policy and pinpoint the defendant's use of it).

[47] 65 Fed. Reg. 17129, 17130 (March 31, 2000).

[48] *See Ballard v. AA Check Cashers, Inc*, Case No. 00-5100 (W.D. Ark. Nov. 4, 2000)(Order of Dismissal); *Cox v. AA Check Cashers*, Case No. 00-2030 (W.D. Ark. Nov. 8, 2000)(Memorandum Opinion and Order of Dismissal).

[49] *Compare* 62 Fed. Reg. 64769 (Dec. 7, 1997) with 63 Fed. Reg. 16669, 16670 (April 6, 1998). The five factors are:

> 1) Whether the credit line is limited to the purchase of items not likely to be purchased in.multiples; a greater variety of products and services available increases the likelihood that the expectation was reasonable.
>
> 2) Whether the credit was established for the purpose of purchasing a designated item.
>
> 3) Where the plan is established to finance the purchase of a designated item, the amount of the purchase compared to the credit line. The establishment of a $5,000 line to purchase a $4,500 satellite dish was an example of where a creditor was not likely to reasonably assume repeated transactions. It noted that the availability of add-on sales which are nominal in amount compared to the initial transaction would not make the expectation reasonable.
>
> 4) Whether the creditor reasonably solicits customers for repeated transactions. For example, if a $10,000 line is filled with a $9000 roof job, a purported solicitation of the customer for a siding job would not appear to be a bona fide offer.
>
> 5)Whether the creditor has data showing that customers actually make repeated purchases.

[50] 65 Fed. Reg. 81438, 81443-44 (Dec. 26, 2000).

[51] *See* 15 U.S.C. §§ 1602(aa)(1)(B) and 1602(aa)(4).

[52] *See, e.g., Culpepper v. Inland Mortgage Corp.*, 132 F.3d 692 (11 Cir. 1998); *Mulligan v. Choice Mortgage Corp. USA, 1998 U.S. Dist. LEXIS 13248* (D.N.H. Aug. 11, 1998).

[53] 968 F. Supp. 1548 (S.D. Fla. 1997).

[54] Official Staff Commentary § 226.32(b)(1)(ii)-1 (emphasis added).