Comments
of the
National Consumer Law Center
to the
Federal Reserve Board
Docket No. OP-1253

Home Equity Lending Market

August 15, 2006

The **National Consumer Law Center ("NCLC")**[1] submits the following comments on behalf of its low income clients, as well as the **National Association of Consumer Advocates.**[2] We very much appreciate this opportunity to provide the Board information, ideas and proposals regarding the current home equity lending market. We also appreciate the extensive effort and time that has been expended by both the Governors of the Board and many Staff in conducting hearings around the nation about this issue. The subject is complex, and of tremendous importance to homeowners, lenders, and the basic economy of the United States.

We commend Federal Reserve Board for the substantial improvements to HOEPA that were made in 2001. These changes did have some positive effect in the industry, specifically in the way they helped dry up the sale of abusive single payment credit insurance premiums. Now we ask the Board to recognize that the abuses in the mortgage market continue and --

1) Recommend to Congress that significant changes be made to the regulation of mortgage lending**;**

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[1] **The National Consumer Law Center, Inc. (NCLC)** 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 sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by Alys Cohen, Elizabeth Renuart and Margot Saunders.

[2] The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

2) Use the Board's authority under 15 U.S.C. 1602(aa)(4)(D) to continue to broaden the triggers for HOEPA loans; and
3) Use the Board's expansive powers – under both the Truth In Lending Act (TILA) and the Federal Trade Commission (FTC) Act – to prohibit unfair and deceptive activities in mortgage lending.

In these comments we seek not only to answer the specific questions posed by the Board in the Federal Register, but also – hopefully -- to instigate visionary changes in the regulation of mortgage lending in this nation.

These comments are provided in the following sections:

I. The current system of mortgage regulation is fundamentally broken, and considerable change in the legal structure is necessary.
II. The Board has significant power to address many of the problems in the mortgage market.
III. Answers to the questions posed in the Federal Register.

I. THE MORTGAGE MARKET IS FUNDAMENTALLY BROKEN, CONSIDERABLE CHANGE IN THE LEGAL INFRASTRUCTURE SUPPORTING FAIR AND RESPONSIBLE LENDING IS NECESSARY

A. The Evidence of a Broken Mortgage System is Overpowering

The primary reason people buy homes is to provide a stable, pleasant place for the family to live, with a sense of community. A secondary, but traditional purpose of homeownership that has developed over the past century is the use of the home as an investment, a mechanism to ease retirement, and a source of funds to provide an inheritance.[3] It is so much a basic precept that homeownership is good for people, families, communities and the economic strength of the nation, that the United States governments expends millions of dollars annually investing in and supporting homeownership through the home mortgage interest tax deduction.

Yet, the policies of this nation in the past two decades have steadily supported the deterioration of many of the inherent advantages of homeownership. While there is no doubt that the rate of homeownership has continued to climb, the rate of loss of homes has climbed at a much higher pace. Additionally, homeownership, at least for millions of subprime borrowers, is now all too often fraught with heartache, concern over defaults and threatened foreclosures. To many, especially minority homeowners, the complexities and dangers of mortgage lending have caused the home to become a potential source of financial and emotional devastation.[4]

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[3] "For millions of families, owning a home ultimately makes the difference between merely surviving between paychecks or building savings for a better future." Testimony of Keith Ernst, Senior Policy Counsel, Center for Responsible Lending, to the House Subcommittee on Financial Institutions and Consumer Credit, June 13, 2006.
[4] *See* Comments offered by Diane Thompson, Attorney with Land of Lincoln Legal Assistance Foundation in East St. Louis, at the Chicago HOEPA hearing on June 7, 2006, in which she described clients who felt they were better off in public housing than trying to buy a home; available at

Consider these raw statistics, and how they fit into the troubling picture of the effect of predatory subprime mortgages on homeownership in this nation:

Although there has unquestionably been a positive increase in homeownership in the past decade:

Black family ownership:	1995—43%
	2005—48.8%
Latino family ownership:	1995—44%
	2005—50%
White family ownership:	1995—71%
	2005—75%[5]

Unfortunately, these gains are ephemeral for many. As will be illustrated below, the loss of home equity and homeownership has escalated dramatically as well.

Raw number of foreclosures in the past two decades

1980 --114,000
1990 -- 382,000
1995 – 425,000
2000 – 450,000
2004 – 704,000[6]

When the growth in homeownership is juxtaposed with the growth in the raw number of foreclosures, it is apparent that something is wrong:

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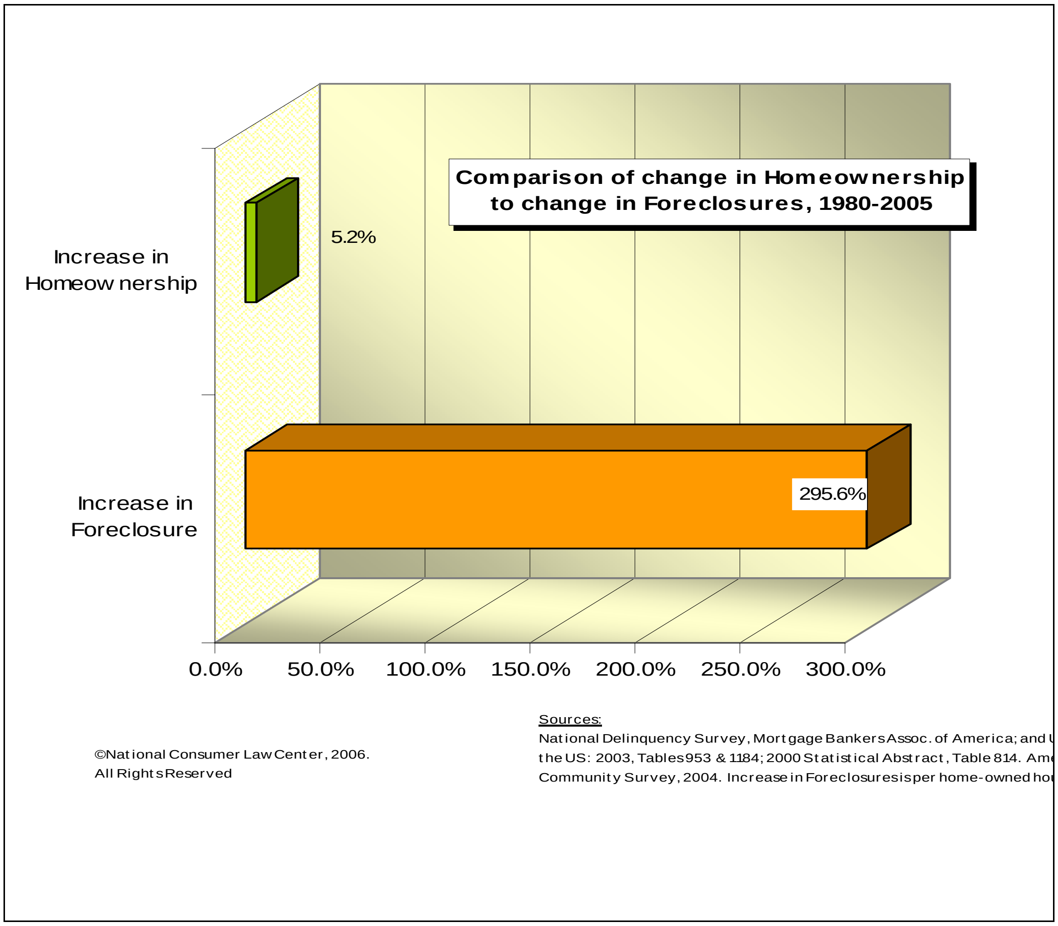
http://www.federalreserve.gov/events/publichearings/hoepa/2006/20060607/001to025.htm.

[5] Economic Policy Institute, "What's Wrong with the Economy" (12/15/05), www.epi.org/content.cfm/pm110.

[6] Sources: MBAA, National Delinquency Surveys (various), U.S. Census, Statistical Abst. Tables #1160 (2002); #814 (2000) American Housing Survey, 2001 & 2003.



The mortgage lending industry typically says that the increase in the number of foreclosures is due to the increase in the number of mortgage loans made, and it will point to statistics that show a relatively stable comparison to the number of foreclosures as compared to the number of loans made.[7] ***But that is exactly our point – there are too many loans being made these days – too many loans being made which lead to the loss of homes through foreclosure and otherwise, too many loans being made which lead to the loss of hard earned home equity.***

An evaluation of *which* loans are being foreclosed upon will reveal *which* loans are causing these problems, and which loans need to be better regulated. They are almost all *subprime loans*:

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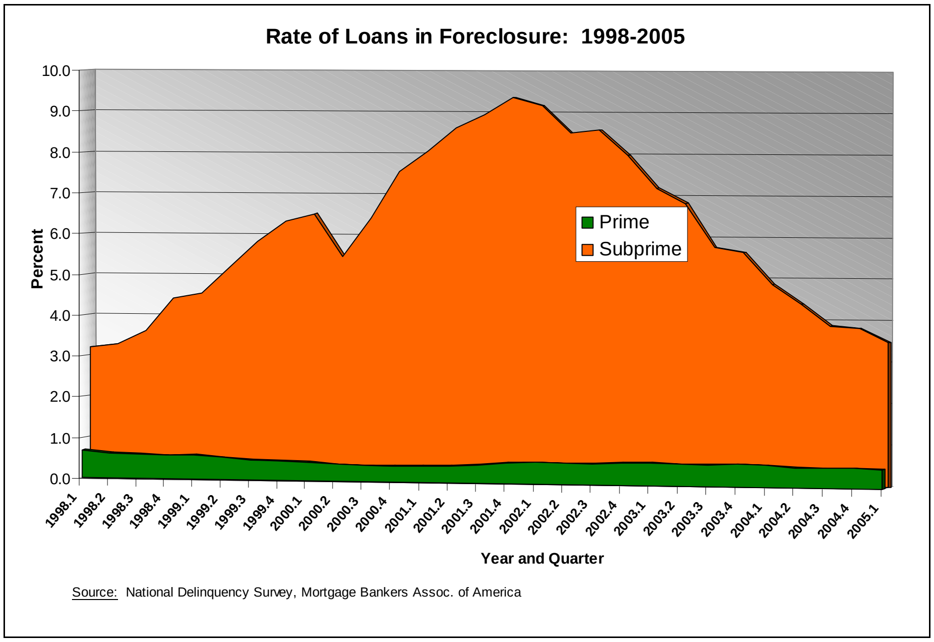
[7] *See, e.g.,* the response to the spike in foreclosures in Massachusetts by the Massachusetts Mortgage Bankers' Association when presented with raw data showing that foreclosures that foreclosures in that state are "spiking." "It 'would seem logical' that the total number of foreclosures statewide would rise, [Kevin] Cuff [the executive director of the Massachusetts Mortgage Bankers' Association] said, because there are more total loans outstanding." Boston Globe, "Foreclosure Filings in Massachusetts Jump 66%" (July 25, 2006), *available at* http://www.boston.com/business/articles/2006/07/25/foreclosure_filings_in_mass_jump_66/



But the number of loans in foreclosure does not tell the whole story of the problems that many subprime loans are causing to homeowners. Even before foreclosure, repeated refinancing of the home by subprime lenders often sucks all available equity out of it. Each refinancing of a home loan will increase the loan-to-equity ratio, until the equity is completely used up.[8] The repeated refinancings are often not a matter of choice, but rather a method of maintaining home ownership and avoiding foreclosure. These forced refinancings are too often only temporary mechanisms to avoid foreclosure, as each subprime loan generally becomes more expensive, and less affordable.

As we read these numbers we should try to envision the many faces of the women, men and children whose lives have been upended by the financial catastrophe that is triggered by foreclosure of one's home. The damage to individuals, families, and the community can be truly devastating.[9]

The statistics cited above are national, and somewhat mask the impact on individual communities which are seeing new, even higher, spikes in foreclosures just this year. For example, foreclosure filings in Massachusetts jumped 66% in 2006, and are expected to keep climbing.[10] This means that in just one small state 2,585 *more* families faced the loss of their homes than did the year before.

[8] As a nation, between 1989 and 2004, homeowners increased their home secured debt by over 90% while their home equity only increased by slightly less than 20%. Federal Reserve Bulletin, Jan. 2000, Jan. 2003, Feb. 2006, using data from the Survey of Consumer Finances.
[9] This information comes from the personal knowledge of our own, many, many clients who have suffered through the heartbreak of foreclosure. It is also well documented by academics.
[10] Kimberly Blanton, Foreclosure filings in Mass. Jump 66%, Boston Globe, Business, at C1, July 25, 2006.

A foreclosure is not just devastating to a family. It is also damaging to the neighborhood in which it occurs. Some examples of this include the drop in property values in low and moderate income neighborhoods in Chicago and Minneapolis directly resulting from foreclosures on homes.[11] Crime rates increase as well when homes are abandoned.[12]

Subprime loans are much more expensive than prime loans. The industry justifies this by arguing that these loans are more risky and thus the added risk of default justifies the additional price. We believe that the added cost actually *creates* the added risk of default, which is exactly the mechanism that is designed to trigger the forced refinancing, which will only provide more profit to the subprime lending industry.

Consider just how much more a subprime mortgage loan can cost when compared with a prime loan:

On a loan of $275,000, with 360 equal payments:

	Interest Rate	Monthly Rent	Total Interest Cost
Prime Loan	5 7/8%	$1,620	$308,409
Subprime Loan	9.5%	$2,312 (+*$692)*	$557,445 (+*$249,036)*

The extra costs of subprime mortgages have a disproportionate impact on families of color, regardless of their income status. Consider the following:

- African-Americans: 2.83 times more likely to get a subprime mortgage loan
- Latinos: 1.74 times more likely
- Native-Americans: 1.6 times more likely
- Asian-Americans: less likely than whites[13]

Moreover, the disparities *increase* as income increases:

- Lower-income African-Americans receive 2.4 times as many subprime loans as lower-income whites
- Upper-income African-Americans receive 3.0 times as many subprime loans as do whites with comparable incomes
- Lower-income Latinos receive 1.4 times as many subprime loans as do lower-income whites
- Upper-income Latinos receive 2.2 times as many of these loans.[14]

[11] Dan Immergluck & Geoff Smith, *The External Costs of Foreclosures: The Impact of Single-Family Mortgage Foreclosures on Property Values* (Dec. 30, 2005), *forthcoming* in Housing Policy Debate.
[12] *Id.*
[13] Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market* at vii-viii, Center for Community Change (May 2002). Note that HMDA data reported since 2002 generally match these findings.

Finally – consider the impact of these statistics on the homeownership rates of these families:

- African-American families experience a termination rate that is 240% of the rate experienced by whites.
- The Latino household rate is 168% of the white rate.

Once lost, homeownership is very difficult to regain. In general, it takes *over ten years for a family to regain homeownership after a foreclosure. Yet, for African-America and Latino families, it can take 3 ½ to 4 years longer than it does for white families.* [15]

B. The Claimed Risks to Lenders When Making Subprime Loans Do Not Discourage Irresponsible Lending

The evaluation of what is appropriate regulation regarding a particular credit product has traditionally been based upon the extent to which this regulation is necessary to ensure the availability of that credit to consumers at low prices. This is the wrong basis upon which to evaluate appropriate regulation. Rather, the basis for regulation should be the potential for damage to individuals, families and communities from the lack of regulation of that credit product.

A basic premise in the mortgage lending industry has always been that adequate underwriting is necessary to protect the lender from loss. Indeed, evaluating the borrower's ability to repay the loan has historically been the basis for assurance against loss to the lender. Evaluation of the borrower's ability to repay the loan provides protections for both the lender and the borrower. It assures the borrower that someone schooled in the business of lending has determined that the borrower can afford to repay the loan. This underwriting process is essential for the borrower, who generally does not have the expertise to determine this question. However, in recent years the subprime mortgage industry has developed mechanisms to avoid the consequences of bad underwriting (see discussion below), and still make substantial profits from mortgage lending. Neither the lenders nor the investors bear the risks that arise from the lack of underwriting or poor underwriting, as practical matter.[16] The industry and investors have developed a myriad of ways to protect themselves from themselves. The real risk of loss due to lender misconduct is now borne almost exclusively by the homeowner.

Risk to consumers is vastly different from risk to industry. Virtually all business risk can be protected against by a mortgage lender: more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way, insurance against loss can be purchased, securitized pools of mortgage loans can be overcapitalized. It is all a matter of numbers to the lending industry. However, to consumers, some risks cannot be measured simply

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[14] *Id.*

[15] Haurin & Rosenthal, *The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells* (Dec. 2004), www.huduser.org/publications/homeown.html.

[16] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (working paper 2006), available at www.ssrn.com (hereafter "Engel & McCoy").

in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon. It is not a risk that this nation's policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy does. Current policy permits mortgage products on the market which are known to lead to foreclosure for a substantial number of borrowers. While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The subprime mortgage industry has a business model of making loans that have a 20% chance of going into foreclosure within the first five years after origination, and a 60% chance of being refinanced.[17] Researchers have consistently marveled at the prevalence of refinancing of subprime mortgage loans, even when there are prepayment penalties present.[18] We--who see these loans to homeowners on a daily basis--know why these loans refinance so often. Despite the costs to the homeowners of these refinances, the lenders use this tool to transform a non-performing loan into a performing one. These forced refinances are one way that the subprime mortgage industry ensures itself against loss: so long as there is sufficient equity in the home, regardless of the homeowner's ability to make the payments, there is unlikely to be a loss to the investor. Rather, because of the nature of the security – the family home – the debtor will go to great lengths to avoid that loss and will refinance, if at all possible.

The current structure of the regulatory environment for mortgage lending is based on the premise that efficient financial markets, with sufficient disclosures, and open access to choices, will produce equitable and appropriate products for consumers. Yet, as we have demonstrated, this is clearly not the case in the subprime mortgage market. Instead, the conversation continues to be about appropriately managing risk, *i.e.,* losses to the industry and investors, not losses to homeowners.

A recent article illustrates how the process of securitizing home mortgage loans facilitates the lack of underwriting – and thus the prevalence of predatory mortgages.[19] As the authors point out: "Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans."[20] This is the case because –

> Investment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from virtually all of the

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[17] *See* Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures:, *The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005. http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf . Tables 7 and 8. Each table shows that five years after a subprime loan with various characteristics typical in subprime mortgage loans (adjustable rates, prepayment penalty, balloon term), that loan would have over a 20% chance of being in foreclosure at some time in this five years, and a 60% chance of being refinanced in this five year period. Only approximately 19% of subprime loans were still in active five years after origination.

[18] *Id.* at Executive Summary.

[19] Engel & McCoy, *supra* note 16.

[20] *Id.* at 3.

> credit and litigation risk associated with predatory loans. Market and legal forces provide additional protections to investors.[21]

The mortgage industry protects itself from anticipated defaults and foreclosures by charging everyone a higher price, by securitizing loans in pools with less risky loans, and by adding credit enhancements.[22] That is fine as a business model for those in the mortgage industry. However, it is bad policy for this nation to fail to add loss of homeownership and to communities into equation. The losses to the homeowner, the family, and the community from forced equity stripping refinancings and foreclosures are simply devastating.

A primary rationale proffered for the continued lack of real regulation of mortgage lending is that we do not want to hamper the healthy mortgage market in this nation. We, who have collectively represented consumers in every state in the nation, and for decades, have this strong message for the Board: this is just what we want you to do, what we must do: the mortgage industry must be reined in, must be regulated. It does the low or moderate income family no good to invite them to participate in the American dream of homeownership, only to allow them to tricked out of that home within a few years.

C. New Non-traditional Mortgage Products are Risky to Consumers

As has been noted by the federal financial services regulators, new, non-traditional mortgages appear to be setting a new standard of risk to the financial services industry. The death of underwriting – which is so apparent in the prevalence of these new products – may even hurt the financial services industry which until now has been able to protect itself from losses, as described above.[23]

In the last five years, alternative mortgage products—especially interest-only loans—have moved from a marginal role in the mortgage market to a place of dominance.[24] Interest-only loans now constitute 27% of loans nationwide and 30% of subprime loans.[25] In 2005, 63%

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[21] *Id.* at 3-4. It is pointed out later in the article that lenders are essentially indifferent to the deceit of mortgage brokers about default risks because they can shift the risk of loss to the secondary market. *Id.* ata 15 n. 52.

[22] *Id.* at 23-29.

[23] This is evidenced by the recent proposed Interagency Guidance on Nontraditional Mortgage Products.

[24] In fact, a huge range of alternative mortgage products is available, including loans with flexible "pick-a-payment" options, no points up front, a fixed rate conversion option, or a short introductory period of a fixed rate followed by ARM terms. *See, e.g.,* World Savings, Loan Features, available at http://www.worldsavings.com/servlet/wsavings/loans-new/popular-combinations.html.

[25] Greg McBride, CFA, www.bankrate.com, Presentation to FRB Consumer Advisory Council (Oct. 26, 2005); *see also* Kirstin Downey, *Interest-Only: Borrower Beware:Popular but Risky Mortgage Draws Government Scrutiny*, Wash. Post, Dec. 21, 2005, at D1 (23% of borrowers in 2005 chose interest only mortgages, compared to 1% in 2000); Kenneth Harney, *Banks Warned They Must Scale Back on Payment-option Mortgage*, S. F. Chron., Dec. 11, 2005, at K12 (payment option mortgages account for roughly a third of new home loans issued by some major lenders in 2005). According to the latest nationwide data, 30% of purchase loans were interest-only as of March 2006. Loan Performance, *Interest-Only, Neg AM and Investor Activity for Purchase Loans,* The Market Pulse, at 3 (March 2006 data).

of new mortgages were interest-only and adjustable-rate mortgages.[26] Over an 18-month period in 2004 and 2005, approximately one-third of homebuyers did not put any money down for their loan.[27] In the secondary market, 23.5% of all securitized subprime originations in 2005 were interest-only loans.[28]

The fact that this has occurred in an environment of low interest rates raises serious questions about how and why consumers are receiving these products. Interest-only loans generally are suitable for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or for investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes, and those with fluctuating incomes do not see substantial upwings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan.

Because many nontraditional mortgage products, and adjustable rate mortgages in general, are made without adequate underwriting, they present major risks to consumers and to the economy. The growth of ARMs and interest-only products in a low-rate environment means that rate increases hold the potential of leading to huge increases in defaults and foreclosures. Such a result would devastate individual consumers, their families, and communities. Moreover, consumers show extreme sensitivity to interest rate variations; upward adjustments in rates often result in unaffordable monthly payments. Because consumers are a major stabilizing force in the economy, a sharp upswing in rates leading to a significant rise in defaults could have broad implications for economic instability. Some subprime lenders underwrite adjustable rate loans only for the teaser rate, making default highly likely.[29] Even prime lenders do not underwrite the loan for the maximum possible payment, but only for the fully indexed payment. The result is that neither consumers nor the market are taking the risk of interest rate increases into account, leading to major safety and soundness concerns. This is evidenced by Standard & Poor's requiring, as of last August, increased credit enhancements for option-ARMs.[30] Further, lenders do not disclose to the borrower that the borrower has not been qualified for the eventual payments she will need to make. Only the originator's investors are privy to such information.

Delinquency rates for subprime ARMs demonstrate the huge risk posed by nontraditional products. At the end of 2005, 12.63% of subprime ARMs nationwide were past due, more than 4.5 times the rate for prime ARMs.[31] An increase in interest rates can only magnify this problem. Subprime ARMs also are much more likely than subprime fixed rate mortgages to go

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[26] Michael Powell, *A Bane Amid the Housing Boom: Rising Foreclosures,* Washington Post, May 30, 2005.
[27] Edmund L. Andrews, *A Hands-Off Policy on Mortgage Loans*, New York Times, July 15, 2005.
[28] "What Else is New? ARMS Dominate Subprime MSB Mix," Inside B&C Lending (Jan. 20, 2006).
[29] *See, e.g.,* Aames Mortgage Trust 2001-1 Mortgage Pass-Through Certificates, Series 2001-1, Aames Capital Corporation as Sponsor, Countrywide Home Loans, Inc. as Servicer, Prospectus Supplement to Prospectus dated March 13, 2001, S-10.
[30] Remarks by Federal Reserve Governor Susan Schmidt Bies (Oct. 12, 2005), *available at* http://www.federalreserve.gov/BoardDocs/Speeches/2005/200510122/default.htm.
[31] Mortgage Bankers Association, National Delinquency Survey, Fourth Quarter 2005.

into default, magnifying the already high rate of default among ARMs.[32] As of March 2006, 4% of six-month LIBOR 2/28 subprime loans were in foreclosure, and 7% were seriously delinquent.[33] Some local studies attribute a significant fraction of the increase in local foreclosure rates since the mid-1990s to subprime ARMs.[34] In addition, a subprime borrower who refinances a first lien with an adjustable rate loan instead of a fixed rate mortgage is 25% more likely to experience foreclosure than a borrower whose loan has an extended prepayment penalty.[35]

D. Abusive Servicing Contributes to the Excessive Foreclosure Rate

According to attorneys representing homeowners in communities around the nation, the rate of foreclosure is dramatically increased by problems with servicers who have no incentives to assist families in maintaining homeownership. The dynamics of the mortgage marketplace must be changed – loan servicers must *want* to avoid foreclosure, just as loan originators should *want* to make loans which are affordable.

Common abuses in loan servicing include:

- Misapplication of payments: Many servicers are infamous for ignoring grace periods, misapplying and failing to apply funds, and improperly charging late fees.[36] Servicers frequently compound this problem by then reporting the homeowner late to the credit rating agencies. The misapplication of a single payment can have a snowballing effect that can leave homeowners fighting foreclosure and struggling to repair their credit for months, or even years.

- Use of suspense accounts: As the name "suspense account" implies, borrowers' funds held in such accounts are in legal limbo—they are not credited to the loan, the borrower does not receive interest on them, and the account is not a trust

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[32] Statistical evidence suggests that subprime ARMs are significantly more likely to result in foreclosure than subprime fixed rate mortgages. Roberto Quercia, et al. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, January 2005, at 28-29 (subprime refinance ARMs are 50% more likely than fixed rate loans to result in foreclosure), *available at* www.kenan-flagler.unc.edu/ assets/documents/foreclosurepaper.pdf.
[33] Loan Performance, *Interest-Only, Neg AM and Investor Activity for Purchase Loans,* The Market Pulse, at 7 (March 2006 data).
[34] *See, e.g.,* Lynne Dearborn, *Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000,* July 2003, p. 23 (from 1996 to 2000, the proportion of foreclosure judgments attributable to adjustable rate mortgages rose from 11% to 30%; at the same time, the proportion of fixed-rate foreclosure judgements decreased almost 20%).
[35] Quercia, *supra* n. 12, at 29.
[36]*See In re* Ocwen Federal Bank FSB Mortgage Servicing, 2006 WL 794739 (N.D. Ill. Mar. 22, 2006)(denying motion to dismiss state law claims including fraudulent concealment, unjust enrichment, breach of contract, breach of good faith and fair dealing, conversion, negligence, misrepresentation, defamation, and fraud and deceit based on federal preemption grounds; allegations in the multi-district litigation assert that the servicer ignored grace period, misapplied payments, failed to apply payments, improperly charging late fees, improperly force placed insurance, assessed unwarranted fees, declared loans in default prematurely and initiated unfair and illegal foreclosure proceedings).

account.[37] In most cases, borrowers are unaware that a suspense account even exists and are confused when payments made are not reflected in the accounting that the homeowner receives from the servicer. The shrouded nature of these accounts and uncertain status of the funds they contain make them ripe for abuse. In many instances, servicers raid suspense accounts to pay unauthorized fees.

- Interest overcharges: Interest overcharges can result when servicers inappropriately claim unaccrued interest or calculate interest in ways that are not authorized by the contract.[38] One particularly pernicious way that servicers have found to extract more money from borrowers is the daily accrual method of charging interest on home mortgages. The effect of using this accounting method can cost a homeowner tens of thousands of dollars over the course of a mortgage. In addition, failure to promptly credit payments on a daily accrual loan or misapplication of payments can result in excessive interest charges.

- Failure to make timely escrow disbursements: There have been numerous instances in which servicers have failed to make timely disbursements from borrowers' escrow accounts for real estate taxes, insurance or other charges. In the most devastating cases, homeowners have lost their homes to tax foreclosure after the servicer failed to make real estate tax payments,[39] while other homeowners have been left to deal with uninsured property damage after the servicer failed to pay insurance premiums.[40] More commonly, penalties assessed by the taxing authorities or reinstatement fees imposed by insurance companies as a result of late payments are simply passed on to the borrower.[41] While such fees or penalties may be relatively small, they can nevertheless lead to escrow account shortages or deficiencies, which in turn may cause the borrowers' mortgage payments to increase.

- Forced placed insurance: This product presents extraordinary potential for abuse.[42] Insurers often provide lenders with refunds, kickbacks or other

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[37] *See* O. Max Gardner, III, *Mortgage Securitization, Servicing, and Consumer Bankruptcy*, American Bar Association, GP Solo Law Trends and News – Business Law, Vol. 2, no. 1 (Sept. 2005), available at http://www.abanet.org/genpractice/newsletter/lawtrends/0509/business/mortgagesecurization.html.

[38] *See* Allenson v. Hone Sav. Bank, 272 Ill. App. 3d 939 (1995)(plaintiff's allegations of misamortization scheme resulting in overcharges sufficient to support RICO claim); Cortez v. Keystone Bank, 2000 WL 536666 (E.D. Pa. May 2, 2000)(allegation of overcharge of interest in home equity line of credit state claim for breach of contract and violation of RESPA).

[39] *See, e.g.,* Mortgage Electronic Registration System, Inc. v. Alicea, 2006 WL 1149236 (M.D. Pa. 2006); Choi v. Chase Manhattan Mortg. Co., 63 F. Supp. 2d 874 (N.D. Ill. 1999).

[40] *See, e.g.,* Monahan v. GMAC Mortg. Corp., 893 A.2d 298 (Vt. 2005)(affirming $43,380 jury award for consequential and compensatory damages for servicer's conduct in failing to renew flood insurance policy and subsequent uninsured property damage).

[41] *See, e.g.*, Settlement Agreement by and between the United States Department of Housing and Urban Development and Mellon Mortgage Company, Sept. 30, 1999, available at *http://www.hud.gov/offices/hsg/sfh/res/paul/rsamello.pdf* (describing HUD's investigation into Mellon's handling of borrower escrow accounts).

[42] For more details about the abuses in forced placed insurance, see generally National Consumer Law

compensation in relation to forced placed insurance policies. In some cases, commissions are paid to affiliates of the lender. Because the lender makes the decision about which insurer to use, and since the lender does not eventually have to pay for the premium, there is a built-in incentive for the lender to select the insurer that pays the lender, or its affiliates, the most in the form of kickbacks or other compensation. The placement of this insurance and the lender's efforts to obtain reimbursement from the consumer frequently causes a huge increase in the homeowner's monthly payments.

- Cascading fees imposed upon homeowners in default: The cascade of fees – late charges, property inspection fees, broker price opinion fees, attorney fees – that befall a borrower who is late on a mortgage payment often make it impossible to get out of default. These fees are highly profitable to servicers and are often imposed on the flimsiest of justifications.

E. Appraisal Fraud and Its Effect on the Solvency of the Homeowner and Integrity of the Market

Appraisal fraud came to widespread public attention in recent years in connection with fraud in FHA insured mortgages.[43] But appraisal fraud is endemic throughout the industry.[44] In a recent speech by an FBI supervisor, appraisal fraud was cited as the leading form of mortgage fraud, accounting for 80% of all reported mortgage fraud cases.[45] For individual borrowers, who do not generally arrange or even see the appraisal, overappraisals can be an unmitigated nightmare. Borrowers end up absolutely trapped by inflated appraisals: they can neither refinance nor sell the property.[46]

Nominally, all federally regulated lenders bear responsibility for ensuring the minimal quality of appraisals they rely on.[47] Significant evidence points to lender complicity in obtaining inflated appraisals, however.[48] Even where the lender does not actively participate in the scheme, lenders have often been indifferent to the incidence of property flipping in their

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Center, Unfair and Deceptive Acts and Practices § 5.3.11 (6th ed. 2004 and Supp.)

[43] *See, e.g.,* Hoffman v. Stamper, 843A.2d 153 (Md. Ct. Spec. App. 2003) , *cert. granted*, 851 A.2d 593 (Md. 2004), *aff'd in relevant part,* 867 A.2d 276 (Md. 2005).

[44] *See, e.g.*, David Callahan, *Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk* (Demos, March 2005) at 4-5, *available at* http://www.demos.org/pubs/home_insecurity_v3.pdf (collecting evidence of high rates of fraud in residential mortgage appraisals).

[45] Ronda Helig, Supervisory Special Agent, FBI, Speech to American Bankers Association, June 14, 2006, article available at http://www.hwforums.com/2097/messages/9007.html.

[46] *See, e.g.,* Michael Moss & Andrew Jacobs, *Blue Skies and Green Yards, All Lost to Red Ink*, N.Y. Times, Apr, 11, 2004, at Sect. 1, p. 1 (appraiser tells purchaser of inflated property, "Lady, you're not going to be able to refinance").

[47] *See* 12 U.S.C. § 3339 and regulations promulgated thereunder, *e.g.*, 12 C.F.R. 34.44 (OCC).

[48] *See* California v. Ameriquest, (Cal. Super. Ct. Alameda County, Mar. 21, 2006) (complaint , ¶10H), *available at* http://ag.ca.gov/newsalerts/cms06/06-005_0a.pdf (alleging that Ameriquest obtained inflated appraisals).

portfolios.[49] HUD itself, nominally stuck with a bad FHA-insured loan, has been subject to suit for failure to exercise due diligence in reviewing FHA insurance requests or warn homebuyers.[50]

Many lenders now conduct perfunctory appraisal reviews of the original appraisals; these reviews are typically desk reviews, done by an appraiser without any knowledge of a local market. Experience of at least some advocates in the field indicates that when discrepancies are found lenders do not uniformly order new appraisals but instead typically adjust the appraised value downwards by a few thousand dollars. It is not clear that lenders generally avail themselves of any of the various national and local on-line databases showing property values or sales records.[51]

The problem is, again, worse for subprime loans. Subprime loan pools have a higher incidence of inflated appraisals than do prime loan pools.[52] For subprime lenders, there may be some perverse rationale in loaning more than the homes are worth. First, as some observers have noted, the prevalence of securitization may lessen former restraints against undercollateralization.[53] Second, having borrowers "under water" or "upside down" by owing more than their homes are worth may also feed into subprime and predatory lenders' business model. A borrower who owns more than her home is worth cannot refinance into a lower cost loan with a competitor. Overappraisals are also increasingly the only way to generate additional fee income through loan flipping. If enough home buyers pay off, or even keep paying for long enough, the total return is likely still positive.

F. Major Reform of the Subprime Market is Overdue

Financial literacy is not the answer – the system is too complex, the bargaining power too diverse. Industry best practices are not the answer. To the extent that some best practices can be agreed to, they are not enforceable by consumers and regulators cannot examine for them since

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[49] *See, e.g.,* Michael Moss and Andrew Jacobs, *Blue Skies and Green Yards, All Lost to Red Ink*, N.Y. Times, Apr. 11, 2004, at Sect. 1, p. 1(division of Chase Manhattan continued lending on suspect home loans arranged by builder until Freddie Mac notified Chase that it was beginning investigation).

[50] *See* M&T Mortgage Corp. v. White, 2006 WL 47467 (E.D.N.Y. Jan. 9, 2006) (denying HUD's motion to dismiss declaratory judgment action that insurance issued in violation of HUD's duty to affirmatively further fair housing, finding that predatory lending scheme caused in part by HUD's issuance of insurance without due diligence); Vaughn v. Consumer Home Mortgage, 293 F. Supp. 2d 206 (E.D. N.Y. 2003) (denying HUD's motion to dismiss declaratory judgment that FHA insurance issued without due diligence, an abuse of discretion).

[51] Two examples of on-line databases set up to help lenders quickly and easily check property values are DISSCO, https://www.dissco.com/members/default.asp, and FRADAR, http://www.appintelligence.com/fradar2/index.html. Many counties now have on-line information available showing assessed values and at least limited sales information, as well.

[52] *Mortgage Foreclosure Filings in Pennsylvania:A Study by The Reinvestment Fund for the Pennsylvania Department of Banking*, Mar. 2005, at 83, available at http://www.trfund.com/policy/pa_foreclosures.htm (reporting significantly higher concentrations of inflated appraisals in subprime loan pools than in prime loan pools).

[53] *See, e.g.*, David Callahan, *Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk* (Demos, March 2005) at 3, *available at* http://www.demos.org/pubs/home_insecurity_v3.pdf

they are not binding. Rogue lenders can simply ignore them.[54] Regulation plays the important role of creating a level playing field for consumers and responsible lenders which does not contenance rogue players.

Tweaking the few federal laws that we have on the books that govern a small piece of the mortgage market – like HOEPA – is also not answer.

The mortgage marketplace has grown and developed in the 14 years since HOEPA was passed. The problems have become much worse. We need wholesale, significant mortgage regulation:

1. To maintain homeownership, to maintain the strength of home equity as a primary savings tool, the mortgage industry must be required **to underwrite subprime mortgage loans** to ensure that the loan is an appropriate loan for this household. To accomplish this, we need strong, but flexible standards, like **suitability**, to apply to all mortgage loans. The Board should use its broad authority under TILA and the FTC Act to adopt a duty of good faith and fair dealing applicable to the subprime market.[55] As elaborated more fully in II(D), *infra*, this duty would–

- a) Require all originators to provide a loan which is suitable for the borrower's purpose, based upon –
  - a. the borrower's circumstances, e.g. –
    - i. amount of other debt
    - ii. reliability of income
    - iii. expectations of changes in income borrower's age and plans
    - iv. number of dependents
  - b. the borrower's objectives in obtaining the loan, e.g. –
    - i. to lower payments
    - ii. to pay off other debt
    - iii. to reduce remaining term of loan
    - iv. to reduce interest rate and pay off loan early
    - v. to maximize home equity savings
  - c. the borrower's ability to repay the loan, e.g. –
    - i. the available income in the household
    - ii. the residual income after all debt is paid

- b) Require all lenders to include the maximum payments possibly due under the loan, all of the borrower's reasonably anticipated expenses,

[54] Just one example of a set of the industry best practices which have been resoundingly ignored are those entered into by Ameriquest Mortgage Corp., which is the subject of a multi-district litigation proceeding in the Northern District federal court in Illinois. *See, e.g.* In re Ameriquest Mortgage Co., 2006 WL 1525661 (N.D.Ill. May 30, 2006).

[55] A suggested definition of a subprime or "covered home loan" is provided in Section II of these comments.

and the borrower's actual residual income when determining the borrower's ability to repay the loan.

c) Prohibit steering borrowers into costlier loans than the borrower's qualification would require.

2. All players involved in the mortgage loan must be part of the solution – just as they are now part of the problem – and there must be full assignee liability applied to every mortgage loan. The industry and the secondary market all argue strenuously against assignee liability of any sort, citing, among other things a series of terrible events that will befall the mortgage industry if full assignee liability is applied.[56] The best answer to all of these concerns is to look at what happened after 1975 when the Federal Trade Commission passed the *Preservation of Consumers Claims and Defenses Rule*.[57] That rule applies full liability in most circumstances to assignees of loans used to purchase goods and services. The automobile dealers and other sellers of goods, among others, argued that if the rule passed that the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.[58] The finance companies and the banks argued that they did not want the responsibility of policing sellers and that sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and that the rule would interfere with free competition.[59] However, there are absolutely no indications that the passage of this FTC rule had any impact whatsoever on the availability of or cost of credit. Indeed, it appears that credit availability continued to expand since the passage of this rule.[60]

3. The Board should add prepayment penalties and yield spread premiums to the HOEPA definition of points and fees (see discussion in Section II(C), *infra*). In addition, the Board should recommend to Congress that the APR trigger for HOEPA loans be lowered so that more loans are covered. At the same time, the strict liability incentives in the current law that discourage lenders from making these high-cost loans should be continued.

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[56] This "sky is falling" list includes – a dramatic decrease in the availability of credit, particularly effecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans as the process is so routinized and involves so many loans at any one time, that a careful review of each loan would be near impossible and would dramatically increase the cost of credit.
[57] 16 C.F.R. § 433, 40 Fed Reg. 53506 (Nov. 18, 1975).
[58] 40 Fed Reg. 53506, 53517 (Nov. 18, 1975).
[59] *Id* at 53518.
[60] In 1970, the total non-revolving credit in the US was approximatly $124 billion; growth continuned steadily through the 1970s and by December 1980, the total non-revolving credit in the US was approximatly $297 billion. This growth continued notwithstanding the announcement and final promulgation of the holder rule. Source: Federal Reserve Statistical Release G.19 1970 through 1980.

4. The Board should recommend that Congress enact a duty of good faith and fair dealing in the making of appraisals to support home loans, requiring appraiser's bonds, the prohibition of communication to the appraiser about the desired appraised value, and a procedure to rewrite the loan amount if a retrospective appraisal shows the original appraisal was inflated.

5. The Board should recommend that Congress establish a requirement of good faith and fair dealing in loan servicing, providing, among other things –

- Limits on fees and charges that can be assessed a homeowner after loan closing;
- Strict protections against the use of forced-placed insurance;
- A comprehensive right to cure defaults – to avoid foreclosures;
- The requirement that alternatives to default ("work-out options") be evaluated before a foreclosure can be initiated.

6. The Board should recommend that Congress establish a Home Preservation Loan Fund to be implemented by state housing finance agencies, which would provide money to homeowners for whom the payment of the mortgage arrearage would avoid a foreclosure, but who have the wherewithal to maintain their mortgage payments going forward. The funds for the payment of these arrearages would operate as "silent seconds," only required to be repaid once the first mortgage is paid off.

II. THE BOARD SHOULD EXERCISE ITS BROAD AUTHORITY TO ADDRESS HOME LENDING ABUSES

A. HOEPA Revisited

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures.

By passing HOEPA, Congress recognized four essential truths:

- There are some loans for which the marketplace does not effectively apply restrictions when left to its own devices;
- Government must step in to ensure a fair playing field for consumers who inherently possess less bargaining power than corporate lenders;
- Parts of the mortgage market operate in non-transparent ways and provide few or no realistic choices for borrowers; and

- Regulation of all lenders prevents both the rogues from profiting more than the responsible and a race to the bottom.[61]

Until October 1, 2002, HOEPA's protections were triggered if a loan had an APR of 10 points over the Treasury bill for the same term as the loan, or points and fees equal to more 8% of the total loan amount.[62] After that date, the Board reduced the APR trigger to 8 points above the comparable maturity for first lien mortgage loans, retained the 10 point spread for subordinate lien mortgages, and added one type of loan term and three acts and practices to the list of prohibitions.[63] The Board took this action after conducting hearings and receiving substantial written comments regarding the need to expand both the coverage of HOEPA and the protections it affords.

HOEPA's enduring strength is that its triggers act as *de facto* price caps. Over the last twelve years since passage, mortgage lenders make an ever decreasing number of loans meeting these high triggers. As a result, the cost of credit for some has declined and those homeowners have saved money.[64] By this measure, HOEPA is a great success.

This powerful effect upon the market is the result of two aspects of the Act: its substantive regulation of loans terms and lender conduct and, more importantly, its strict assignee liability. Congress crafted HOEPA's assignee liability standard "to ensure that the market polices itself in order to eliminate abuses."[65] The effect of this assignee liability provision on the rating agencies and the market is clear. Lenders make far fewer HOEPA loans because the secondary market will not invest in them.

However, abuses and their consequences, as evidenced by high foreclosure rates, continue nonetheless, as discussed elsewhere in these comments. In our view, the main reasons for this situation lie in the weaknesses of HOEPA.

First, the APR and points and fees triggers for HOEPA are still too high despite the 2002 changes, causing many abusive lenders who want to avoid HOEPA regulation to make high cost

[61] The need for regulation to keep the playing field fair and competitive for the responsible lenders was one of the principal reasons for the passage of the Truth In Lending Act in 1968. H. R. Report No. 1040, 90th Cong. (1968), *reprinted in* 1968 U.S.C.C.A.N. 1962, 1965 ("This legislation is urgently needed to…[p]rotect legitimate lenders against competitors who misrepresent credit costs.")(quoting speech of President Lyndon Johnson). "Significantly, no one segment of the industry feels it can afford to reform itself by disclosing an annual percentage rate without incurring a competitive disadvantage. Clearly, the only solution is to require by legislation that all creditors use the same method in computing and quoting finance charges…" *Id.* at 1970. *See also* 15 U.S.C. § 1601(a).
[62] 15 U.S.C. § 1602(aa)(1).
[63] 66 Fed. Reg. 65604 (Dec. 20, 2001).
[64] *See, e.g.,* Wei Li & Keith S. Ernst, *The Best Value In the Subprime Market: State Predatory Lending Reforms,* Center for Responsible Lending (Feb. 23, 2006)(evidence shows that state HOEPA-like laws reduce the prevalence of abusive terms, do not impede credit access, and mortgage loans are less expensive), *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.
[65] H.R. Conf. Rep. No. 652, 103d Cong. 2d Sess. 147, 163 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1987 (accompanying H.R. 3474).

loans just under the trigger. The effect is that there are no federal substantive protections whatsoever against very high cost loans that lenders design to cruise under HOEPA's radar.

Second, HOEPA does not include an ability to repay standard that requires meaningful underwriting for either traditional fixed rate mortgage loans or the increasingly common panoply of alternative mortgage products.

Third, HOEPA does not in any way limit what the lender can charge as up-front costs to the borrower. It is the excessive, combined fees -- in closing costs and points -- which deplete the equity in abusive loans. These fees are charged over and over, each time the loan is refinanced. And with each refinancing, the homeowner's equity is depleted because these charges typically are all financed in the loan. The effect of this situation is to encourage lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.

Fourth, HOEPA does not apply to open-end loans and purchase money mortgages. When HOEPA was passed in 1994, there were few predatory open-end mortgage loans being made. Virtually all of the abusive loans were refinancings. In the past twelve years, that picture has changed. It has become apparent that open-end credit provides another vehicle for mortgage abuses. Purchase money mortgages are a growing segment of the subprime market. There is no longer any reason to exclude these loans from HOEPA's coverage. More importantly, unless open-end loans are brought within the scope of HOEPA, the failure to regulate them will simply push the bad actors into that market. While the Board cannot directly cure this statutory problem, we urge the Board to ask Congress to plug these holes in the HOEPA fabric.

B. Necessary Board Action

We believe that the Board possesses the authority to make several changes that can ensure HOEPA's continued vitality and effectiveness. Specifically, we suggest the Board expand HOEPA's coverage and utilize its authority under §§ 1602(aa)(4)(d)[66] and 1639(*l*)(2)[67] of HOEPA and § 57a(f)(1) of the FTC Act[68] as follows:

- **Points and Fees Trigger**: count prepayment penalties, clarify that yield spread premiums are included in the trigger; and define "payable."

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[66] "For purposes of paragraph (1)(B), points and fees shall include—(D) such other charges as the Board determines to be appropriate."

[67] "The Board, by regulation or order, shall prohibit acts or practices in connection with—
(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provision of this section; and
(B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower."

[68] "The Board of Governors of the Federal Reserve System (with respect to banks)…shall prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."

- **Prohibited Acts and Practices:** establish meaningful underwriting standards; establish a suitability standard; and prohibit the financing of closing costs.

NCLC urged to the Board to make several of these changes during the 2000 hearings. We continue to believe strongly that these changes make good sense and will revisit those suggestions in these comments. In addition, NCLC believes that one of the most devastating aspects of abusive lending today is the trend away from responsible underwriting. Accordingly, we will outline a new strategy to reduce that form of risky lending.

C. Points and Fees Trigger

1. Introduction

Without additional authority from Congress, the Board is saddled with statutory restrictions regarding the APR trigger, at least for first lien mortgages.[69] In contrast, Congress granted the Board broad authority to add to the enumerated points and fees for trigger purposes--"such other charges as the Board determines to be appropriate."[70] In 2001, the Board used this mandate to add single premium credit insurance premiums and debt cancellation fees to the points and fees definition.[71] If this action resulted in more loans coming within HOEPA's grasp, the Board opined that consumers would benefit in greater numbers from HOEPA's protections--- a positive result.[72] The Board should now xpand this trigger to include prepayment penalties and to make clear that yield spread premiums are included.

The industry may argue that expanding this trigger will reduce credit availability." Our response is: Only harmful credit will be reduced, not constructive credit. 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.[73]

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,[74] the disintegration of many low income and minority neighborhoods,[75] and the erosion of the tax base and the costs to cities due to foreclosures.[76]

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[69] 15 U.S.C. § 1602(aa)(2)(B)(the Board cannot reduce the APR trigger below 8 points).
[70] 15 U.S.C. § 1602(aa)(4)(D).
[71] Reg. Z § 226.32(b)(1)(iv); 66 Fed. Reg. 65604, 65608-65610 (Dec. 20, 2001).
[72] 66 Fed. Reg. at 65609.
[73] 65 Fed. Reg. 81438, 81441 (Dec. 26, 2000).
[74] *See* discussion in Section I of these comments.

The following discussion addresses the merits of including prepayment penalties in the points and fees trigger. In addition, we discuss two issues that need Board clarification: yield spread premiums as a point and fee and the definition of the word "payable."

2. Prepayment Penalties

Prepayment risk to the mortgage holder occurs when homeowners pay off the mortgage loan in full before maturity. Prepayment may result in the inability of holders to recoup the cost of a yield spread premium paid to the broker since the broker payment is repaid by the homeowner over the life of the loan in the form of a higher interest rate. In addition, prepayment terminates the cash flow from interest payments to lender (or, in the case of securitization, to the trustee) which forces investors to reinvest the principal at a lower rate of interest in a declining rate environment. However, in a rising interest rate environment (as is the case now), the opposite result occurs, *i.e.*, the investor can reinvest the principal at a higher rate.

Prepayment penalties are very common in subprime loans but are almost non-existent in prime loans.[77] However, there is little evidence that subprime borrowers prepay at rates faster than their prime counterparts.[78] Two academics review a body of research showing that prepayment penalties "push the cost of subprime loans above their risk-adjusted price."[79] There is as much or as little justification for prepayment penalties in the subprime market as in the prime market. The huge disparity in the existence of these terms in subprime loans cannot be justified.

In subprime loan transactions we have reviewed over the years, we have seen no evidence that subprime mortgages with prepayment penalties provide beneficial trade-offs to consumers, for example by offering lower interest rates than mortgages without penalties. This

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[75] 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.

[76] *See* Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending,* 38 Conn. L. Rev. 355 (2006)(describing the effects of predatory lending upon cities); William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom* 6, (estimating the cost to cities from properties that remain vacant after foreclosure can run up to $34,000), available at http://www.nmhc.org/Content/ServeContent.cfm?IssueID=556&ContentItemID=3489&siteArea=Topics.

[77] Engel & McCoy, *supra* note 16 at 28; *see, e.g.,* Ameriquest Mortgage Securities Inc., Prospectus Supplement for AMERIQUEST MORTGAGE SEC INC ASSET BK PAS THR CERT SE 2004 R3 at S-12-13 (April 6, 2004)(over 81% of the Group I mortgage loans and over 74% of the Group II mortgage loans in this pool may subject the homeowner to a prepayment charge generally within the first three years of the loan, though some may have a prepayment penalty term of up to one year), available at http://www.sec.gov/Archives/edgar/data/1286486/000088237704000735/0000882377-04-000735.txt; Option One Mortgage Company Overview at 29 (March 2005)(73.34% of Option One's loans in 2004 contained prepayment penalties; 71.21% of 2005 loans through Q3 contained prepayment penalties)(on file with authors).

[78] Engel & McCoy, *supra* note 16 at 29-30 and research discussed therein.

[79] *Id.* at 28..

observation is confirmed by a recent study.[80] Lack of consumer information, and the inherent complexity of these transactions, makes such sophisticated term-by-term bargaining a complete fiction in this market (and perhaps in any market for most consumers).

Prepayments by subprime borrowers should be facilitated, not penalized. One of the common sales pitches by subprime lenders is that homeowners with poor credit histories may be able to get a subprime mortgage, make payments regularly for a year or two, and then refinance in the conventional market at better interest rates. Consumers who could actually benefit from such a process should not be penalized merely to protect the duration of investors' returns.

Solution: For these reasons, we urge the Board to include in the HOEPA points and fees trigger:

The maximum prepayment fees and penalties which may be charged or collected under the terms of the loan documents and all prepayment fees or penalties that are incurred by the consumer if the loan refinances a previous loan made or currently held by the same creditor or an affiliate of the creditor.

The 8 % points and fees trigger ensures that lenders can charge and recoup reasonable costs when making loans, even when prepayment penalties are included.

3. Yield Spread Premiums

Yield spread premiums should be counted in the points and fees trigger because "*all* compensation paid to mortgage brokers" must be included under the Act.[81] When the Board finalized the HOEPA additions to Regulation Z in 1995, it stated: "The Board believes that including in the total fee calculation all broker fees required to be disclosed under RESPA is consistent with the intent of Congress and addresses the commenter's concerns about broker fees that are unknown to the creditor."[82] HUD does require that yield spread premiums be disclosed to the borrower.[83] Therefore, yield spread premiums should be included in this trigger.

Most lender-advanced broker fees (with the exception of volume-based compensation) are paid in a lump sum to the broker at or before closing. Such fees are paid or payable by the

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[80] Keith Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (Jan. 2005), *available at* http://www.responsiblelending.org (prepayment penalties had little or no downward effect on interest rates after controlling for several factors; indeed, for purchase money loans, prepayment penalties occurred in loans with higher interest rates after controlling for geography and risk).

[81] 15 U.S.C. § 1602(aa)(4)(B)(emphasis added). *See also* Reg. Z § 226.32(b)(1)(ii); Official Staff Commentary § 226.32(b)(1)(ii)-1("compensation 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.")

[82] 60 Fed. Reg. 15463, 15466 (March 24, 1995).

[83] Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10080, 10082 (March 1, 1999).

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 financed 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 charges 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.[84]

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.[85] 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

[84] *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).
[85] 968 F. Supp. 1548 (S.D. Fla. 1997).

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 (in this case $2,457), given that it meets the definition of a fee, ought to be figured into the points and fees trigger.

Lenders may argue that the yield spread premium already is counted, albeit through the APR trigger due to the higher interest rate. Therefore, they state, the same amount would be counted twice under the consumer view—both in the APR trigger and in the points and fees trigger. The response to this claim is that each trigger is independent from the other. HOEPA can regulate a loan when either trigger is met can or when both are met. The same charges can be counted in both triggers. For example, any closing cost that is a finance charge is included in the APR trigger AND those same finance charges are "points and fees" for that trigger as well.[86]

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."[87] 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.

Yield spread premiums can be quite large. For example in the case of Ms. D from Brooklyn, the lender contended that the broker fee and lender's fees amounted to 7.956% of the loan amount. These fees, as calculated by the lender, amounted to $7,296, compared to an amount financed of $91,704. The broker also received a yield spread premium of $990, which was not figured into the lender's HOEPA fees calculation. The loan included numerous features that would violate HOEPA, including a 24% default interest rate, a prepayment penalty, and a borrower whose income was less than the loan payment.

> *Solution*: Amend the Commentary § 226.32(b)(1)(ii)-1 to insert the following after the first sentence.

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[86] Lenders also might argue that consumers may never repay the yield spread premium if they immediately default, make no payments, and the creditor forecloses. There are at least three responses to this claim. First, neither § 1602(aa) nor the Commentary require that the consumer actually repay the *creditor* for the funds it advances on the borrower's behalf. The *broker* need only be paid directly or indirectly by the borrower. Second, the consumer is contractually liable to the creditor through the loan note to repay the premium through the higher interest rate. Third, even if the consumer never makes a single payment and the creditor forecloses, the creditor has a claim both for the outstanding principal (which includes any per diem interest) plus the earned interest (plus foreclosure costs). Creditors typically do not begin foreclosure for at least 90 days from the first default because most consumers cure the default in that period. The foreclosure sale cannot occur immediately thereafter, even in non-judicial foreclosure states, due to advance notice and advertisement requirements. Consequently, at least 4 to 5 months of interest accrues. Therefore, some or all of the earned interest represents repayment of yield spread premium.

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

Broker compensation includes yield spread premiums if payable at or before closing.

4. Clarify the Word "Payable"

Problem: Lenders and assignees argue with greater frequency that closing costs that otherwise meet the definition of a point and fee are *not* counted if they are financed. This claim is clearly wrong under the statute and Regulation Z.[88] One court adopted this erroneous conclusion by holding that points and fees are not "payable" at or before closing if they are financed.[89] More recently, another court wholeheartedly disagreed with the *Terry* decision.[90]

In *Short v. Wells Fargo Bank Minnesota, N.A.,* the court relied upon two facts, both of which are universally true in mortgage loan closings where the lender finances the costs. The first fact: the closing charges were paid out of the amount loaned. The second fact: the HUD-1 Settlement Statement acknowledges that the closing costs are paid by the homeowner.[91]

The court then tackled word "payable" and distinguished it from "paid" in this way: "Congress did not use the term "paid" in § 1602(aa), instead, it used the term 'payable' which looks to the fact that the consumer bears the cost of those fees at the time of closing, not whether those fees were financed, paid separately or deducted from the loan proceeds."[92] The court concluded that the *Terry* case "and its progeny have been wrongly decided" and denied summary judgment to the defendants.[93]

Beyond the rationale of *Short*, Regulation Z categorizes finance charges that are paid separately in cash or by check before or at consummation or *withheld from the proceeds* of the loan (*i.e.*, they are financed) as "prepaid" finance charges.[94] If the finance charge is prepaid by financing, then it is certainly "paid" or "payable."

Of further significance is the fact that the FRB Staff provides examples in the HOEPA Commentary illustrating how to calculate the total loan amount by subtracting prepaid finance charges from the principal.[95] If the *Terry* misunderstanding continues to spread (see cases cited in *Short*). HOEPA coverage will be completely emasculated because points and fees are almost always financed, at least in the subprime market.

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[88] 15 U.S.C. § 1602(aa)(1)(B)(the total points and fees must be "payable" at or before closing

[89] Terry v. Community Bank of No. Virginia, 255 F. Supp. 2d 811 (W.D. Tenn. 2003).

[90] Short v. Wells Fargo Bank Minnesota, N.A., 401 F. Supp. 2d 549 (S.D.W. Va. 2005).

[91] The phrase "paid from borrowers funds at settlement" appears on the top of one of the columns on page two of this form. This statement should appear on *all* Settlement Statements where the lender uses the HUD standard form. For a copy of the standard form, *see* 25 C.F.R. 3500 App. A, reproduced in National Consumer Law Center, Cost of Credit: Regulation, Preemption, and Industry Abuses App. K.2 (3d ed. 2005).

[92] Short, 401 F. Supp. 2d at 562-563.

[93] *Id.*

[94] Reg. Z § 226.2(a)(23).

[95] Official Staff Commentary § 226.32(a)(1)(ii)-1, example i.

Solution: Define "payable" in the Official Staff Commentary as:

A sum that is to be paid,[96] *or that may, can, or must be paid.*[97] *Closing costs that are financed are "payable" by the consumer.*

The Board should specifically repudiate the *Terry* holding in the Supplementary Information accompanying this Commentary and clarify that this has been the state of the law all along to avoid prospective application of this definition.

D. Prohibited Acts or Practices

1. The Board Should Create a Duty of Good Faith and Fair Dealing to Address Irresponsible Underwriting, Unsuitable Loans, and Steering in the Subprime Market

There is substantial evidence that large numbers of homeowners are losing homes to foreclosure as a result of subprime refinancing loans, and, more recently, subprime purchase money loans. Many lenders offer "no-documentation" or "stated income" programs, which do not require any income verification.[98] These programs are an open invitation to broker fraud, and, by definition, constitute making loans without regard to the borrower's repayment ability. As noted elsewhere in these comments, lenders do not underwrite adjustable rate loans based on either the fully-indexed rate or the maximum rate possible. Finally, the consistency of the data from study to study raises the very real question as to whether discrimination and steering account more for placement in the subprime market (and, hence, higher prices) than risk.[99]

Both the Federal Housing Administration and the Veterans Administration have developed income underwriting guidelines for mortgage borrowers. The VA includes an assessment of "residual income" for lower-income borrowers. Residual income becomes important because even reasonable debt-to-income ratios leave lower-income borrowers with

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[96] *See* Black's Law Dictionary 1165 (8th ed. 2004); Black's Law Dictionary 1150 (7th ed. 1999).

[97] Webster's New Collegiate Dictionary (1979).

[98] *See, e.g.,* The 2006 Mortgage Market Statistical Annual, Vol. 1 at 4, Vol. II at 15, Inside Mortgage Finance Publications, Inc. (2006)(Total Alt A originations in 2005 by volume were $390 billion of which $332 billion was securitized via non-agencies (i.e. not Fannie Mae, Freddie Mac); from this information we can infer that a high proportion of the total Alt A loans were made in the subprime/non-conforming market; Alt A is defined as: "Loans made to borrowers with limited income or asset verification, or no employer, or impaired credit—generally non-traditional circumstances."); *see also* Option One Mortgage Company Overview at 29 (March 2005)(37.71% of Option One's subprime loans in 2004 were stated or limited documentation loans; 39.29% of 2005 supbrime loans through Q3 were contained stated or limited documentation loans)(on file with authors); Allen J. Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* at 13, Consumer Federation of America (May 2006)(finding that in the conventional market 4.3% of borrowers who received loans did not disclose income). From these figures it can be concluded that, if 4.3% of borrowers in the conventional market account for stated income or no document loans, then most of these loans are made to the subprime borrowers.

[99] *See* Elizabeth Renuart, *An Overview of the Predatory Lending Process,* 15 Housing Pol'y Debate 467, 477-78 (2004)(and research cited therein).

unreasonably small amounts of dollars in absolute terms to pay for utilities, food, transportation, and other basic needs. This is especially true for homeowners with several dependents. The VA has established amounts for different regions and family sizes, that represent the minimum required residual income after subtracting mortgage, utility, and work-related expenses.[100]

Taking residual income into account is obviously most important for borrowers with lower incomes or families with several dependents, for whom the ratios do not adequately measure repayment ability. Because subprime lenders have disproportionately high percentages of lower-income borrowers,[101] residual income analysis is an essential component of determining repayment ability for subprime mortgages.

NCLC urges the Board to use its authority under § 1639(*l*)(2) to craft standards addressing underwriting, suitability, and steering for *all* subprime loans.[102] Congress did not limit its directive to the Board in § 1630(l)(2) to HOEPA loans, as is clear from the plain language of this provision.

> *Solution:* Accordingly, NCLC urges the Board to adopt standards along the following lines:
>
> *Duty of Good Faith and Fair Dealing in Underwriting*
>
> *The duty of good faith and fair dealing requires that a creditor must determine that a borrower has the ability to repay a covered home loan, based upon a consideration of the borrower's current and reasonably expected income, current and expected obligations, employment status, and other available financial resources, other than the borrower's equity in the home. Such determination shall be based upon the following:*

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[100] 38 C.F.R. §36.4337; VA Form 26-6393, Loan Analysis, available at http://www.hudclips.org/sub_nonhud/cgi/hudclips.cgi.

[101] Glenn Canner and Wayne Passmore, *The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers*, Federal Reserve Bulletin 709, 718 (November 1999).

[102] We propose the following definition of subprime or "covered home loans":

> *The term `covered home loan' means a consumer credit transaction that is secured by the consumer's principal dwelling, other than a reverse mortgage transaction, if—*
>
> *(1) the points, fees, and prepayment penalties as defined in Section 103(aa)(4) of the Truth in Lending Act (15 U.S.C. § 1602(aa)(4)) payable in connection with loan exceed 2% of the loan amount for a home loan above $40,000, or $400 for loans under $40,000, or*
>
> *(2) the undiscounted interest rate for the home loan exceeds by more than one percentage point the required net yield for a 90 day standard mandatory delivery commitment for a home loan with a reasonably comparable term from either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, whichever is greater.*

(1) The calculation assumptions shall use (a) the maximum monthly payments which would be due under the loan being offered, calculated with reference to the maximum interest rate and payments in the case of loans where the interest rate, or principal and interest payments may vary, and (b) the borrower's expenses, including the scheduled monthly payments on the loan being offered, including principal and interest (calculated in accordance with this paragraph), taxes, insurance, assessments, private mortgage insurance premiums, combined with the scheduled payments for all other debt;

(2) The resulting combined debt-to-income ratio does not exceed 50 per cent of the borrowers documented and verified monthly gross income, provided that the borrower has sufficient residual income as defined in the guidelines established in 38 C.F.R. 36.4337(e) and VA form 26-6393;

(3) All sources of income are verified by tax returns, payroll receipts, or other third-party verification.

<u>Duty to Provide a Suitable Loan</u>

The creditor shall reasonably ensure that the loan is suitable for the borrower's purposes, including, but not limited to the borrower's circumstances, the borrower's objectives in obtaining the loan, the borrower's ability to repay the principal and interest on the loan, as well as other obligations, and the loan is based on an appraisal that accurately reflects the fair market value of the dwelling.

<u>Steering Prohibited</u>

Steering borrowers into loans with terms worse than those the borrower qualifies for is a violation of the duty of good faith and fair dealing.

(1) A creditor shall not steer, counsel or direct any prospective borrower to a loan with rates, charges, and prepayment terms that are not reasonably advantageous to the borrower considering all of the circumstances, including the loan terms the borrower qualifies for, and the property securing the loan.

(2) If the creditor is unable to suggest, offer, or recommend to a prospective borrower a reasonably advantageous loan, a creditor shall: a) based on the information reasonably available to a creditor and using the skill, care, and diligence reasonably expected for a creditor, originate a reasonably advantageous loan on behalf of another creditor to the borrower, if permitted by and in accordance with all applicable laws; or b) state to the prospective borrower:

i. that the creditor does not offer a consumer home loan that would be reasonably advantageous to the prospective borrower but that other creditors may offer such a loan; and

ii. the reasons the creditor's products are not available to or reasonably advantageous for the prospective borrower.

(3) In no event shall a creditor:

a) mis-characterize the prospective borrower's credit history or the availability of consumer home loans to the prospective borrower; or b) discourage the prospective borrower from seeking a consumer home loan from another creditor if the creditor does not offer a reasonably advantageous loan.

2. The Board Should Prohibit the Financing of Points and Fees in Subprime Loans

One of the most disastrous consequences of predatory lending is the stripping of the homeowner's equity--the equivalent of stealing one's savings account. The financing of high points and closing costs and the flipping of loans is a recipe for huge profits for the lender and huge losses for homeowners. Whether these charges are labeled 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.

Points become exponentially difficult for homeowners to repay over the course of several refinancings. Generally, there are no limits on points under state law if the loan is a first mortgage due to federal preemption.[103] In addition, many states do not cap the amount of points that can be charged on second mortgages. Thus, homeowners are left completely unprotected.

NCLC supports a limitation on the financing of 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. Instead, 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 ownership in the home will be preserved. In addition, transparency will be enhanced because shopping based almost exclusively on the rate is much easier than deciphering the relationship between the rate and differing amounts of fees, particularly those that are not finance charges under TILA, from one loan product to another. These loans will be structured exactly the same as the "no cost" mortgage loans provided to prime borrowers all the time.

No equity will be 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 nothing more. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will *not* rise when there is no cash out. The equity in the home will

[103] Depository Institutions Deregulation and Monetary Control Act of 1980, 501 (DIDA), codified at 12 U.S.C. 1735f-7a.

no longer be 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.[104]

Consider the following example involving a high cost loan:

Borrower receives: $70,000

Borrower pays:

6 Points	$4,200	($4,200 all profit to lender)
Closing Costs[105]	$2,500	($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 an investor)

Interest Rate of 12%
30 year term
Monthly payment - $811.58
Consumer owes after 36 payments - $77,927.52
Consumer owes after 60 payments - $77,056

So long as there is sufficient equity in the home (and there generally is plenty), the lender can *benefit* 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. Yet, 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.

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[104] A prepayment penalty can pose a problem in this scenario. However, the snag that a prepayment fee can play in preventing the homeowner from refinancing is simply one more reason why prepayment penalties should be included in the points and fees trigger---to discourage their use in the subprime market.

[105] In over 50% of mortgages loans, closing costs includes a broker's fee.

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

Borrower receives	$70,000
Borrower pays:	
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
Consumer owes after 36 payments -- $71,415
Consumer owes after 60 payments -- $70,784.

The lender makes up the entire difference amount not permitted to be refinanced [$8,900 - $2,100 = $6,700] in 6 years in additional interest charges paid by the consumer. 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, not from upfront charges.

Solution: NCLC urges the Board to adopt the following:

> *No creditor may directly or indirectly finance, in connection with any covered home loan mortgage, more than 3% of the total closing costs.*

3. The Board should Regulate Deceptive Practices in Connection with Variable Rate High Cost Mortgage Loans

This suggestion is discussed more fully in Section III of these comments in response to a question posed by the Board.

III. RESPONSES TO THE BOARD'S SPECIFIC QUESTIONS

Topic 1: Predatory Lending: The Impact of HOEPA Rules and State and Local Predatory Lending Laws

1. Have the revisions to the HOEPA regulations (12 CFR 226.32 et seq.) been effective in curtailing predatory lending practices? What has been the impact of these changes on the availability of subprime credit? Have other abusive practices emerged since the 2002 revisions? If so, what are they?

As discussed more fully in Section II, the primary role of HOEPA in the marketplace has been to serve as a cap on the cost of high-cost loans. The Board's revisions to the HOEPA regulations have contributed to this by lowering the triggers (both directly and indirectly, by including more fees in the triggers), somewhat reducing the price for many subprime loans. While some of the highest cost loans have been curbed, abuses in the subprime market continue to thrive. Over the last several years, predatory mortgage lending cases have most often come in the form of origination of unaffordable loans by use of nontraditional mortgage products, falsified income on applications (initiated by originators and often unknown to the borrower), and inflated appraisals. Predatory subprime servicing—including improper application of payments resulting in the piling-up of fees, force-placing expensive property insurance, and foreclosures without investigation of reasonable alternatives—exacerbates this problem.

While research indicates that the availability of affordable credit has not been hampered by federal or state law changes in recent years, the Board's question about availability—and the repeated public reference to this issue in forums addressing predatory lending—appears to assume that any constraint on credit availability is disadvantageous. We disagree. While access to affordable credit that builds equity and communities is essential, unrestrained market activity in low-income and minority communities erodes equity and destabilizes communities through increased foreclosures. The correct question is whether all reasonable means have been employed to stop the abuses, and whether the building of personal wealth and strong communities—even for low and moderate income families—is happening. The answers then are no, and not enough.

2. What has been the impact of state and local anti-predatory lending laws on curbing abusive practices? Have these laws adversely affected consumers' access to legitimate subprime lending? Have certain provisions been particularly effective, or particularly likely to negatively affect credit availability?

The state laws, like HOEPA, have brought the price of subprime mortgage loans down, which somewhat limits their damage. As noted above, however, even with lower pricing in these states, predatory lending continues. In the first quarter of 2006, delinquencies and foreclosures in the states with some of the strongest laws were still unacceptably high. For Massachusetts, New Jersey, North Carolina and New Mexico, delinquency rates for subprime loans were, respectively, 10.81, 8.62, 13.17, and 9.6 percent. Moreover, foreclosures hovered over 3 and one-half percent, with figures, respectively for those same states, at 3.03, 3.01, 4.12, and 4.25 percent.[106]

Remediation of this dire economic situation for working Americans only will come when the risk for predatory mortgage loans is borne by the originators, servicers and investors who currently profit from them with little risk to their business. Predatory originators, who profit from the sale of the loans must be pressured by investors to make loans that perform long-term. State and local anti-predatory lending laws have shown that disparate groups can work together to try to improve the situation. The strong Ohio state law is a testament to this.[107] A stronger federal law, that requires market discipline and requires lenders and investors to be

[106] Mortgage Bankers Association, National Delinquency Survey (2006).
[107] 2006 Ohio Legis. Serv. Ann. 115 (West)(Senate Bill 185).

interested in the life of the loan, and that serves as a floor upon which states can build, would also help improve the picture by updating the laws to address the changing market.

3. Since the 2002 revisions to HOEPA, what efforts to educate consumers about predatory lending have been successful? What is needed to help such efforts succeed?

The question of consumer education often arises in discussions regarding predatory lending. Even an educated consumer can only shop effectively in a market that operates fairly, with transparency, and where the loan terms are simple and easy to understand. This is especially important in the area of mortgage lending, where the products are multiplying and their complexity is mind-boggling even for highly educated consumers. The complexities are created by the industry and not by consumer demand.

In the subprime market, however, shopping is basically unavailable (the market is not transparent) because borrowers need to make a financial commitment in order to find out the type of loan for which they are eligible. Moreover, loan lock-ins are rare and changes in terms at closing are common. Thus, consumers are left with adhesion contracts, often on terms that are unacceptable to them (that is, unfair), but are presented at a time (at closing) when they do not view themselves as having alternatives. After the fact, many people do not seek help, because they are embarrassed or because they assume no remedy is available. In order to discuss effective consumer education and counseling, the market first has to provide a level playing field in which fair contracts with non-abusive terms are available and with terms that are discernible from a distance.

4. Should the existing HOEPA disclosures in Regulation Z be changed to improve consumers' understanding of high-cost loan products? If so, in what way?

The Board (and Congress) should focus on creating a fair and transparent market. Without prohibition of unfair terms and practices, and early and firm disclosures, the market will not change. The burden cannot be only on consumers to discern a fair deal from one that will gut their accumulated savings and wealth.

***Topic 2*: Nontraditional Mortgage Products and Reverse Mortgages**
Interest Only Loans and Payment Option Adjustable Rate Mortgages

1. Do consumers have sufficient information (from disclosures and from advertisements) about nontraditional mortgage products to understand the risks (such as payment increases and negative amortization) associated with them?

The primary problem in the subprime mortgage market, as described above, is the paucity of underwriting. In the nontraditional mortgage arena, many lenders underwrite only for the initial rate, and even underwriting for the fully indexed rate is far from standard. Any analysis of ability to repay generally relies solely on ratios and does not consider residual income, a key factor for low and moderate income borrowers and those families with several dependents. Thus, the initial question (addressed in section II. above) should be how the market can change to provide simple, easy to understand products that will build, rather than drain, wealth for *all* communities.

Then, assuming a fair market, what should consumers know in order to choose among available products, including nontraditional mortgages? Right now, many consumers, especially victims of bait and switch, do not even know they have adjustable rate mortgages. Nor do they usually receive the "CHARM" booklet (and we are sure they would not understand the transaction better even if they did). We urge the Board to require the TIL disclosures given at closing to state clearly and conspicuously the length of the initial interest rate, the maximum interest rate that could be imposed, the maximum payment amount that could be required, and information about where to find the index used for the loan (such as a website). To be effective, this critical information should be placed in the federal box. All mortgage disclosures also should include clearer information regarding prepayment penalties, a notice regarding any negative amortization[108] and a clear description of what that means, and a notice regarding any amount of taxes and insurance not included in monthly payments.

Disclosures must be loan specific, contain the information that the consumer is most focused on, and be given in binding form both at consummation and at a clearly-defined time before closing so that the consumer understands their importance and can evaluate the loan terms. There must also be meaningful consequences attached to the creditor's failure to comply, including the possibility of statutory damages.

Solution: We propose that the Board make the following changes in Regulation Z for closed-end home-secured loans:

a. Amend 12 CFR § 226.18(g) by adding subsection (3):

(3) In a transaction secured by the consumer's principal dwelling in which the annual percentage rate may increase after consummation, the creditor must disclose the following in addition to the initial payment schedule:

(i) The fact that the credit involves a variable rate and that the consumer's interest rate and monthly payment can change substantially over time;
(ii) The number of months to which the initial interest rate applies;
(iii) The maximum interest rate and monthly payment that could result from variable rate increases, based on the initial principal;
(iv) A reference to an Internet site or a widely-circulated newspaper feature where the consumer can find the index.

b. Delete 12 CFR § 226.18(f)(2).

c. Amend 12 CFR § 226.18(g) by adding subsections (4) and (5):

[108] The negative amortization disclosure should apply both to loans with an explicit negative amortization feature in the fixed payment schedule or in the option-ARM terms, and to adjustable rate mortgages where the adjustment dates cause periods of negative amortization.

(4) For credit secured by the consumer's principal residence, the creditor shall state whether property taxes and homeowner's insurance are included in the payment schedule and the annual amount due of any separate payment for taxes and insurance shall be provided.

(5) For all loans that expressly permit or could result in negative amortization despite regular, timely payments by the borrower, the creditor shall state whether the loan permits negative amortization, a clear description of negative amortization, and the expected consequences of negative amortization.

d. Amend 12 CFR § 226.18(k) by adding subsection (3):

(3) For all loans with prepayment penalties, information regarding the time period during which the penalty is applicable, how the penaltyis calculated and the maximum amount of the penalty.

e. In addition, we ask the Board to revise the model form for ARMs in accord with the suggested form attached as Appendix A. The sections on taxes and insurance and prepayment penalties also should be incorporated into the model form for fixed rate mortgages.

The timing of disclosures also needs to be addressed. For non-purchase money mortgages, the consumer has three days after closing to review the documents and decide whether to cancel. Giving this disclosure at closing would at least mean that consumers would have this information during that critical window, when they are focused on the loan. Disclosure at closing is certainly less than ideal, especially for purchase money mortgages, where there is no three day right of rescission. The Board could address part of the problem posed by the current regime by altering its regulation for the timing of the early, estimated disclosures. Under 15 U.S.C. 1638(b)(2), these disclosures are to be:

> made in accordance with regulations of the Board under section 1631(c) of this title before the credit is extended, or shall be delivered or placed in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

We recommend that the Board revise Reg. Z, 12 CFR § 226.19(a)(1), which implements this timing requirement, to read as follows:

> *In a residential mortgage transaction subject to the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) the creditor shall make good faith estimates of the disclosures required by section 226.18 seven days before consummation, or shall deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.*

This amendment would mean that the consumer would get the estimated disclosures at least seven days before closing, regardless of when the creditor received the consumer's written application. The Board should also delete footnote 43 to Reg. Z, 12 CFR § 226.18(f)(1).

In addition, we recommend that the Board add a requirement that, when the estimated disclosures become inaccurate in closed-end home-secured transactions, corrected disclosures be given before closing as well as at closing. Getting the corrected estimated disclosures only at closing makes them of far less use to the consumer, and invites the bait and switch tactics that we see so often in transactions involving low-income consumers. We recommend that a new 12 CFR § 226.19(a)(3) be added to Regulation Z as follows:

> *If the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than 1/8 of 1 percentage point in a regular transaction or more than ¼ of 1 percentage point in an irregular transaction, or is changed from a fixed rate to a variable rate or from a variable rate to a fixed rate, the creditor shall disclose all the changed terms no later than seven days before consummation or settlement.*[109]

This addition to Regulation Z is within the Board's authority under Section 15 U.S.C. 1604(a) of the Act, which allows the Board to promulgate regulations that implement Congressional mandates or fill in gaps where Congress was silent. In 15 U.S.C. 1638(b)(2), Congress requires early disclosures for certain transactions within three days of application and at consummation if the early disclosures are not accurate. This provision does not prohibit additional disclosures at other times.

2. Should any disclosures required under Regulation Z be eliminated or modified because they are confusing to consumers, unduly burdensome to creditors, or are simply not relevant to nontraditional mortgage products? Do the required disclosures present information about nontraditional mortgage products in an understandable manner?

Other than the lack of strong substantive regulation in this area, the main disclosure problem is that sufficient, specific information is not currently provided to borrowers. The $10,000 example is not relevant to almost any borrower, and should be replaced with more loan-specific information.

3. Are there some Regulation Z disclosures that should be provided earlier in the mortgage shopping and application process to aid consumers' understanding of key credit terms and costs for these products?

See #1 above in this section.

***Topic 3*: Informed Consumer Choice in the Subprime Market**

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[109] A corresponding revision would need to be made to Reg. Z § 226.17)(f) and footnote 39.

1. How do consumers who get higher-priced loans shop for those loans? How do they select a particular lender?

The subprime market reaches borrowers more often than not by push-marketing. The loan shops for a borrower, rather than the reverse. Even where a borrower is seeking out a loan, many do not view themselves as having a variety of options (either because of damaged credit or because of real or perceived discrimination). Accordingly, when borrowers are provided with *a* loan, they often feel lucky to have it, or desperate enough for the money that they feel they must say "yes" at closing, no matter the terms. Moreover, exaggerations in advertising, or real promises based on unaffordable loan products (no downpayment, no credit check, no interest for the first few years) lure borrowers to products that are unsuitable for them. Research indicates that borrowers often do not understand the loan terms that bind them.[110] Even when shoppers try to shop on the internet, often the offers do not represent the actual loan terms.[111]

2. What do consumers understand about the role of mortgage brokers in offering mortgage products? Has their understanding been furthered by state-required mortgage broker disclosures?

Consumers generally view mortgage brokers as working for them. Either because of advertising, or because of personal interactions, or both, consumers expect a mortgage broker to get them a good deal. While many people understand that the broker also must get paid out of the deal, they view the broker fee they are paying as the sole compensation to that agent, and that the incentive is to find an appropriate loan (hopefully "the best") for the borrower. Consumers generally do not expect that brokers are also paid by lenders to upsell loans and they do not know that mortgage brokers often view themselves as having a primary duty to the lender, not the borrower.

While some of the largest subprime lenders engaged in predatory lending operate at times without brokers, many predatory loans are originated through brokers, with the assistance and funding of the creditor. Although some brokers do seek to find a good deal for their clients, only a duty of good faith and fair dealing can push more of the broker community into this posture. Disclosures can not break this often-dysfunctional relationship filled with false expectations.

3. What strategies have been helpful in educating consumers about their options in the mortgage market? What efforts are needed to help educate consumers about the mortgage credit process and how to shop and compare loan terms and fees?

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[110] Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract* 13.2 Stanford Law & Policy Review 233 (2002); Press Release, Consumer Federation of America, *Lower-Income and Minority Consumers Most Likely To Prefer and Underestimate Risks of Adjustable Rate Mortgages* (July 26, 2004), *available at* http://consumerfed.org/pdfs/ARM_survey_release.pdf.

[111] Michael Hudson, *Popular Mortgage Web Site Under Scrutiny for Lending Practices*, The Wall Street Journal Online, July 13, 2006, *available at* http://www.realestatejournal.com/buysell/mortgages/20060713-hudson.html.

Consumers need to be provided with a fair marketplace in which to comparison shop, and a way to compare apples with apples. Early and firm disclosures, combined with suitable mortgage loans, are the most important first step.

4. What are some of the ``best practices'' that lenders, mortgage brokers, consumer advocates and community development groups have employed to help consumers understand the mortgage market and their loan choices?

Any market changes must apply to everyone and not rely only on best practices. While we appreciate the efforts of some lenders to reform their practices and products and reach out to consumers, without comprehensive regulation, the market is simply a race to the bottom. "Best practices" cannot be enforced by consumers nor can regulators examine for compliance.

5. What explains the differences in borrowing patterns among racial and ethnic groups? How much are the patterns attributable to differences in credit history and other underwriting factors such as loan-to-value? What other factors may explain these patterns?

Even with comparable qualifications, people of color are more likely to receive higher-rate subprime mortgages. After accounting for credit scores, African Americans and Latinos are commonly 30% more likely to get the most expensive financing. We refer the Board to the Center for Responsible Lending's recent report.[112]

IV. CONCLUSION

The long-term risks created by short-term myopia cannot be overstated. Foreclosures are rising. We have permitted our economic system to depend far too much on the creation of and churning (refinancing) of mortgage debt. The debt underlying our national well-being must be responsibly created and priced, and the creation of unsustainable debt should be restrained. The mortgage marketplace needs new regulation to create a level and fair playing field both for consumers and responsible lenders. We hope the Board will take this opportunity to play an important role in achieving these results.

[112] Center for Responsible Lending, *Unfair Lending: The Effect of Race And Ethnicity on the Price of Subprime Mortgages* (2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf

APPENDIX A: PROPOSED VARIABLE RATE DISCLOSURES FOR CLOSED-END CREDIT

Sample Truth In Lending Disclosure Statement

ANNUAL PERCENTAGE **RATE** The cost of your credit as a yearly rate.	**FINANCE CHARGE** The dollar amount the credit will cost you.	**Amount Financed** The amount of credit provided to you on your behalf.	**Total of Payments** The amount you will have paid after you have made all payments as scheduled.

You have the right to receive at this time an itemization of the Amount Financed.

☒ I want an itemization ☐ I do not want an itemization

Your payment schedule will be:

Number of Payments	**Amount of Payments**	**When Payments Are Due**

Taxes and insurance Are they included in the monthly payment? ☐ yes ☐ no
If no, you must pay approximately this additional amount each year: $______ per year.

Variable Rate Information

This is a variable rate loan and your interest rate and monthly payment can change substantially over time. The monthly payment listed above is for an initial period of ____ months.

The **highest possible** interest rate that you can be charged at any time during this loan is _____%. If the rate goes as high as is allowed under your loan note, your **highest possible** monthly payment would be $_______(based upon the initial principal amount).

The index that will be used to calculate your interest rate can be found on the Internet at____.

☒ This loan has negative amortization. Some monthly payments will not cover the interest due and the **loan balance will increase.**

You may obtain **property insurance** from anyone you want that is acceptable to (creditor). If you get the insurance from (creditor) you will pay $ ______________.

Security: You are giving a security interest in:
☒ the goods or property being purchased
☐ (brief description of other property)

Filing fees $__________ **Non-filing insurance** $_______

Late Charge: If a payment is late, you will be charged $_______/______% of the payment.

Prepayment Penalty:

	☒ yes	☐ no	
You	☐ may	☒ will not	get a refund of part of the finance charge.

If you pay off your loan, refinance or sell your home before ____(date), you will have to pay your lender some additional money, over the principal and interest owing on the loan.

The highest amount you will have to pay is ____.

This will be calculated _______.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.