Comments of the National Consumer Law Center

on behalf of its low income clients

to the

Office of the Comptroller of the Currency--Docket No. OCC-2007-0013

Federal Reserve Board--Docket No. OP-1292

Office of Thrift Supervision--Docket No. OTS-2007-0016

Federal Deposit Insurance Corporation

October 15, 2007

Proposed Illustrations of Consumer Information for Subprime Mortgage Lending

The National Consumer Law Center ("NCLC")[1] submits the following comments on behalf of its low income clients. We appreciate this opportunity to provide the agencies with our views and concerns regarding the Proposed Illustrations of Consumer Information for Subprime Mortgage Lending ("Proposed Illustrations").

The Proposed Illustrations

The Proposed Illustrations are completely inadequate as a response to the widespread consumer confusion in the subprime market and the many ensuing market inefficiencies. We have three main areas of concern: a lack of substantive regulation, failure to mandate binding and uniform disclosures, and omission of key loan specific information in a form that consumers can use.

First, disclosure will not cure the ills of the subprime market. The complexity in the market exceeds what most consumers can comprehend, even with adequate disclosures. As all consumer representatives have consistently stated (and we made

[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 Diane E. Thompson and Margot Saunders.

clear in our comments to the Statement on Subprime Mortgage Lending -- the Statement [2]) only substantive regulation will address the fundamental imbalance between lenders and borrowers. Disclosures, particularly non binding and non loan specific disclosures, not only will not resolve the problem, they may exacerbate the problems. The burden will remain on consumers to dissect the credit marketplace and protect themselves from overreaching creditors.

Second, making the Proposed Illustrations non-binding will create *more* confusion. As the regulators' own words indicate, "[u]se of the Proposed Illustrations is entirely voluntary. Accordingly there is no Agency requirement or expectation that institutions must use the illustrations in their communications with consumers." The failure to mandate use of any particular illustration or any particular format means that there is no reason to expect any uniformity from lender to lender. Even worse, lenders are likely to make subtle changes in the illustrations so that they appear to resemble other lenders' illustrations but in fact lead consumers to compare apples to oranges. The failure to mandate the content and format of the Proposed Illustrations allows creditors to manipulate the illustrations to steer consumers into disadvantageous loans.

By suggesting that creditors individually create non-uniform illustrations, the Proposed Illustrations actually undermine the goal of requiring uniform, binding, loan-specific disclosures. Once creditors invest the time and effort to create their own illustrations they will be more likely to resist efforts to impose uniform disclosure requirements by regulation.

There is no guarantee that any two lenders will use the same form. Indeed, the agencies encourage a proliferation of different forms, presumably as a form of testing disclosures in the marketplace. Such an uncontrolled experiment is unlikely to lead to any clear results. At best, the agencies are encouraging a muddle. At worst, the agencies' agnosticism on the Proposed Illustrations facilitates continued gamesmanship in disclosures.

The use of nonbinding illustrations encourages brokers and lenders to continue to hide the ball from consumers through the use of complex products and convoluted disclosures. *Any lender who succeeds in making clear the risks of loans to consumers is likely to lose market share; there is no market incentive for lenders to make disclosures clear and comprehensive.*

Third, the Proposed Illustrations completely fail to convey key information in a form consumers can understand and use. As such, they leave the burden on consumers to protect themselves without providing the tools to foster a rational decision making process.

To be useful, disclosures must be –

[2]The National Consumer Law Center's full comments on the Statement are available at http://www.consumerlaw.org/issues/predatory_mortgage/content/COMMENTS_MS_May07.pdf.

- in a uniform format,
- that is binding on all lenders making the same types of loans,
- which are loan specific.

Consumers want and need loan specific disclosures.[3] Generic language as suggested in the Illustrations is open to misunderstanding, misinterpretation, and misrepresentation. As discussed in our comments to the Proposed Illustrations for non traditional mortgages,[4] it is naïve to the point of cynicism to expect consumers to obtain from lenders honest, intelligible, and comprehensive responses to oral questions. While these Proposed Illustrations do not directly suggest that consumers question their lenders or brokers about the loans, neither do they provide borrowers with sufficient information to assess independently whether or not they can afford the loan offered. Consumers are told of the potential dangers in their loans: a teaser rate, lack of an escrow, a prepayment penalty, a stated income loan. Consumers are not told of the magnitude of any of these risks.[5]

Consumers have limited understanding of the mortgage market.[6] For most consumers, mortgage lending transactions are a relatively rare occurrence; few consumers take out a mortgage loan more than once every five years—an entire product life cycle in the subprime market. Lenders, in contrast, design, develop and market subprime loans; they can be expected to understand the products and the risk. Nonetheless, even the lenders, as made evident by the failure of several large subprime institutions this year and recognized by the Interagency Guidance on Nontraditional Mortgage Products, have not adequately assessed the risk of many subprime loans.[7] It is unreasonable to expect consumers to make good decisions

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[3] GOV'T ACCOUNTABILITY OFFICE, GAO-06-929, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURE TO CONSUMERS 25, 27 (2006), *available at* http://www.gao.gov/new.items/d06929.pdf (most consumers want loan specific disclosures based on their own accounts); *see also* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U.L. REV. 1373, 1403-04 (2004) (discussing importance of consumer specific disclosures).

[4] These comments are available at http://www.consumerlaw.org/issues/predatory_mortgage/content/nontradillustrationscomments.pdf.

[5] The Proposed Illustrations also caution against balloon payments. Consumers are told, at least indirectly, of the magnitude of the balloon payment, on the payment schedule of the Truth in Lending disclosure.

[6] WILLIAM C. APGAR & CHRISTOPHER E. HERBERT, U.S. DEP'T OF HOUSING AND URBAN DEV., SUBPRIME LENDING AND ALTERNATIVE FINANCIAL SERVICE PROVIDERS: A LITERATURE REVIEW AND EMPIRICAL ANALYSIS at x (2006) ("[G]iven the . . . complexity of . . . the cost of [mortgages], even the most sophisticated borrower will find it difficult to evaluate mortgage options."); JAMES M. LACKO & JANIS K. PAPPALARDO, FED'L TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURE: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS at ES-11 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex).

[7] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609, 58616 (Oct. 4, 2006) (neither lenders nor consumers understand these products; lenders "should recognize that their limited performance history with [nontraditional mortgages] . . . increases performance uncertainty," and "consumers may not fully understand these products").

about their loans when they are given less loan specific information than the lenders have and evaluate.

ARMs in particular are poorly understood by consumers.[8] All the evidence suggests that through a combination of cognitive biases, limited financial literacy, and deceptive marketing, most consumers who end up in subprime loans, particularly ARMs, fail to understand these documents.

Any attempt to make the risks evident to consumers requires that consumers be given concrete information about the actual risks posed by *their* loan; *i.e.,* the actual maximum payment.[9] Consumers, for a wide range of reasons, continue to shop on monthly payments. It is well established that, particularly in the subprime market, many consumers use the monthly payment as a proxy for the interest rate risk and as a gauge of affordability.[10] The lender can easily calculate the maximum monthly payment and should be evaluating the consumer's repayment ability with reference to the maximum monthly payment. There is no reason not to require the lender to share the loan specific information with the consumer. Lenders should make clear what the actual maximum payment is, with taxes and insurance.

<u>Stated-Income Notice.</u> Lenders should be required to tell consumers how much higher their payments are if they obtain a reduced documentation or no documentation loan. A bland statement in a form is unlikely to alert consumers to the substantial costs they may incur as a result of their broker's selection of a reduced documentation product. Many lenders' pricing sheets increase the interest rate as much or more for a stated income loan as for any other pricing feature, including high LTV or non-owner occupied status. On a loan of $100,000, for example, an increase in the rate by 75 basis points (a common amount) can lead to a nearly 8% increase in the monthly payments. For low income borrowers the resulting payment increase can mean the difference between an affordable loan with sustainable homeownership and an unaffordable loan with foreclosure.

A broker who has pushed the submission of a loan application as a stated income loan is extremely unlikely to answer a borrower's questions candidly as to the amount of the loan interest rate increase. Even advising borrowers of the interest rate increase is inadequate: an increase in the interest rate of 0.75 percentage points

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[8] *See, e.g.,* CONSUMER FED'N OF AM., LOWER-INCOME AND MINORITY CONSUMERS MOST LIKELY TO PREFER AND UNDERESTIMATE RISKS OF ADJUSTABLE MORTGAGE (2004) (consumers cannot calculate the increase in the payment in and adjustable rate mortgage and underestimate the interest rate risk).

[9] *See* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing,* 44 Harv. J. on Legis. 123, 153-54 (2007**)** (discussing importance of loan specific disclosures for variable rate loans, particularly the maximum payment).

[10] REN S. ESSENE & WILLIAM APGAR, JT. CTR. FOR HOUSING STUDIES, HARVARD UNIVERSITY, UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 20 (2007); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L.REV. 707, 788-89 (2006).

sounds small; an increase in the monthly payments by over $50 does not. Borrowers must be given the increase in the form of the increase in the monthly payment.

Sample Mortgage Comparison. The sample mortgage comparison is unlikely to be of any help to most borrowers. It does not necessarily bear any relationship to their loan size, interest rate, or monthly payments. As such, it is likely to be disregarded by most consumers. Even borrowers who pay attention to that document are likely to have trouble translating the payment shock effect to their own loans. If borrowers use the illustration to estimate their own payment shock risk, to the extent the loan size or interest rate is lower than the borrower's, the borrower is likely to underestimate the potential payment shock.[11]

Actual Risk Calculations Extremely Difficult. Borrowers will face nearly insurmountable hurdles if they want to actually calculate their risk, rather than estimating it, particularly since there is no requirement that they be told in one place what the current rate on their loan is, what the fully-indexed rate is, what the maximums interest rate is, what the index is, and where they can find the index. Meaningful understanding of the risks posed by an ARM would still require, under the Proposed Illustrations, that consumers extract key information from at least two complex documents (the note and the adjustable rate rider), track down other information (the index rate), and then use an amortizing calculator to figure out the payments. We have trained hundreds of lawyers in the past five years on how the payments are calculated on ARMs. Most of the lawyers we train have great difficulty understanding the calculation. Lawyers may be math challenged, but they usually are comfortable working with complex documents; not so ordinary consumers. We believe that most consumers will not be able to work from their contract terms and the Proposed Illustrations to assess their own risk.[12]

Disclosure cannot be an adequate counterweight to the information asymmetries in the market—information asymmetries that fuel our current high levels of default and foreclosure[13]—if consumers are given less information than lenders possess about the loans, yet this is precisely what the illustrations propose. Lenders do not evaluate the repayment ability of consumers with reference to some generic consumer; they do not rely on a sample credit report and a summary of what the risks of an appraisal might be. Nor should consumers have to rely on sample disclosures about their actual loan costs.

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[11] REID HASTIE & ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD: THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 99-107 (2001)(describing anchoring effect: estimates anchored to the example given).

[12] *Cf.* Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 238 (2002) ("96% of American adults cannot extract and compute credit cost information from contract and disclosure documents").

[13] *See* Philip Bond, David K. Musto & Bilge Yilmaz, *Predatory Lending in a Rational World* 3-4 (Fed. Res. Bank of Philadelphia Working Paper No. 06-2, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875621 (information asymmetries in favor of lenders partially explain high default rates).

Instead of suggesting that lenders make confusing, non-uniform disclosures, the agencies should, as we discussed in our comments on the Statement, mandate that consumers receive advance, binding, loan-specific disclosures that include (in addition to what is already required):

- the fact that the payments are based on an interest rate which will change and the consumer's monthly payment will change substantially over time;
- the number of months to which the initial interest rate applies;
- the maximum interest rate and maximum monthly payment that can result from variable rate increases under the loan documents, based on the initial principal, as well as the dates the payment increases may first occur; and
- a reference to an Internet site or a widely-circulated newspaper feature where the consumer can find the index.

The creditor also should be required to state the payment with property taxes and homeowner's insurance included. For all loans with prepayment penalties, creditors should be required to provide information regarding the time period during which the penalty is applicable, how the penalty is calculated, and the maximum amount of the penalty.

Nothing in any disclosure (or illustration) should relieve lenders of their basic responsibility to fully evaluate a borrower's ability to repay the loan. Disclosures should not provide any lender with an argument that the information provided through the loan documents and any supplementary materials, including those required by federal law, can supplant the lender's duty to undertake a critical and thorough analysis of the borrower's ability to make all of the payments due under the loan.

Even with detailed disclosures, few consumers are able to:

- *comprehend* the complex variety of mortgage products available;
- *appreciate* the costs and benefits of these different products;
- *calculate* the effect of this risk analysis for their own families' situation;
- *shop* efficiently in the nationwide mortgage marketplace to find alternatives;
- *ask* the necessary questions of the mortgage originators to determine all of the risks and benefits of the mortgage product being offered;
- *negotiate* effectively with the originator to obtain the chosen product; and
- *examine* the documents closely enough at closing to make sure that the final loan terms are the same as those disclosed.

For the rest of us – consumers who do not have this combination of financial savvy and access to alternative loan sources – substantive regulation of the mortgage origination process is still essential.

Conclusion

The gravity of the current situation calls for meaningful steps to create a level and fair playing field both for consumers and responsible lenders. These steps must include the introduction of additional regulation to curb a never-satiated mortgage market and the requirement of early, firm, loan-specific disclosures. The Proposed Illustrations would serve to confuse consumers on the risks they face without providing them with substantive useful information. We hope the agencies will seize this unique moment to help create an environment where people can seek economic stability through sustainable homeownership.