IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

National Association of Mortgage Brokers, *Plaintiff*	)	
v.	)	No. 1:11-cv-00506-BAH
Board of Governors of the Federal Reserve System, *et al.* *Defendant*	)	
National Association of Independent Housing Professionals, Inc., *Plaintiff*	)	
v.	)	No. 1:11-CV-00489-BAH
Board of Governors of the Federal Reserve System, *Defendant*	)	

MEMORANDUM OF *AMICI CURIAE* CENTER FOR RESPONSIBLE LENDING AND NATIONAL CONSUMER LAW CENTER IN SUPPORT OF DEFENDANT FEDERAL RESERVE BOARD'S OPPOSITION TO PLAINTIFFS' MOTIONS FOR A TEMPORARY RESTRAINING ORDER AND PRELIMINARY INJUNCTION

STATEMENT OF INTEREST

Amici are national non-profit organizations with a commitment to consumer protection and a safe and sound housing market. *Amici* have an interest in seeing effective and common-sense oversight and regulation of mortgage lending, and are among those who have long urged the Federal Reserve Board (the Board), Congress, and state legislators to curb the insidious practice of rewarding loan originators for steering homeowners and home buyers to loans that are unnecessarily expensive and unnecessarily risky. The regulation Plaintiffs seek to enjoin, in whole or in part, Regulation Z, 12 CFR §226.36(d) and (e) (referred to by the Board as the "Loan Originator Rule," here, the Rule), reduces the likelihood that loan originators will improperly steer consumers into such unnecessarily risky and expensive loans by eliminating certain types and methods of incentive payments. This Rule is long overdue, has been the subject of lengthy deliberation since 2006, and is precisely the type of common-sense regulation necessary to protect both prospective homeowners and the soundness of the housing market itself.

Plaintiff trade associations have asked this court to issue a temporary restraining order and preliminary injunction delaying the effective date of the rule scheduled to go into effect April 1, 2011. *Amici* believe that delay would be contrary to the public interest and we urge the Court to deny the plaintiffs' request.

This brief focuses solely on the harm to consumers and the public that resulted from an originator compensation system that is partly responsible for today's financial crisis and the continuing harm that would result from a delay in this one small step toward reform.

I. INTRODUCTION

A fire swept through the American economy in 2008 and 2009 and its embers are still smoldering. The smoke was carried around the world. It began with loans made by loan originators to homeowners and home buyers. To be sure, all participants in the mortgage distribution system are culpable – not just mortgage originators and lenders – but securitizers and rating agencies, as well as the creators, sellers, and purchasers of collateralized debt obligations and credit default swaps. But the story begins with unstable and unsustainable loans made, one by one, to individual consumers. These loans came to dominate the mortgage market. These loans were the first sparks to ignite.

How and why such poorly designed and underwritten loans came to be so pervasive is the question that policy makers must confront. The "why" is a question still widely debated.[1] But we do know that a key answer to the "how" question is that perverse market incentives rewarded those front line originators for steering customers to risky loans. This Rule is not about eliminating fair compensation to originators for fair labor – it is simply about eliminating that misaligned reward structure that so distorted the market. Unless those pernicious incentives are realigned, we remain vulnerable to a recurrence of shaky lending practices as the market resumes and we regain confidence.

The Board, like other financial regulators, might be fairly criticized for not acting soon enough. But it cannot be faulted for acting too precipitously. Originator compensation practices, specifically the yield-spread premium (YSP), have been a focus through four Board hearings, an advanced notice of proposed rule-making, and two proposed rule-makings since 2006.[2] The Rule that resulted from the Board's lengthy review and consideration does three things. First, when a party other than the borrower (primarily the lender) compensates the loan originator, the compensation cannot be based on what terms and conditions are included in (or excluded from) the loan, other than the amount of the loan principal. *See* §226.36(d)(1). Second, the originator

---

[1] Borrower demand is not the explanation. This shift originated on the supply side. "And so you had Wall Street's securitizers basically then talking to the mortgage brokers saying, 'We'll buy what you've got'... The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke.'" Jon Meacham & Daniel Gross, *The Oracle Reveals All*, Newsweek, Sept. 24, 2007, at 32 (quoting former Board Chairman Alan Greenspan). As this brief discusses, the loans those brokers sold into the market were the ones the market paid them the highest prices for – the ones that helped ignite the crisis.

[2] *See* Def. Board Mem. in Opp'n at 7-8 (Board Mem.); 72 Fed. Reg. 30380 (May 31, 2007), 73 Fed. Reg. 1673 (Jan. 9, 2008) (proposing disclosure), 73 Fed. Reg. 44522 (July 30, 2008) (withdrawing disclosure proposal in light of questionable effectiveness), 74 Fed. Reg. 43232 (August 26, 2009) (second proposed compensation rule).

cannot receive payments from both the consumer and a third party,[3] known as "dual source" or "split" compensation. *See* §226.36(d)(2). Third, the originator cannot steer consumers based on the compensation the originator expects to receive. *See* §226.36(e). The Rule also provides a straightforward way for originators to comply with the latter "anti-steering" provision.

These same practices – their market-distorting effect, the harm to consumers, and especially to minority consumers – were also brought to Congress' attention,[4] and the Board's rules are consistent with the reforms enacted to redress abuses in originator compensation in the Dodd-Frank Wall Street Reform Consumer Protection Act. *See* Pub. L. 111-203, §1403, *adding* 15 U.S.C. §1639b(c)(1),(2) (Dodd-Frank).

Plaintiffs petition this court for relief protesting that their profession is threatened by this long-studied and long-overdue reform. But if an existential threat exists to Plaintiffs' profession, it is the macroeconomic environment, not this one small step toward reform. The fact is, the credit and housing bubbles burst, and as discussed herein, it was the absence of a rule like this that was in part to blame. Mortgage lending volume dropped dramatically, and by 2009 the broker-originated share had dropped by half from its peak in 2005.[5] For the time being, the market is gun-shy about getting back into mortgage loans, and the foreclosure crisis that is still with us is keeping the housing market uncertain. Furthermore, there is a loss of trust facing the

---

[3] The third party might be a lender or it might be a loan officer or mortgage broker's employer.

[4] *See, e.g.*, Testimony of Martin Eakes, Center for Responsible Lending, Before the Joint Economic Committee of Congress, *Evolution of an Economic Crisis? The Subprime Lending Disaster and the Threat to the Broader Economy*, at 13 (September 19, 2007), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-sept-07-final.pdf

[5] The overall volume of mortgages originated in 2006 was $2.98 trillion, but dropped to $1.815 trillion in 2009. Inside Mortgage Finance, 2010:21 (May 28, 2010) at 4. *See also* 1 Inside Mortgage Finance Publications, Inc., The 2010 Mortgage Market Statistical Annual 5 (on market share originated by brokers).

profession.[6] If anything, rules limiting risky practices can help restore public trust and ensure that brokers will continue to have an important role in the market going forward.

In this brief, we first emphasize that the passage of Dodd-Frank and the impending transfer of rule-making authority to the new Consumer Financial Protection Bureau not only fails to support plaintiffs' request for delay, but instead supports the Board's actions in moving ahead. (Section II). We then describe in Sections III and IV the "yield spread premium" as it devolved to a market-distorting system rewarding originators for steering consumers to more expensive loans. The benefits of that rewards system to consumers were nominal, but the harms were not. The compensation schemes also rewarded originators for steering consumers to loans with other unsafe features – ones which also added more cost, and, crucially, more risk to loans. Section V describes other loan terms and conditions for which originators were rewarded, and Section VI describes the correlation of these loans to increased likelihood of default and foreclosure. The proliferation of unstable and unsustainable loans in the market, encouraged by perverse compensation incentives, started us down the road to today's foreclosure crisis.

II. THE PASSAGE OF DODD-FRANK SUPPORTS THE ARGUMENT THAT THE PUBLIC INTEREST IS BEST SERVED BY IMPLEMENTING THE RULE AS SCHEDULED.

Plaintiffs' assertions that Congressional reforms and the pending transfer of Truth in Lending Act (TILA)[7] authority to the Consumer Financial Protection Bureau (CFPB) "tip[] the balance in favor of the TRO" are without merit. (*See* Pl. Nat'l Assoc. of Indep. Hous. Prof'ls Mem. in Support of TRO (NAIHP Mem.) at 23.) If anything, Congress signaled that it wanted the Board to proceed promptly. It specified the Board, not the Bureau, when referring to the rule-writing authority associated with the originator incentive and steering provisions. *Compare*

---

[6] Ron Lieber, *Some Tips for Homebuyers on Using Mortgage Brokers*, N.Y. Times, Apr. 4, 2009, at B1.

[7] 15 U.S.C. § 1601 *et. seq.*

Dodd-Frank §1403 (amending TILA to prohibit "steering incentives" and instructing the "Board" to promulgate regulations with respect to compensation and steering), *with* §1098 (amending § 2603 of the Real Estate Settlement Procedures Act[8] and directing "the Bureau" to publish a single, integrated disclosure document for mortgage loan transactions).[9]

After years of study, both Congress and the Board arrived at virtually the same conclusion regarding the way to realign appropriate compensation incentives to mortgage originators. The Board's decision to not delay rule-making until after the new Bureau was in place was especially significant, given that the Board's proposal had been released one year earlier in August 2009. By the close of the comment period, the Board had received some 6000 comments, including from members of Congress.[10] The final bill that passed some nine months later in May 2010, so closely tracks the Board's rule that it belies any notion that Congress sought to roll-back the Board's pending action. To the contrary, Dodd-Frank goes even farther than the proposed rule. To allow further delay would contravene the clear message of Congress that origination practices need precisely the sort of reform the Board promulgated. *Cf. Sandoz v. Food and Drug Admin.*, 439 F. Supp. 2d 26, 33-34 (D.D.C. 2006) (public interest favored denying the injunction; to do otherwise would mean there was no generic drug competition pending resolution of case on the merits against the clear purpose of a statute designed to get generic drugs into the hands of patients at reasonable prices quickly).

---

[8] The Real Estate Settlement Procedures Act (RESPA) is codified at 12 U.S.C. §12 U.S.C. 2601 *et. seq.*

[9] Dodd-Frank defines "the Bureau" to be the CFPB, §§ 2(4), 1002(2). Dodd-Frank also expressly preserved the Board's existing authority until the date that the authority transfers to the Bureau, now scheduled for July 21, 2011. *See* § 1062(a)(1).

[10] *See* 75 Fed. Reg. 58509.

III. THE YIELD-SPREAD PREMIUM: THEORY AND PRACTICE

There are costs associated with originating a loan. When a broker is involved, the broker's fee is one of the larger of those "upfront" costs. Borrowers have three ways to pay that fee: in cash directly to the broker, by increasing the loan amount and paying the fee from loan proceeds, or in the variant under scrutiny, by increasing the interest rate on the loan. This latter method inserts the lender into the picture. The consumer pays a higher rate to the lender, and the lender in turn pays the broker's fee from the expected stream of income generated by that increased interest rate. That form of broker's fee is known as a yield spread premium or YSP. In theory, the consumer can reduce or eliminate the upfront origination costs in exchange for paying this higher interest rate.[11] In practice, that rarely happens. *See* Section IV, *infra.*

Were this YSP merely an alternative way to pay a broker's fee, it wouldn't affect the *amount* of the fee – just how the consumer pays it. But inserting the lender into the relationship immediately complicates the picture. Professor Howell Jackson describes "the trilateral dilemma in financial regulation" -- situations in which there is a consumer, a market professional in a position to influence the consumer's decision, and a third party (lender) "who can profit from those decisions and can also make side payments to the market professional in order to influence the professional's recommendation."[12] When this situation arises with respect to a transaction involving considerable legal and mathematical complexity, a trust relationship between broker

---

[11] *See, e.g.* U.S. Dep't. of Housing & Urban Dev., Office of Pol'y Dev. and Research, RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-F-02, Final Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-20 – 2-21(2008), *available at* http://www.hud.gov/offices/hsg/rmra/res/impactanalysis.pdf; *see also* Howell E. Jackson and Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J. L. Bus & Fin. 289, 338 (2007).

[12] Jackson & Burlingame, *Kickbacks or Compensation*, 12 Stan. J. L. Bus. & Fin. at 312.

and consumer (in reality, if not in law), a lack of transparency, and few meaningful rules, it is ripe for abuse.

Over the four years the Board considered the compensation issue, the evidence mounted that YSPs had devolved into a reward system for originators who pushed loans with unnecessarily higher costs and highly risky loan terms. So fashioned, YSPs created a "reverse competition" effect: brokers aimed to sell consumers loans that would garner the highest YSPs for the brokers, rather than selling loans that provided customers with the lowest rates or most stable loan features.[13] Lenders who might not wish to pay YSPs lost market share to those lenders who did pay, and so were forced to join in the race to the bottom.[14] These incentives to brokers were significant, as can be seen in an example from New Century, one of the many now bankrupt lenders:

> Amber Barbosa, who got into the loan origination business as an employee at New Century, eventually became an independent mortgage broker. At twenty-eight years old, with no college degree, Ms. Barbosa made $500,000 a year in YSPs. She drove a Mercedes CLS 500 and a Cadillac Escalade and owned three pieces of property, including one with an ocean view. She described YSPs of $15,000 to $20,000 "as kickbacks."[15]

---

[13] *See, e.g* Keith Ernst, Debbie Bocian & Wei Li, Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers, and Subprime Loans* (2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.

[14] The potential loss of market share was significant at a time when the broker channel accounted for 45% of all mortgages and 71% of the nonprime loans. *See* Ron Essene and William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for all Americans*, at 8, Harvard University, Joint Center for Housing Studies (2007); *see also id.* at 43 (discussing "prisoner's dilemma" facing banks that imposed tougher standards); David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans,* Washington Post, May 7, 2007, at A1 (reporting that one Wall Street investment bank explained that the pressure worked both ways – they lost business from subprime lenders if they exercised too much due diligence).

[15] Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, at 32 (Oxford Univ. Press 2011).

The Board's rule targets only the abuse of YSPs, not their legitimate use to finance payment for broker fees and other upfront costs. The consumer remains free to pay the originator's fee (as well as costs) through an increased interest rate under both the Board rule and Dodd-Frank and there is no limit on the amount of that fee.[16] What can no longer occur is for the consumer to unwittingly pay twice – through visible upfront cash and or financed fees and also through invisible YSPs. The Board had ample evidence that consumers and the public suffered significant harm from the misuse of originator incentives when it decided to limit how -- but not how much -- the broker could be paid.

IV. AS PRACTICED IN THE MARKET IN RECENT YEARS, YIELD SPREAD PREMIUMS HAVE BEEN VERY COSTLY FOR CONSUMERS.

A. YSPs and Brokers are an Especially Costly Pairing for Consumers.

There is considerable evidence that brokers and yield spread premiums have been a costly combination for consumers. Borrowers are often overcharged on brokered loans in three ways: they pay more for the broker's services, they pay again for those services through increased interest rates, and they pay more for other closing costs.[17]

---

[16] "Section 226.36(d)(1) does not limit a creditor's ability to offer a higher interest rate in a transaction as a means for the consumer to finance the payment of the loan originator's compensation or other costs that the consumer would otherwise be required to pay directly (either in cash or out of the loan proceeds)." Official Staff Commentary to Regulation Z, §226.36(d)(1)-4a; *see also* Dodd-Frank §1403, adding 15 USC § 1639B(c)(2)(B), (Originators may receive compensation from the creditor if there are no other origination costs, other than bona fide third party charges not retained by the originator or creditor. The Board has the authority to waive this or create exemptions only if it "is in the interest of consumers and in the public interest.").

[17] *See, e.g.*, Susan E. Woodward, U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev. and Research, *A Study of Closing Costs on FHA Mortgages,* (2008) (reporting data showing that borrowers on FHA loans pay more in interest, broker fees, and other closing costs when there is a YSP), *available at* http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf.

The brief and affidavit of NAIHP cited one study with results contrary to those cited in this section. (*See* NAIHP Mem. at 19, NAIHP Mem., Exh. 1, Aff. of Mark Savitt, ¶ 12.) The methodology of that cited study has been questioned and its results leave questions unanswered. *See* McCoy, Patricia A., Banking on Bad Credit: New Research on the Subprime Home Mortgage Market, discussed at *Promises & Pitfalls: As Consumer Finance Options Multiply, Who Is Being Served and at What Cost,* a Federal

When otherwise similar loans are compared, mortgage brokers receive, on average, $800 to $900 in additional fees for loans with YSPs, as compared to loans that do not have YSPs.[18] In the subprime market, borrowers on average pay more, as measured by the loan's annual percentage rate (APR), for a loan that is brokered.[19] Mortgage borrowers with credit (FICO)[20] scores below 600 pay significantly more in interest for brokered loans than for loans originated directly by lenders.[21] This holds true after controlling for certain credit characteristics of the borrower: the ratio of the borrower's debt to her income (DTI) or the ratio of his home's value to

---

Reserve System Community Affairs Research Conference (July 26, 2005), *available at* http://www.chicagofed.org/digital_assets/others/events/2005/promises_and_pitfalls/remarks_mccoy.pdf

[18] Jackson & Burlingame, *Kickbacks or Compensation*, 12 Stan. J. L. Bus. & Fin. at 323.

[19] The APR is a "price tag" for credit that reflects the combined cost of both interest and fees for the loan over the scheduled life of the loan. *See* TILA, 15 U.S.C. §1606(a).

A study of 2004 and 2005 prime and subprime loans found that on average, both in the prime and subprime market, borrowers had a higher APR if the loan was brokered than not. The one exception was for 2004 subprime loans when the APR was 0.08 percentage points lower for a brokered subprime loan versus a retail subprime loan. The highest premium on brokered loans was 0.31 percentage points in the APR for 2005 subprime loans. *See* Marsha J. Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?*, 29 J. Real Est. Res. 399, 416, 418, 430 (2007); *see also* Keith Ernst, Debbie Bocian & Wei Li, Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers, and Subprime Loans*, (2008) *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf (prime borrowers sometimes save by using a broker but the magnitude of their savings is small compared to the costs imposed on borrowers in the subprime market); *cf.* Michael LaCour-Little, Economic Factors Affecting Home Mortgage Disclosure 24 (May 18, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992815 (loans originated by brokers were, after controlling for other economic factors, significantly more likely to have increased APRs from 2004 to 2005 than loans originated directly by lenders).

[20] A "FICO" score is a numerical score that is used to capture the creditworthiness of the borrower, named after one of the largest credit scoring companies, the Fair Isaacs Corportation. Some form of numerical scoring is widely used to determine the credit risk of the borrower.

[21] Ernst, Bocian & Li, *Steered Wrong*, at 18, Table 5, *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf

the loan amount (LTV).[22] Even in the prime market, some research finds that borrowers pay more in costs and APR for brokered loans than for loans originated directly by a lender.[23]

African Americans and Hispanics are particularly overcharged by brokers.[24] Evidence shows that Latinos and African Americans pay even more for loans originated through brokers than whites pay and are more likely to be overcharged for brokered loans than loans originated directly by the lender without a broker.[25]

B. Loans re More Expensive Where Originator Compensation is Paid in Part by the Consumer and in Part by the Lender and they are More Difficult for Consumers to Understand.

Under the Rule, a broker can be compensated by the consumer, or a lender, but it may not be compensated by both. *See* §226.36(d)(2). Notably, Dodd-Frank also bans dual source

---

[22] *Id.*

[23] *See* Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers*, 29 J. Real Est. Res. at 416, 418, 430 (finding that prime borrowers in 2004 and 2005 had a higher APR for brokered loans than for retail loans); Jackson & Burlingame, *Kickbacks or Compensation,* 12 Stan. J. L. Bus. & Fin. at 332, (borrowers in a survey of over 3000 prime loans pay on average $869 more in costs to have a loan brokered).

[24] Jackson & Burlingame, *Kickbacks or Compensation,* 12 Stan. J. L. Bus. & Fin. at 350.

[25] *See* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A157-A158 (2006), *available at* www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (pricing disparities between whites and minorities highest for broker originated loans); Robert B. Avery & Glenn B. Canner, *New Information Reported Under HMDA and Its Application in Fair Lending Enforcement*, Fed. Reserve Bulletin 344, 380, 394 (Summer 2005), *available at* www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf (same); Jackson & Burlingame, *Kickbacks or Compensation*, 12 Stan. J.L. Bus. & Fin. at 350 (African Americans and Hispanics pay more, on average, in broker compensation than whites); Press Release, Office of the New York State Attorney General, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 5, 2006), *available at* www.oag.state.ny.us/press/2006/dec/dec05a_06.html (pricing disparities between whites and minorities highest for broker originated loans); *cf.* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li (Durham, NC: Center for Responsible Lending, 2006) *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* 21/-/23, *available at* www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives).

compensation. *See* §129B(c)(2).[26] Plaintiff NAMB's challenge concerns only the portion of the Rule that prohibits dual source compensation. (*See* NAMB Compl., ¶¶ 1, 33.)

The Rule's ban on dual source compensation provides critically important protection, as evidence shows that dual source (or split) mortgage originator compensation is particularly challenging for homeowners. As the Department of Housing and Urban Development has described, homeowners end up paying the most in transactions where the loan originator receives payment from both the homeowner and the lender. These homeowners pay the highest prices, not just for broker compensation, but for other closing costs as well.[27] Consumers are able to shop successfully for the cheapest loan only when the originator's fee is either "all in" the rate, or "all out" of the rate, not when it is paid by a combination of the two. ("All in" means the fee is all paid by the lender from the interest rate stream, although of course that is indirectly paid by the borrower through an increased interest rate. "All out" means it is a separate, discrete upfront fee paid by the borrower in cash and/or by increasing the loan principal.) Research shows that homeowners simply end up paying more when they must shop for multiple pricing variables -- on both fees and rate -- regardless of the quality of disclosure. [28]

---

[26] Dodd-Frank allows the Board to make exemptions only if it is in the interest of consumers and in the public interest.

[27] Dep't. of Hous. & Urban Dev., Office of Policy, Dev., & Research, RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-F-02: Final Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24–2-43 (2008), *available at* http://www.hud.gov/offices/hsg/rmra/res/impactanalysis.pdf.

[28] *See* 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 121-23 (2007) (summarizing failure of current mortgage cost disclosures to adequately convey actual key mortgage costs to consumers), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf; Susan E. Woodward, Consumer Confusion in the Mortgage Market, at 2 (2003), (consumers who try to combine two or more price components in home mortgage shopping pay more for their mortgages than consumers who are shopping on a single price component), *available at* http://www.sandhillecon.com/pdf/consumer_confusion.pdf.

C. The Costs of the Practice are Considerable, The Benefits Few

Overall, incentive payments tied to higher interest rates impose a staggering cost on consumers. On an individual basis, a $200,000 subprime loan with a 2% yield spread premium delivers a $4000 YSP to the broker. That $4000 YSP imposes an additional cost to the family of $10,000 in just the first four years of the loan.[29] We estimated that collectively, borrowers paid almost $20 *billion* dollars in excess interest on loans originated between 2004 and 2006 because they received their loans from brokers, a cost borne primarily by subprime borrowers.[30] As the previous section indicates, this is not simply compensation for services rendered to the consumer. Instead YSPs "create[] the incentive for brokers, in an effort to obtain the highest possible commission, to induce borrowers to agree to the highest possible interest rate." *Martinez v. Freedom Mortg. Team, Inc.*, 527 F. Supp. 2d 827, 834 (N.D. Ill. 2007).

In exchange for these higher costs, consumer benefits from YSPs are few. One study estimates that borrowers on average receive only 30 cents of benefit for every dollar paid in YSPs.[31]

---

[29] Testimony of Martin Eakes, Center for Responsible Lending, Before the Joint Economic Committee of Congress, *Evolution of an Economic Crisis: The Subprime Lending Disaster and the Threat to the Broader Economy*, at 13 (September 19, 2007), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-sept-07-final.pdf

[30] Comments of the Center for Responsible Lending, Consumer Federation of America, and the National Consumer Law Center (on behalf of low-income clients), on Proposed Rules Regarding Regulation Z, §226.36(d) and (e), at 7-8 (December 24, 2009), Federal Reserve Board Dkt R-1366, *available at* http://www.consumerfed.org/elements/www.consumerfed.org/file/CRL%20et%20al%20Comment%20Reg%20Z.pdf; *see also* Ernst, Bocian & Li, *Steered Wrong*, at 14 (estimating that a subprime consumer pays over $5,000 more in interest on a $166,000 mortgage during the first four years alone with a brokered loan as compared to a loan directly from the lender). The collective figure of $20 billion was derived from the *Steered Wrong* findings by its authors for CRL.

[31] *See* Jackson & Burlingame, *Kickbacks or Compensation*, 12 Stan. J. L. Bus. & Fin. at 342; *see also* U.S. Dep't. of Housing & Urban Dev., Office of Policy, Dev. and Research, RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-F-02, Final Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-54, (noting, *inter alia,* that YSPs were least advantageous for brokered loans, with a $93 net loss per $100 of YSP), *available at* http://www.hud.gov/offices/hsg/rmra/res/impactanalysis.pdf.

V. ORIGINATOR COMPENSATION TIED TO LOAN PRICE, TERMS, AND CONDITIONS ENCOURAGED ORIGINATORS TO STEER CONSUMERS TO HIGHER COST, HIGHER RISK LOANS

This Rule targets all forms of compensation that offer incentive payments to originators to encourage them to write loans with particular terms and conditions – of which the interest rate is just one. The yield spread premium is most frequently associated with an incentive payment to the broker in exchange for a higher interest rate on the loan.[32] Certainly under the rule (and Dodd-Frank), originators will no longer be able to earn more simply for delivering higher interest rate loans to creditors. But originators received incentive payments for other lender-promoted loan terms, not just higher interest rates, when they sold loans with these features to consumers. Originators were richly rewarded for selling loans with prepayment penalties, adjustable rate mortgages (ARMs), and loans in which the originator and lender did not document or verify the borrower's income or assets ("stated income" or "low/no-doc" loans). In theory, such features were to offer some advantages to consumers, but in reality, those often failed to materialize. A full explanation of how they worked to distort the market is beyond the scope of this brief,[33] but the salient point is that in practice, the advantages went to the originator, in the form of bonus compensation.

A. Prepayment Penalties: An Illustration of the Wrong Incentives

In the nonprime market, loans commonly included a term that would require borrowers to pay an extra penalty fee to pay the loan off early, typically within the first two to five years; this term was called a prepayment penalty. These penalties were favored by lenders and investors,

---

[32] *See, e.g.* Kathleen C. Engel & Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1264 (2002) (describing YSPs as "side payments by lenders to mortgage brokers" for higher rates).

[33] For a recent in-depth explanation of practices and products in the subprime market, including those discussed herein, and the subsequent crisis, *see* Engel & McCoy, The Subprime Virus.

because they helped assure them of a promised income stream for at least the penalty period: the penalties were the market's insurance against the risk of prepayment. In theory, borrowers should have received a lower interest rate on the loan in exchange for taking a prepayment penalty.

But prepayment penalties were seriously disadvantageous to consumers, especially those who did not have conventional mortgages with interest rates that were fixed for the full life of the loan at market rates (fixed-rate, prime loans). The penalties often trapped consumers in these expensive loans. By adding thousands of dollars to the cost of refinancing, and sharply reducing – or even extinguishing – the homeowner's equity, these penalties could prevent them from refinancing into more affordable mortgages. Homeowners could not take advantage of lower interest rates, or escape from adjustable rate mortgages after an interest rate hike made their mortgage payments unaffordable because of prepayment penalties.

Here, too, the purported interest rate advantage to consumers generally failed to materialize[34] because of the way the prepayment penalty was linked to originator compensation and the YSP. In the nonprime market,[35] originators who sold loans without prepayment penalties commonly received no yield spread premium at all and they received smaller YSPs for loans with a shorter prepayment penalty period than the lender's desired penalty. This YSP bonus offered in exchange for a prepayment penalty locked the borrower into an expensive loan,

---

[34] Keith Ernst, Center for Responsible Lending, *Borrowers Gain No Interest Rate Benefits From Prepayment Penalties on Subprime Mortgages*, 1, 7 (January 2005), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/rr005-PPP_Interest_Rate-0105.pdf

[35] Definitions of the terms "subprime" and "nonprime" are inconsistent. We define "subprime" loans as those in which the loan's annual percentage rate (APR) is more than 1.5% above the average prime offer rate for comparable transactions (first liens) and 3.5% above that rate for subordinate liens. Regulation C, 12 C.F.R. §203.4(a)(12). We use "nonprime" to refer to both subprime and loans that are below that rate threshold, but have other non-standard terms, such as stated income our or negative amortization. (These are also sometimes called "Alt-A" or "non-traditional" loans.)

but was invisible to the consumer.[36] (And even if it were visible, the mathematical analysis needed to net out the impact of the prepayment penalty, a term that is supposed to *lower* the rate, and the YSP, another term that is supposed to *raise* that very same rate, is a task defying all but the most financially sophisticated.)

The Board's record includes the following example of the distortion caused by the originator's incentive.[37] The borrower qualifies for a $200,000 loan from the lender, given her credit score and collateral, at a rate of 9.45%. The borrower is unaware of this fact. The broker is the professional who controls the complex information and the choices put before the consumer. The lender's rate sheet tells the broker that the borrower can "buy-out" the prepayment penalty at a cost of 1% higher interest, but the broker can get no YSP if she does this. On the other hand, the broker can be paid a 2% YSP if she includes a 2 year prepayment penalty in the loan. A comparison is illustrated below in *Table 1.*

Table 1

	Consumers' Interest Rate	Prepayment Penalty	Broker's Fee/YSP
Loan A	10.45% (additional 1% to "buy out" the prepayment penalty)	No	$0
Loan B	10.55% (the charge to the consumer for the 2% YSP)	Yes	$ 4000

That scenario is a no-brainer for the consumer: Loan B is the worst of both worlds – a higher rate and a prepayment penalty. But the broker receives a $4000 bonus payment for

[36] Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research,* 15 Housing Policy Debate (Special Issue: Market Failures & Predatory Lending), 503, 509-12 (2004).

[37] Comments of the Center for Responsible Lending on Home Equity Lending Market, at 14-15, Appx. F, Docket OP-1288 (August 15, 2007), *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/crl-frb-comment-aug-15-2007.pdf

steering the consumer to Loan B, putting the broker into "a position in which to be honest [is] a strain on him." *Frey v. Fraser Yachts*, 29 F.3d 1153, 1159 (7th Cir. 1994).

B. Adjustable Rate Mortages (ARMs): Another Illustration of Steering Incentives

In addition to prepayment penalties and higher interest rates, loan originators were also richly rewarded for steering consumers away from safe, fixed rate mortgages and into risky adjustable rate mortgages.

1. Loan Originators Steered Consumers into Adjustable Rate Mortgages

Whether to take out a loan in which the interest rate remains fixed over the full term of the loan, or one whose interest rate adjusts with market changes is another choice to be made when a loan is originated, and another opportunity for the originator to steer the choice. On a fixed rate loan, the lender or investors assumed the risk that their costs of borrowing might rise during the life of the loan, but got the benefit if market rates fall. On traditional adjustable rate mortgages (ARMs), the borrower assumed the risk. Traditionally, when borrowers assumed such interest rate risk, they would get the benefit of lower interest rates in exchange. But the cost-benefit analysis was very different over the past decade because the prevailing market rates were at an all time low and it rarely made sense for consumers to choose an adjustable rate mortgage over a safe fixed rate mortgage.

Since market rates were very low by historic standards, the fixed rates available in the market were not much higher than the ARM rates: for only a relatively small difference in monthly payments, the borrower could have stable, predictable payments over the life of the mortgage. In this market, it made no sense for a rational consumer to take on interest rate risk.

2. The Adjustable Rate Mortgages That Prevailed Over the Past Decade Acquired Risky and Pernicious Features

As adjustable rate mortgages evolved over the past decade, particularly in the nonprime market, they shed the traditional falling rate benefit and acquired new pernicious features. They tended to be "up-escalator only ARMs" – meaning that the rate would not fall no matter how low market rates fell, thus subjecting borrowers to the risk of rising rates, without a corresponding benefit from falling rates.

More problematic was the introduction of the "2/28" or "hybrid-ARM" that predominated in the subprime market. These mortgages featured a fixed "teaser" interest rate and fixed payments for the first two years of the loan, followed by a 28 year adjustable rate period. The "teaser" rate was a lower rate than would have been obtained using the contract's adjustable rate formula (rate index plus a fixed "margin"). At the end of the teaser period, the interest rate and the payments would "reset" – according to the contract formula. Since the initial rate was a teaser, the rise in payments was frequently very significant, resulting in "payment shock." (For that reason, they were sometimes called "exploding ARMs.")

The payment option ARM (POARM) was yet another kind of ARM that became especially prevalent in the regions where the housing price bubble was most pronounced.[38] These extraordinarily complex mortgages allowed homeowners to pay minimum payments for an introductory period of several years but these payments were insufficient to cover even the interest that accrued each month. The interest shortfall resulting from minimum payments was added to loan principal, making the loan balance grow, or "negatively amortize."

---

[38] California accounted for 58% of these loans. *See* Brian Louis, *Option ARMs Threaten Housing Rebound as Resets Peak*, BLOOMBERG (June 11, 2009), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQ_ZgC75Zfyw

Lenders evaluating borrowers' ability to pay for these loans generally considered only the minimum payments so that when the POARMs reset they, like exploding ARMS, often became unaffordable. And, since the loans were negatively amortizing, the loan balance grew instead of falling. With or without a prepayment penalty, a POARM often trapped the homeowner and made refinancing into a lower cost, or fixed rate mortgage difficult, if not impossible.

There were both sales and bonus compensation advantages to originators in steering consumers to these loans. The teaser rates and minimum payments facilitated deceptive sales practices, as originators could "low-ball" the monthly payments, with promises to refinance borrowers when the rates reset and payments jumped.[39] As for the compensation advantages, Countrywide, the nation's largest lender and one that used both broker-channels and retail channels to originate loans, provides a good illustration. It had a sliding scale that rewarded originators for the riskiest loans: 1.48% for standard, fixed rates, 1.88% for subprime, and up to 2.5% of principal for selling POARM loans.[40]

C. Stated Income and No-Doc and Low-Doc Loans.

Loans for which the originator and lender did not verify or document the borrower's income and assets (stated doc or low/no-doc loans) helped the origination machine operate more efficiently and cheaply, moving new loans to market more quickly and with less work for the

[39] *Cf. Andrews v. Chevy Chase Bank*, 545 F.3d 570, 578 (7th Cir. 2008) (Evans, J., dissenting) (describing the payment option ARM as "a booby trap waiting to explode").

[40] Ruth Simon & James R. Hagerty, *Countrywide's New Scare – Option ARM Delinquencies Bleed Into Profitable Prime Mortgages,* Wall Street Journal, October 24, 2007, at C1. The reason for the incentives were clear, a 4% profit on POARMs, compared to 2% for FHA loans. *See* Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender,* N.Y. Times, Nov. 11, 2007, at B1. Just before its collapse in 2007, its subprime loans were earning gains of 2%, compared to .82% percent from prime loans. Gretchen Morgenson, *Inside the Countrywide Spending Spree,* N.Y. Times, Aug. 26, 2007, at B1.

originator and lender.[41] Underwriting for ability to pay became increasingly lax – as with underwriting to teaser rates as described above – and this stated/low/no-doc feature also made it easier for lenders and originators to mask the fact that the industry was increasingly dropping the second "C" from the old underwriting formula: "character, *capacity*, and collateral." For example, the absence of documentation and verification made it easier to originate unaffordable loans, such as the "exploding ARMs," where the borrower's inability to meet reset payments were often predictable from the outset. While the credit spigot was open, those resets might prompt the consumers to seek to refinance, if they could get past the prepayment penalty, leading to another round of revenue to be made from another loan.

It should come as no surprise, therefore, that brokers and retail originators often earned more for steering consumers to these loans -- as much as $15,000 on a $300,000 loan, compared to less than $5000 for a comparable fixed rate, fully documented and verified loan.[42] Consumers paid higher rates for stated income loans than for fully documented loans.[43] Even when they supplied full documentation to their originator, consumer often unknowingly received a higher cost stated income loan anyway.

---

[41] Engel & McCoy, *The Subprime Virus*, at 37. It was also likely a feature that facilitated mortgage fraud, with inflated incomes supplied on applications, sometimes by brokers, sometimes by borrowers, and sometimes even by employee-loan officers.

[42] *Id.*

[43] For example, according to the rate sheet applicable to the borrower described in V-A, the rate for a fully documented loan is 9.45%, compared to 11% for a stated income loan. *See* Comments of the Center for Responsible Lending on Home Equity Lending Market, Appx. F, Docket OP-1288 (August 15, 2007), *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/crl-frb-comment-aug-15-2007.pdf

VI. INCENTIVES STEERED CONSUMERS TO LOAN PRODUCTS AND TERMS THAT INCREASED THEIR RISK OF DEFAULT AND COSTS AND CONTRIBUTED TO THE FORECLOSURE CRISIS

A. Incentives Harmed the Housing Market by Promoting Loans More Likely to Default.

Paying more than necessary was not the only harm to consumers that flowed from this incentive system. The kinds of loan terms and features that these incentives promoted unnecessarily increased the risk of default and foreclosure. The harm from this flowed far beyond the consumers to the mortgage system as a whole.

The Board began its consideration of the distortions caused by originator compensation in 2006, when the massive system-wide crisis was still a year away. (Board Mem. at 7.) Early concerns focused on the subprime market segment – loans in which the annual percentage rate exceeded market rates by more than 1.5 percentage points for first liens.[44] As events unfolded over the next three years, it became clear that elevated rates of foreclosure and abusive terms were not limited to that specific subcategory of mortgages, but had spread to broader segments of the market. And, of course, as events unfolded, it also became clear that there were more problems than had been identified in 2006.

But even in 2006, it was clear that some types of mortgage products were failing at high rates. One of the *amici* examined the longitudinal performance through October 2006 of some six million subprime loans originated between 1998 and 2004. We predicted an astonishing failure rate of 1 in 5 for loans originated in 2005-06 and estimated that 2.2 million subprime loans made in the few years before the study had already failed or would end in foreclosure.[45]

---

[44] *See* note 33, above, for a more complete definition of "subprime" loans as used herein.

[45] Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, Center for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and the Cost to Homeowners,* at 3-4 (December, 2006), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-

More granular statistical analysis of that data base found that certain loan features were associated with significantly increased risk of foreclosure.[46] And some of those features were the very ones generating rewards to originators. Many loans included more than one unsafe feature, and such "risk-layering" compounded the danger. Perhaps in part because the incentives to steer borrowers wrong were so successful, simply being in a subprime loan originated by a broker increased the odds of default.[47] As detailed below, the degree by which these terms are correlated with the increased risk of default or foreclosure is significant.

- Higher rates are correlated to increased risk of default.[48]
- On 2000 vintage loans, a prepayment penalty increased the likelihood of foreclosure by over 50%.[49]

---

report-2-17.pdf. Though highly criticized as being a "worse case scenario" when released, this report sadly underestimated the scope of the foreclosure crisis and the imminent harm to the housing market from these loans.

[46] The increased odds of foreclosure found for loans originated in each year of the study ("vintage") are charted in *Losing Ground. See id.* at 21, Table 11. The low end of the ranges described in the bullets below refers to the cohort of loans originated in 2000, the high end for those originated in 2003.

[47] Lei Ding, Roberto G. Quercia, Wei Li, Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,* at 29, UNC Center for Community Capital (Working Paper: May 17, 2010) (finding that the "broker-origination channel is significantly associated with an increased level of default"), *available at* http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf

[48] Studies have found a significant relationship between a higher mortgage interest rate and mortgage default. *See* Ctr. for Community Capital, Community Advantage Panel Study: *Good Business and Good Policy: Finding the Right Ways to Serve the Affordable Mortgage Market* 6 (2009), *available at* http://www.ccc.unc.edu/documents/CAP_Policy_Brief_July09.pdf (finding that the relationship between the market rate and mortgage interest rate is one of the leading predictors of default); Gov't Accountability Office, GAO No. 09-741, Home Mortgages: *Provisions in a 2007 Mortgage Reform Bill (H.R. 3915) Would Strengthen Borrower Protections, But Views on Their Long-term Impact Differ* 29-30 (2009), *available at* http://www.gao.gov/new.items/d09741.pdf (finding a significant increase in the 24 month default rate for a wide variety of subprime products based on the increase in the rate over the comparable index; as this spread increased, so did the rate of default).

[49] *See Losing Ground*, p. 21, Table 11; *see also* Roberto 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*, at 23, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill (Jan. 2005), *available at* www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf

- The increased foreclosure risk for an adjustable rate feature ranged from 72% for 2000 vintage loans to 117% for 2003 vintage loans.[50]
- Stated income loans increased the likelihood of foreclosures by 29% (2000 vintage) to 64% (2003 vintage).[51]

Despite the dangers, these unsafe loan features grew to dominate the market. The incentives worked, and originators steered borrowers to these products. When the Board began its examination of this issue, 77% of securitized subprime loans were ARMs, and 90% of those were the 2/28s or 3/27 hybrid loans due to reset; 70% had prepayment penalties, and more than 1 in 3 were stated income.[52] Astonishingly, only about 17% of the negatively amortizing POARMS originated between 2004 and 2007 were fully documented.[53]

B. Risky Loans, Not "Risky Borrowers" are Behind these Odds.

A common response to warnings based on these frightening statistics was to deflect the criticisms, simply responding that the market was populated by "subprime borrowers" – less credit worthy customers. However, over time research belied that simplistic notion. A 1996 study by Freddie Mac found that 10% to 35% of homeowners in the subprime mortgage market

---

[50] *See Losing Ground*, p. 21, Table 11; *see also* Quercia, *The Impact of Predatory Loan Terms on Suprime* Foreclosures, at 28-29 (50% greater odds of foreclosure on subprime ARMs). Though in theory consumers should get some advantages from ARMs in exchange for added risk, as with prepayment penalties and YSPs, those advantages generally failed to materialize.

[51] *Losing Ground,* at 21, Table 11.

[52] These figures represent the average share of the feature in ten mortgage-backed securities offerings in the first half of 2007. *See* Testimony of Michael C. Calhoun Before the U.S. Senate Committee on Banking, Housing and Urban Affairs—Subcommittee on Housing, Transportation and Community Development, *Ending Mortgage Abuse: Safeguarding Homebuyers,* at 3, 12-13 (June 26, 2007), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d9b8f4a0-306e-42f8-8297-187ff8e3c21c

[53] *Option ARMs: It's Later Than It Seems,* Fitch Ratings, September 2, 2008, at 5.

would be eligible for prime-market mortgages.[54] In 2000, Fannie Mae opined that almost half of all subprime borrowers could qualify for lower-cost conventional financing.[55] By 2006, *The Wall Street Journal* reported, a majority of all subprime mortgage borrowers were eligible for prime credit.[56] In the face of such large numbers of prime-eligible borrowers receiving subprime credit, the Board's anti-steering rule is rational. Moreover, the evidence from studies that control for borrower characteristics relating to credit-worthiness is that the same "risky" borrowers can manage loans without those risky features.[57] In short, the quality of the loans, more than the quality of the borrowers, drove the astonishing and tragic foreclosure rate in the segment that constituted the first domino to topple in the ongoing foreclosure crisis that continues to dominate today's housing market.

---

[54] Peter E. Mahoney and Peter M. Zorn, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for American Families*, 1996 Mortgage Market Trends 18, 22 (Freddie Mac Rept. No. 259 Sept. 1996).

[55] Kathleen Day, *Fannie Mae Chief Defends Record; HUD Alleged Mortgage Giant's Policies Hurt Black Buyers*, Washington Post, March 3, 2000, at E1.

[56] Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market,* Wall St. J., Dec. 3, 2007, at A1 (reporting that 61% percent of subprime borrowers in 2006 were prime eligible based on their credit score); *cf.* Marsha J. Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?*, 29 J. Real Est. Res. 399, 415, 417 (2007) (reporting that, in 2004 and 2005, respectively, 17.29% and 12.15% of subprime borrowers had FICO scores of 700 or higher, well into prime territory).

[57] Lei Ding, Roberto G. Quercia, Wei Li, Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,* UNC Center for Community Capital, 33-34, (Working Paper: May 17, 2010), *available at* http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf.

VII. CONCLUSION: CONSUMERS AND THE PUBLIC HAVE SUFFERED GRAVE CONSEQUENCES FROM THE PERVERSE INCENTIVES THAT THE BOARD – AND CONGRESS – HAVE IDENTIFIED FOR REFORM. FURTHER DELAY IS CONTRARY TO THE PUBLIC INTEREST.

Originator incentives worked as lenders intended, but with unintended consequences. These incentives contributed to the proliferation of the dangerous loans they rewarded. But the swelling ranks of risky loans "crowded out" more stable, sustainable, affordable and proven mortgage products.[58] And then the market blew up.

This is the public harm at which the Board's rule took aim. In the context of these identified harms to the public, it is clear that the Board's rule is actually narrowly targeted to deal with specific perverse incentives. The Plaintiffs argue that if their "wholesale" price can be "unfair," then every retail price is in jeopardy. (NAIHP Memo at 18.) But this argument misses the mark. A retail grocer does not hide his milk under the counter, then sell fresh milk for $3 a gallon to customer A, and tainted milk for $4 a gallon to customer B. That is an unfair practice. Further, it would be equally unfair whether it was a small business grocer or a nationwide chain.

The Board's rule by no means strikes at the heart of brokers' ability to earn their living; it only prevents brokers from being rewarded for larding on unnecessary costs and increased risks to the products they sell to their customers. Eliminating perverse incentives serves consumers, the public, the economy, and the housing industry, including honest brokers. The Board was

---

[58] *See* Engel and McCoy, *Subprime Virus*, at 38-40. By 2006, nonprime originations outstripped prime originations: $1.6 trillion non-prime ($600 billion subprime and $958 billion "alt-A"), compared to $990 billion prime. The alt-a figure includes non-traditional loans like the POARMs that are lower than the "subprime" rate threshold, and the "jumbo" loans. These figures were complied from Inside B&C Lending's 2008 Mortgage Market Statistical Report, and were cited in *amici*'s Comments to the Board. *See* Comments of the Center for Responsible Lending, Consumer Federation of America, and the National Consumer Law Center (on behalf of low-income clients), on Proposed Rules Regarding Regulation Z, §226.36(d) and (e), at 4 (December 24, 2009), Federal Reserve Board Dkt R-1366, *available at* http://www.consumerfed.org/elements/www.consumerfed.org/file/CRL%20et%20al%20Comment%20Reg%20Z.pdf.

well within its authority when it considered the effect of originator incentives and the complexities which make disclosure a completely ineffectual approach, and adopted the ban on certain forms of originator compensation. The public needs this reform now, and this Court should refuse the Plaintiffs' motions for delay.

Dated: March 23, 2011

Respectfully submitted,

Nina F. Simon (DC Bar No. 256396)
Kathleen E. Keest
Center for Responsible Lending
910 17th Street, NW, Suite 500
Washington, DC 20006
(202) 349-1850
(202) 349-9009 (fax)
nina.simon@responsiblelending.org

Diane E. Thompson, *Of Counsel*
National Consumer Law Center
7 Winthrop Square
Boston, MA 02110
(617) 542-8010
(617) 542-8028 (fax)

Counsel for Amici Curiae