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The FRB's Final HOEPA Rule: A First Step, But Real Reforms Are Still Needed

Summary Analysis
National Consumer Law Center[1]

The Board's rule is a step in the right direction. The Board has recognized that loans should not be made if that cannot be repaid, that lenders should make some effort to verify borrowers' repayment ability, that there should be significant limits on prepayment penalties, and reaffirmed that lenders bear primary responsibility for inflated appraisals. Nonetheless, the Board's rulemaking has not solved the problem. Many loans are excluded from protection, enforcement mechanisms are weak, and the Board's rulemaking is largely more suggestive than proscriptive, particularly in defining what constitutes ability to repay. The Board's action will not stop abusive loans from being made.

I. The Good News: Regulatory Improvements Will Increase Access to Fair and Affordable Mortgages.[2]

A. **The Ability to Repay Standard.** The Board has affirmatively required creditors making higher-cost loans to evaluate the borrower's ability to repay the loan, including taxes and insurance, in light of current obligations and known and reasonably expected future changes in income (such as retirement). This rule, particularly without a pattern and practice requirement, begins to address the central cause of the current crisis—lack of underwriting. While an important step in the right direction, both the standard itself and enforcement mechanisms for the standard are limited, as discussed in III(A) below.

B. **Verification of Repayment Ability.** The Board's ability to repay standard is backed up by a requirement to verify the borrower's repayment ability on higher-cost loans. The Board's approval of a range of documents, including but not limited to W-2's, for verifying income is an appropriate and sorely needed flexible approach to documenting income. As discussed below, however, the income verification and affordability rules as a whole do not provide adequate safeguards for homeowners seeking affordable mortgages.

C. **The Escrow Requirement.** By requiring escrowing for the first year of higher-cost mortgages, the Board's new rule will help borrowers with higher cost mortgages to better assess and satisfy all of their mortgage-related obligations at the outset of the loan. Servicers may be able to engineer opt-outs after 12 months.

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1 Analysis by Alys Cohen, NCLC Staff Attorney, and Diane E. Thompson, Of Counsel, NCLC.
2 This discussion does not address the Board's advertising rules or proposed HMDA rule.

D. **Prepayment Penalty Limitations.** The Board, in a welcome move, limited prepayment penalties for higher-cost loans to two years or less, and then only when the loan has fixed payments for at least four years . In the subprime market, prepayment penalties generally have been an additional loan burden rather than a fee exchanged for a better rate, and prepayment penalties disproportionately occurred in high cost loans made to lower-income borrowers and borrowers of color. The rescission remedy available for violations of this rule will help ensure compliance. Borrowers with fixed-rate higher-cost loans, however, still remain subject to prepayment penalties in the first two years, and no limits are put on prepayment penalties in the prime market.

E. **Appraisal Controls.** The Board's new appraisal rules provide needed guidelines for identifying appraisal fraud. While the examples of prohibited and permissible conduct, which require substantial proof, are helpful, the lack of a bright line test still may make it difficult to systemically remove inflated appraisals from the market.

II. Steps Backward: Three New Invitations To Abuse

A. **Many Consumers, Including Older Borrowers, Still Are Unprotected Because the Rule Excludes Prime Loans and HELOCs.** Most subprime borrowers will be covered by the Board's new rule. However, the ability to repay rule and other higher-cost restrictions do not apply to the many borrowers with nontraditional prime mortgages and other abusive bank loan products and the increasingly sizeable pool of homeowners with HELOCs. Failure to consider a borrower's ability to repay has been endemic in parts of the prime and alt-A market not covered by the rule. This rule is narrower than the federal guidance on nontraditional mortgages and sends the wrong message about underwriting in the majority of the mortgage market.

B. **The Board's Failure to Use A Points and Fees Test for Higher Cost Loans Encourages Creditors to Shift Costs Out of Interest and Into Fees.** The Board's definition of higher-cost loans is based solely on a rate trigger and does not include a points-and-fees trigger. This omission leaves the door open for creditors to evade the regulation of higher-cost loans by increasing loan prices through fees, as they did in the 1990's.

C. **The Board's Early Disclosure Regime Is An Incentive to Bait and Switch.** The Board updated the mortgage disclosure regime by requiring early disclosures for all closed end loans secured by the borrower's principal dwelling. The disclosure regime promulgated by the Board is weak: the Board did not set a minimum amount of time before closing that the disclosures be provided, nor did the Board require that the disclosures given be accurate. Under the Board's regime, , creditors are free to wait to provide accurate disclosures up until closing. Closing, as the Board has recognized, is too late for shopping. Moreover, requiring early disclosures without any requirement that the early disclosures be accurate is an invitation to creditors to provide misleading early disclosures. More stringent early disclosure requirements were enacted into law as part of the Housing and Economic Recovery Act of 2008.[3] The Board is

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[3] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2501, *et seq.*, 122 Stat. 2654. The statute, in contrast with the Board's regulations, requires that at least seven days elapse between application and

tasked with issuing regulations under the statute. Unless the Board provides clear penalties for the failure to provide accurate early disclosure—by, for example, explicitly making the failure to provide the early disclosures a material violation and grounds for rescission—private enforcement of the early disclosures will be uncertain and subject to litigation. This regime of requiring early disclosures without providing an enforceable remedy encourages creditors to bait and switch—to lure a borrower with a promise of one set of terms and to then provide other, less advantageous terms at closing. Accurate and binding disclosures are essential to increasing market discipline.

III. Missed Opportunities: The Board's New Rule Makes Some Progress but Stronger Rules and Remedies Are Still Needed

A. The Ability to Repay Standard Still Is Limited.

1. The Ability to Repay Standard Does Not Require Analysis of the Maximum Possible Payment or the Risk of Increasing Interest Rates. The Board touts its requirement that the analysis of ability to repay be conducted on the maximum scheduled payment over seven years. The maximum scheduled payment is not the maximum actual payment; rather it is based on the fictional notion that interest rates will remain exactly as they are at closing, without either increasing or decreasing. Thus, the Board's maximum scheduled payment standard significantly understates the interest rate risk posed to borrowers and permits creditors to continue to use an artificially low and excessively optimistic yardstick with which to determine ability to repay. Moreover, if, under the loan terms, the full payment of interest and principal at the rate in effect at closing will not be reached in the first seven years of the note, the Board requires no analysis of ability to repay at even the maximum scheduled rate. For example, the Board makes clear that a loan underwritten based on seven years of interest-only payments would satisfy this standard, even where the loan payments (excluding any market jump in interest rates) would increase significantly in the eighth year. Only by comparing the borrower's income to the maximum possible payment, based on the loan terms and the maximum rate and rate increase caps in place in the loan, is it possible to determine whether or not the borrower has the true ability to repay the loan over the life of the loan.

2. Without a Required Residual Income Analysis, the Ability to Repay of the Most Vulnerable Borrowers Cannot Be Assessed. The Board approved an affordability analysis based on either debt to income ratios or residual income, yet refrained from requiring residual income as an independent criterion. For lower-income borrowers, however, a residual income screen is essential for assuring affordability and sustainability. Nor did the Board set a strict limit for debt-to income requirements. Thus, lenders are free to vary widely the conditions under which they approve loans, without any assurance that the loans be affordable. The Board suggests that its lack of definition will encourage market innovation. Historically, market innovation has worked to undermine even weak affordability standards. The market is unlikely to develop more rigorous affordability standards than those imposed by the Board.

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closing, absent a bona fide personal financial emergency, and that, if the cost of the loan changes significantly, new disclosures be provided at least three days before closing.

3. The Board's Rule Permits Lenders to Continue to Make No-Doc Loans. The Board specifies that a lender will face no liability for making a no-doc loan where the originator's loan decision would not have been materially different had the proper information been available. This affirmative defense may serve as an invitation to originators to circumvent proper underwriting procedures and to continue to rely instead on the representations and warranties of brokers. Especially for non-depository institutions that are not examined, liability under this rule will depend entirely on enforcement by borrowers, who may have difficulty ascertaining before suit what the originator's underwriting standards were and whether the borrowers' actual, undocumented income met those underwriting standards.

B. **Remedies for New Rules Provide Insufficient Incentive for Compliance.** Giving borrowers the ability to enforce the new rules— both against mortgage originators and against entities that purchase mortgage loans—is key to ensuring compliance. Many of the new rules the Board has created, including the ability to repay standard, are toothless because enforcement by borrowers will be difficult or impossible. The Board made rescission available only for violation of the prepayment penalty rules; for all the other new rules borrowers have weak or murky enforcement rights. The Board has the power to strengthen the availability of actual and statutory damages, to ensure that enhanced damages are available against assignees, and to clearly apply rescission to prohibited practices such as underwriting without regard to repayment ability.

C. **Steering Remains Unaddressed; Yield Spread Premiums Need Substantive Regulation, Not Disclosure.** We welcome the Board's withdrawal of an unworkable yield spread premium rule. Nonetheless, the Board's expressed intent to address mortgage steering through disclosure defies the Board's own research on the limited effectiveness of broker disclosures. Yield spread premiums–widely linked to racial steering—must t be addressed through substantive limitations. The Board has the power to do this.

D. **Servicing Protections Provide No Remedy for Harmed Homeowners and Further Servicing Protections Are Sorely Needed.** The Board's new rules on mortgage servicing, while helpful improvements, provide no means for a borrower to enforce them. The Board could change this. Moreover, additional servicing abuses must be addressed. In particular, the Board did not meaningfully restrict force-placed insurance nor require reasonable loss mitigation prior to foreclosure.