COMMENTS
On
Real Estate Settlement Procedures Act (RESPA)
Proposed Rule to Simplify and Improve the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers

Department of Housing and Urban Development
24 CFR Parts 203 and 3500
[Docket No. FR-5180-P-01]
RIN 2502-AI61

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

- Consumer Action[2]
- Consumer Federation of America[3]
- National Association of Consumer Advocates[4]

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[1] The **National Consumer Law Center** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eleven practice treatises and annual supplements on consumer credit laws, including *Truth In Lending,* (6th ed. 2007) and *Cost of Credit: Regulation and Legal Challenges* (3rd ed. 2005), and *Foreclosures* (2nd ed. 2007) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers.

NCLC has been writing about the exploding problem of predatory mortgage lending to since the 1980's. NCLC has advised and trained thousands legal services and private attorneys on litigation strategies to deal with such loans, and provided extensive testimony to Congress regarding necessary protections to be included in federal law, including the Home Ownership and Equity Protection Act, as well as recent proposals to address predatory lending. Since the passage of HOEPA, NCLC has continued to work with a broad coalition of consumer and community groups and with various federal agencies to create a comprehensive solution to abusive mortgage lending practices. These comments were written by Alys Cohen, Margot Saunders, Diane Thompson, and Tara Twomey.

[2] **Consumer Action** (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action (CA) serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. CA offers many free services to consumers and communities. Consumer Action develops free consumer education modules and multi-lingual materials for its network of more than 10,000 community based organizations. The modules include brochures in Chinese, English, Korean, Spanish and Vietnamese.

[3] **Consumer Federation of America (CFA)** is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education. Recent reports issued by CFA on mortgage lending include: *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Products for Consumers and Lender; Women are Prime Targets for Subprime Lending; and, Subprime Locations: Patterns of Geographic Disparity in Subprime Lending.*

[4] 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.

We wish to commend the staff of HUD for the comprehensive and thoughtful changes suggested in these new proposed rules to RESPA.[5] Clearly, the Department has recognized that the current state of RESPA's consumer protection is ephemeral, at best. The stated goals and orientation of the Proposed Rule are wonderful -- to protect consumers and we credit the hard work and creativity of HUD staff in the conception of this Rule. We request that the staff accept these comments in the spirit in which they are offered – as constructive assistance to help HUD in achieving its goals of creating a regulatory regime to achieve the purposes of RESPA that is truly protective of consumers.

There are several overarching concerns (and a myriad of important details) that need to be analyzed to ensure that the Rule does in fact protect consumers, instead of simply providing a shield behind which mortgage originators can hide inappropriate, unfair, and illegal activities. While the overall concepts are very good, there are still changes in the details of the rules which must be made to prevent harm to consumers, including much better harmonizing with the Truth in Lending Act and the Home Ownership and Equity Protection Act. These include:

- Many aspects of the proposal on Good Faith Estimates ("GFEs") are excellent; however, several specific provisions must be retooled:
    - Most importantly, the APR must be included instead of the interest rate and the total of settlement costs should be highlighted, rather than various subtotals.
    - The HUD-1 should be further synchronized with the GFE.
    - The closing script (or any application script, if required instead), should notify borrowers about the loan's APR and any applicable rescission rights while omitting the acknowledgement.
- The proposals to permit average cost pricing and volume based discounts only if consumers unequivocally benefit are good, but important tweaks in the language of the regulations are necessary to ensure that all charges actually imposed on the consumers are always disclosed.
- The prohibition against required use is excellent, but the regulation needs important language amendments to ensure that HUD's intentions are fulfilled.

In these comments, we attempt to comprehensively evaluate and critique all of the important recommendations HUD makes.

- In Section I, we address issues relating to the GFE, HUD-1 and Closing Script.
- In Section II, we discuss the complex questions regarding allowing yield spread premiums ("YSPs") and disclosing them.
- In Section III, we address Average Cost Pricing, Volume Based Discounts, and Required Use.
- In Section IV, we suggest additional, necessary regulations that HUD should make by regulation, as well as those HUD should recommend to Congress for statutory amendments.

[5] The Real Estate Settlement and Procedures Act ("RESPA"), 12 U.S.C. § 2601, *et seq.*

I. The GFE, the HUD-1 and the Closing Script

A. The Proposed GFE is Much Improved but Needs to Include the APR as the Key Loan Term

In its proposal, HUD has taken many important steps towards improving market transparency. The standardization of the GFE, increasing the linkages between the GFE and the settlement statement, and mandating the early provision of a binding GFE are all important. Cumulatively, all of these changes should increase consumer understanding and competition in the mortgage marketplace.

When provided in the current marketplace, GFEs – when given – often bear no relationship to the final closing costs. Some originators only provide the GFE at the closing; others give GFEs that significantly low-ball total costs. Still others provide GFEs that disclose the costs within such a wide range that there is no meaningful information exchanged. Widely different GFE forms are used; often with the result that consumers perceive fees for identical services to be different. Comparing the GFE to the final settlement statement requires perseverance and a high tolerance for detail. The variance in GFE forms, the lack of congruence between GFEs and settlement statements, and the failure to place any of these documents in consumers' hands in a final format before closing all have hindered competition in the mortgage marketplace. HUD's movement to standardization has the promise to improve the mortgage marketplace. At the very least, by standardizing the GFE, improving its comparability to the settlement statement, and requiring that some of the terms of the GFE be binding, HUD will reduce bait and switch tactics among the most unscrupulous originators.

HUD should go further in standardizing and simplifying the GFE and settlement statement. HUD must require the prominent disclosure of the annual percentage rate ("APR") on the GFE. In addition, as discussed below, without substantive regulation of yield spread premiums that permits them only in the case of no-cost loans, where homeowners can realize the potential benefits of lender-paid broker compensation, homeowners nevertheless will continue to make costly errors in purchasing home-secured credit.

Finally, to effectuate the goals of the GFE, HUD should recommend to Congress that a private right of action be added to ensure meaningful enforcement of these consumer protections.

1. The Early and Binding Provision of the GFE is Essential for Consumer Shopping

We applaud HUD for requiring that the GFE be provided early and at a uniform time in the mortgage shopping process.

For this improvement to effective, the relevant costs must be disclosed accurately and completely, consumers must be given enough time to shop, and HUD should not undermine other existing consumer protections.

HUD proposes to permit the charging of a fee for the cost of providing the GFE and a credit report.[6] This provision potentially runs afoul of both federal and state consumer protection provisions. RESPA itself forbids the charging of any fees for the preparation of the final settlement statement.[7] HUD's endorsement of a fee on the GFE, the necessary precursor to the settlement statement, undercuts this prohibition. Implicitly, authorizing the charging of a fee for the preparation of a GFE encourages lenders to pass on to consumers at the GFE stage the costs of preparing the final settlement statement. Moreover, some states prohibit the charging of any nonrefundable application fee before the credit is issued. HUD's proposal could be seen to preempt those state statutes by permitting the charging of a fee. Similarly, the model GFE has a space for the lender to fill out the amount of an application fee. Not all loans have up front application fees; it is unclear why HUD should create a presumption that the fees may be and are charged on all applications, before the credit is extended.

Accordingly, we recommend that HUD not mention any fees in relation to the GFE. The cost of providing a GFE is simply a cost of doing business, and there is no reason for HUD to encourage – and sanction – the addition of a new fee.

HUD proposes to only require that the GFE be held binding for 10 business days before a complete mortgage application is submitted.[8] This proposal does not make sense to us. This does not seem to be sufficient time for consumers to shop for a different mortgage, obtain alternative GFEs, compare them and then make the decision to return to a particular originator, particularly without requiring an interest rate lock. More importantly, it does not seem to be sufficient time even to close on the loan for which the GFE is offered.

Industry practice generally assumes that in the purchase-money context a minimum of 30 days is needed to shop for and obtain a binding mortgage commitment.[9] If an interest rate lock is required, such a short time frame might be legitimate to protect lenders from interest rate fluctuations. Without a mandated interest rate lock, however, the short time frame is useless. While interest rates might fluctuate over 30 days significantly, settlement costs are unlikely to fluctuate at all. Certainly, lenders should be able to predict the settlement costs with a high degree of certainty a month in advance. *Accordingly, the GFE should be binding for at least 30 days.*

Moreover, a GFE must include an interest rate lock. Without an interest rate lock, consumers can only shop on the settlement costs of the loan, not the interest rate. The failure to require an interest rate lock undermines the effectiveness of the early provision of the GFE. Interest is the largest component of the price of a mortgage. If interest rates are allowed to float while settlement costs are fixed, consumers are encouraged to shop on the smallest portion of

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[6] 73 Fed. Reg. 14030, 14057 (Mar. 14, 2008).

[7] 12 USC §2610.

[8] 73 Fed. Reg. 14030, 14057 (Mar. 14, 2008).

[9] *See, e.g.,* Woodbury Title Goup, The Closing Process, http://www.woodburytitle.com/page/page/2189688.htm (most mortgage contingency clauses in contracts specify 30-45 days to shop for a mortgage).

mortgage costs, the settlement costs, and lenders are encouraged to play bait and switch games with the offered interest. *To be a useful shopping tool, all costs must be fixed at the time the GFE is delivered.*

HUD, in supplementary information accompanying the proposed rule, rightly observes that whether or not the GFE application constitutes an application under the Equal Credit Opportunity Act ("ECOA") depends on Federal Reserve Board rulemaking.[10] Also implicated is coverage under the Fair Credit Reporting Act ("FCRA"), for which the Federal Reserve Board also has rule- making authority. There should be no ambiguity as to coverage under both ECOA and FCRA for the GFE application. Current definitions in both statutes and accompanying regulations cover the GFE application. Coverage of the GFE application by ECOA and FCRA is vital to ensuring binding, accurate early disclosures. The application of these two statutes limits lenders' ability to bait and switch on interest rates. If the initially offered rate is not provided, the lender is generally required to give an explanation to the consumer. HUD should coordinate with the Federal Reserve Board *to ensure* that the GFE application remains covered under the FCRA and ECOA. If the Federal Reserve Board were to exclude the GFE from coverage under ECOA and FCRA, then the interest rate disclosed to be disclosed on the new GFE would become nothing more than a fiction. Without ECOA and FCRA coverage, lenders would remain free to change—for any reason—the interest rate offered on the GFE, without notice or explanation. Interagency coordination remains important in the implementation of the early GFE.

Despite the promise of this rulemaking, it remains possible that the requirement that the GFE be delivered early in the mortgage application process will be honored more in the breach than in actuality. Without aggressive enforcement by HUD and a private right of action for consumers, as discussed below, lenders will not have sufficient incentives to make sure that consumers are supplied with shopping tools in a timely fashion. HUD assumes repeatedly that its new rules will change the marketplace and cause unscrupulous originators to become more transparent.[11] There is a fatal flaw in this reasoning: there are no teeth in the GFE's enforceability. Currently, many borrowers never receive a GFE, and many of those who do so receive it at closing. Without enforcement by consumers on both the time of delivery and the accuracy of the numbers, GFEs are likely to continue to be used as much as a tool for bait and switch as for honest competition.

[10]73 Fed. Reg. 14030, 14036 (Mar. 14, 2008). HUD also comments on the definition of application under the Home Mortgage Disclosure Act. While there are important compliance issues for lenders and public information issues relating to whether or not a GFE application triggers HMDA coverage, those issues are not the focus of these comments.

[11] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 3-58 (2008) ("[T]his table makes it more likely that . . . originators will [explain loan options] since the failure to do so might result in a bunch of questions on the topic, and a change in the loan requested, and the need to write-up a new GFE.").

2. A Standardized GFE that Focuses Consumer Attention on the Key Price Components is Critical

HUD should be praised for its extensive consumer testing of the new GFE. As a result, the new GFE is standardized and legible. It does a very good job of letting a consumer do what the GFE was designed to do: choose the cheaper loan when the difference is all in the settlement costs.

Consumers need a standardized and streamlined GFE in order to be able to shop. The current GFE provides too much information and does not point to the most important costs. Most consumers can tolerate no more than three or four decision points.[12] Compare this to the 45 separate fees listed on a single GFE reviewed by HUD in its Economic Analysis.[13] Few, if any, borrowers are able and willing to aggregate so many disparate fees. Only 13% of consumers have the quantitative literacy to add fees in order to compare prices,[14] even if they were willing and could take the time to do so. Aside from the math, borrowers have trouble just identifying fees when presented with a long list. For example, when reviewing model disclosure forms with focus groups, half of the respondents in a survey conducted for the Federal Reserve missed at least one fee charged on a sample credit card statement.[15] Similarly, in a recent survey conducted for the Federal Trade Commission ("FTC"), consumers reviewing mortgage disclosures were unable to identify or aggregate fees, although the listed fees were fewer than 20.[16]

Borrowers easily can be misled about the cost of any particular fee depending on the category the fee is assigned to and whether it is, compared to the overall transaction, a large sum

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[12] For example, most consumers in credit card shopping will only look at two pieces of information. Jinkook Lee & Jeanne M. Hogarth, *Relationships among Information Search Activities When Shopping for a Credit Card*, 34 J. Consumer Aff. 330, 340 (2000). Similarly, in reviewing credit card activity, most borrowers only look at three categories of information in evaluating the card and their continued use of the card. Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 19 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf. The three categories reported were information about payments, the account activity summary, and the transaction list. Most other information was disregarded. Some evidence suggested that even the account activity summary was largely disregarded in favor of the transaction list. *Id.* at 31.

[13] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 3-154 (2008).

[14] *See* Mark Kutner, Elizabeth Greenberg & Justin Baer, U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics, A First Look at the Literacy of America's Adults in the 21st Century 3, 4 (2005), *available at* http://nces.ed.gov/NAAL/PDF/2006470.PDF (only 13% of the adult population has quantitative proficiency; a "sample task "typical of level" is "computing and comparing the cost per ounce of food items").

[15] Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 12, 40-41 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf. Only when the researchers grouped and totaled the fees did the borrowers consistently find the fees.

[16] James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms 32-33 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.

or small sum.[17] By unbundling fees, lenders hide the magnitude of the cost of credit from consumers in at least two ways. First, depending on how the fees are characterized, consumers may intuitively place them in different categories of their mental budget—insurance and interest, perhaps. Consumers are willing to pay twice out of two separate budget items, but less happy about paying twice out of the same budget line item. Second, the fees may look small compared to the total transaction and thus are more palatable. Unbundled fees, in addition to challenging quantitative literacy skills, can evade cognitive notice altogether.[18] Consumers do not perceive the total cost if they allocate the fees to different pots. The current marketplace, where fees are listed by hundreds of different names, in a multitude of different lines, does not permit comparison shopping.[19]

Totaling and aggregation of fees is therefore critical. More totaling is better. The easier it is to shop the more likely it is that consumers *will* shop, and shop effectively.[20] We must take care, however, to make sure that we focus consumers on the important and relevant totals, not irrelevant subtotals.

Unfortunately, HUD's consumer testing neglected the relationship between two critical pricing factors: the settlement costs and the interest rate. HUD has not tested whether or not consumers can use the loan summary sheet, or the tradeoff box, or any other element of the proposed GFE, to determine which of two loans that vary by more than settlement costs—by interest rate, term, or loan features—is cheaper or otherwise more desirable. What HUD tested was consumer's ability to choose the loan with the lower settlement costs when the two loans are otherwise comparable. Unfortunately, most loans in the market will vary by more than the total settlement costs. Any two loans offered a consumer are likely to vary by the interest rate, the amortization schedule, the term of the loan, whether the rate is fixed or adjustable, and a myriad of other factors, all of which affect the overall price. While the simplified, standardized GFE

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[17] Reid Hastie & Robyn M. Dawes, *Rational Choice in an Uncertain World: The Psychology of Judgment and Decision Making* 222-24 (2001).

[18] *See* Macro International, Inc., Design *and Testing of Effective Truth in Lending Disclosures* at vii (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (consumers do not notice cumulative effect of paying small amounts of fees every month); Richard H. Thaler, *Mental Accounting Matters,* 12 J. Behavioral Decision Making 183, 194 (1999) (small disaggregated fees ignored).

[19] The National Consumer Law Center has collected and analyzed over 981 settlement statements. The settlement statements tend to be more uniform than the GFEs, but even among the settlement statements there is wide disparity. On the 981 settlement statements analyzed, there were 326 different fee names used in the 800 series, 221 different fee names in the 1110 series, and 133 different fee names in the 1300 series. The same fees were reported with different names and on different lines more often than not. Nat'l Consumer Law Ctr., *Lenders' Use of the HUD-1 and HUD-1A Settlement Statements: An Early Analysis of Data from the National Mortgage Data Repository 3-4* (Aug. 2007). HUD's analysis of 3000 settlement statements from five metropolitan areas, shows comparable divergence, with over 130 different fee names in the 800 series and nearly 200 different names in the 1100 series. Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., *RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 3-155 – 3-159* (2008).

[20] As Herbert Simon points out, the easier it is to discover a satisfactory solution, the higher the standard for an acceptable solution becomes. Herbert A. Simon, *A Behavioral Model of Rational Choice,* 69 Q. J. Econ. 99, 111 (1955). *See also* Yu-Chun.Regina Chang & Sherman Hanna, *Consumer Credit Search Behavior*, 16 J. Consumer Studies and Home Economics 207 (1992) (consumers seek a solution that meets minimum requirements without expending too much energy).

and the tradeoff table do a good job of aggregating most of that key information, HUD has done no testing to see whether consumers can, on average, using the GFE, determine which of two loans is cheaper or which better fits individual circumstances.

The standardization of the GFE will promote consumer shopping and facilitate market transparency. To ensure that the GFE is useful and not misleading to consumers, HUD must make the following further revisions:

- *Replace the interest rate disclosure on the GFE with the APR.*
- *Provide only the earliest date on which the interest rate can rise, not the maximum (while retaining disclosure of the maximum payment—a key price measure for consumers).*
- *Reduce the focus on settlement costs, by reducing the font size and eliminating the bold for settlement costs.*
- *Only provide a total for all settlement costs on the first page of the GFE, without breaking out the origination costs.*
- *Provide guidance to originators as to the calculation of the maximum payment and maximum loan balance.*

a. Consumers Should Not be Encouraged to Shop Primarily on the Settlement Costs Alone, as They are only a Small Portion of the Overall Cost of the Loan

Consumers do not currently shop on settlement costs. Partly as a result, settlement costs are inflated and arbitrary. In its laudable effort to correct this deficiency, the reworked GFE focuses attention on the settlement costs. The problem is that for most loans settlement costs are not the primary cost factor: interest is.

The proposed GFE gives far greater prominence to settlement costs than to interest. If the GFE is successful in getting consumers to shop on settlement costs, there is a real risk that consumers will neglect the primary cost component of loans, interest. Lenders would have an incentive to boost up interest prices while holding settlement costs low. If consumers, sensibly enough, continue to shop on the largest cost, the interest rate, lenders and settlement agents are likely to continue to manipulate settlement costs and other upfront fees to maximize their returns. Neither result serves HUD's intention of increasing transparency in the market.

The new GFE very likely will encourage consumers to shop based on the total closing costs. The prominence given to the total settlement costs will highlight the importance of the closing costs at the expense of the other loan terms (such as interest rate, existence of a balloon payment or prepayment penalties). In addition, the settlement costs, expressed as a dollar amount and in relatively low numbers, may become more significant for some consumers.[21] That may not be a good thing, given that interest continues to make up the major cost and the largest price differential between any two loans. Expensive settlement fees may be 10% of the loan amount. High cost interest may be five to six times the loan amount. Consumers should not be encouraged to shop on settlement costs at the expense of paying more in interest.

Settlement costs do matter. They matter most, however, not as a stand alone cost but in relation to the interest rate. When the costs are split, lenders can manipulate either fees or interest to boost the total cost while concealing the total cost from the borrower.[22]

While the focus of RESPA is to regulate settlement costs, HUD should not permit itself to produce disclosures that are misleading or that obscure the actual cost of credit. To the extent that the Federal Reserve Board and HUD can work together toward this end, the final product will far better meet consumers' interests and needs.

b. The GFE Should Provide Consumers With a Uniform Price Comparison Tool: the APR

HUD is focused on reducing costs for consumers and facilitating shopping. The APR, in the mortgage market, is a necessity to achieve those goals.

The APR is the only apples-to-apples shopping metric in the mortgage market.[23] Its consistent use reduces the cost of consumer credit.[24] Consumers look for and rely on the APR when shopping. In 2000, ninety-one percent of the population was "aware" of the APR.[25] More than seventy percent of the population reports using the APR to shop for closed-end credit.[26] Seventy-eight percent of homeowners who refinanced their homes report comparison shopping on the basis of the APR.[27]

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[21]Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 Md. L. Rev. 707, 781-82 (2006).

[22]*Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24-2-43* (2008).

[23]*See, e.g.,* Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (2008).

[24] *See* Victor Stango & Jonathan Zinman, *How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets* 3-4, Sept. 5, 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956 (in markets where TILA disclosures made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures not made reliably, same consumers pay 200-400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree).

[25] Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, Fed. Res. Bull., 623, 631 (Sept. 2000), http://www.federalreserve.gov/pubs/bulletin/2000/0900lead.pdf.

[26] Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. Pub. Pol'y & Marketing 66, 74 (1999)

[27] Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else?*, 9 Fin. Services Rev. 277, 286 (2000).

If HUD wishes to facilitate consumer shopping for mortgages, *HUD must mandate the inclusion of the APR on the GFE.* Interest rates are not as useful and can undermine the disclosure of the APR.

Interest rates, while reflecting the largest cost of credit, do not bundle all costs. Reliance on an interest rate in shopping can result in taking out the more expensive loan overall. Depending on the term of the loan, the fees, and how the rate is stated and calculated, interest rates can be inherently misleading and deceptive and quite often are not comparable with each other.[28] Moreover, interest rates do not control for the term of the loan.

Unlike interest rates, the APR takes the total cost of the loan, including fees and the time cost of money, and scales that cost to the size and term of the loan. The APR bundles the fees with the interest rate and standardizes the rate over an annual term. Thus, a shopper can tell whether a 15 year loan is cheaper than a 30 year loan by looking at just one number, no matter how many fees the lender has piled on at origination.

In recent years, the marketing of payment option ARMs has underscored the need for uniform disclosure of and reliance on the APR and the problems with the use of interest rates in disclosure. Payment option ARMs are typically advertised as, for example, "a 2% fixed rate" even though this rate may be fixed for no more than a day.[29] The APR, while it does not entirely reflect the risk of upwards adjustments in the interest rate, given problems with how it is calculated,[30] at least reduces the distortion, by requiring that the rate disclosed be a composite rate.[31] Composite rates reflect both an initial low rate and the rate that would be in effect but for the initial teaser rate.

Consumers cannot do the math to determine which of two loans is cheaper, given different rates, different fees, and different terms. The APR solves that problem and permits

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[28] *See generally* Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Slight of Hand: Salience Distortion of American Credit Pricing Limits*, Minn. L. Rev. (forthcoming 2008).

[29] *See, e.g.,* Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007) (describing payment option ARM sold as having a fixed rate, when interest varied monthly; fixed rate is the payment rate); Complaint at 4, Fed'l Trade Comm'n v. Chase Financial Funding, Inc., No. SACV04-549 (C.D. Ca. 2004), *available at* http://www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (adjustable rate mortgage with initial minimum payment, based on interest at 3.5% amortized over 30 years, which results in negative amortization, since actual interest rate is much higher, advertised as "3.5% fixed payment 30 year loan."); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006), *available at* http://www.gao.gov/new.items/d061021.pdf (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%; interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page).

[30] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Legis. 123, 143-44 (2007) (discussing limitations of variable rate disclosures in detail).

[31] 12 C.F.R. §226.17, Official Staff Commentary, §226.17(c)(1)-(10).

consumers to shop intelligently and efficiently. Failing to include the APR on the GFE obscures the cost of credit and hinders consumer shopping.

It is no answer to suggest that consumers can rely on an early TIL disclosure for the APR. Originators are only required to provide an early TIL disclosure in the case of a purchase money mortgage.[32] Even when the early TIL disclosure is provided, there is no penalty for providing an inaccurate TIL disclosure, whether accidentally or intentionally. As a result, many of the early TIL disclosures actually provided in the current marketplace are misleading.

Moreover, if the GFE is to have its maximum effect, it should be the single shopping tool for the mortgage. If consumers have to use multiple sheets to shop, the usefulness of the GFE is considerably diluted. Permitting multiple summary sources of critical information virtually guarantees that some consumers will ignore one or the other source. Ignoring the settlement costs and key loan terms reflected on the GFE would be undesirable. Ignoring the APR would be disastrous in most cases. Thus, if the GFE is to be used for shopping, *disclosure of the actual APR must be mandated by HUD.*

c. The Summary Sheet, by Collecting Key Loan Terms in One Place, is an Important Advance in Consumer Disclosure

Using a loan summary sheet is a terrific advance. As HUD recognizes, consumer shopping is facilitated when loan information is condensed and summarized. Placing the most critical information in consumers' hands in a consistent, user friendly format should facilitate consumer shopping, market competition, and transparency. Loan terms matter as much or more than settlement costs and origination fees. Loan features will in the end affect more to consumers than settlement costs.

More important than tolerances on settlement costs, whether individually or in the aggregate, is binding lenders to the rate and terms offered. The big surprises at closing are often a change in loan terms, from fixed to variable, for example, or an increase in the rate. HUD is right to be concerned with fees; HUD should also be concerned with the terms of the loan.

In the ever-spiraling complexity of the mortgage market, consumers need standard signposts in order to avoid fraud and deception.[33] Any two loans offered a consumer will vary by the interest rate, the amortization schedule, the term of the loan, whether the rate is fixed or adjustable, and a myriad of other factors, all of which affect the overall price and risk for the consumer. On the whole, the loan summary sheet strikes a reasonable balance between disclosing the critical information and preventing information overload.

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[32] 15 U.S.C. §1638(b)(2).

[33] *Cf.* Burrows v. Orchid Island TRS, LLC, 2008 WL 744735 (S. D. Cal. Mar. 18, 2008) (broker advertises "lower monthly mortgage payments" and promises perfect loan while refinancing homeowner from low fixed-rate fully amortizing loan to high-rate negatively amortizing loan).

i. Consumers Will Use the Disclosure of the Maximum Payment and Maximum Loan Balance on the Loan Summary Sheet to Weigh the Interest Rate Risk of Various Loans

We applaud HUD's inclusion of the maximum payment amount and maximum loan balance amount in the loan summary. In these days of increasingly exotic and toxic products, these two pieces of information are critical for consumers. HUD's insistence that the amounts be disclosed in loan specific dollar amounts is critical. Consumers must be presented with the risks of their actual loans in terms they can understand and that are relevant to them.

The maximum balance and maximum payment must be disclosed –

- *in dollar amounts;*
- *at the actual maximum possible under the note terms.*

Most borrowers use their monthly payment as a proxy for the loan's affordability and for their interest rate exposure.[34] Unlike rates or total payments on the loan, consumers intuitively understand monthly payments.[35] Monthly payments are stated in dollar amounts. Those dollar amounts mean something to consumers in their budgets. Moreover, the scale of the maximum monthly payment is within the daily experiences of most borrowers. Maximum monthly payments are large numbers, but not so large as to lose all meaning for borrowers. The maximum payment, for many borrowers, is the key number for measuring a loan's affordability. Monthly payments are not, of course, a perfect disclosure of the interest rate risk of the loan; but the maximum monthly payment reflects in real terms that consumers can understand the worst case scenario and allows consumers to evaluate their own risk tolerance.

HUD is right to include the mortgage insurance in the maximum payment. Mortgage insurance, for non-FHA loans, varies depending on the originator. It is also part of the finance charge. And mortgage insurance can be avoided if the loan amount is less than 80% of the value of the home. Since lenders' fees often push the total of the loan over this limit, the price of mortgage insurance should be included in the comparable maximum monthly payment.

HUD should provide further guidance in the instructions for completing the GFE on how to calculate the maximum payment. The maximum payment should not, for example, be calculated

[34] *See* Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., *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, 788-789 (2006).

[35] *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 Md. L. Rev. 707, 781-782 (2006). Consumers often have trouble intuitively understanding large numbers, particularly when those large numbers do not need to be paid until well into the future. Rates, while extremely important for comparative purposes, are less helpful when borrowers want to manipulate the numbers and determine their actual payment amounts. Most consumers have trouble performing even simple mathematical operations using percentages. Leda Cosmides & John Tooby, *Are Humans Good Intuitive Statisticians After All? Rethinking Some Conclusions from the Literature on Judgment Under Uncertainty*, 58 Cognition 1, 18 (1996); Justin Kruger & Patrick Vargas, *Consumer Confusion of Percent Differences,* J. Consumer Psychol. (forthcoming 2008), *available at* http://ssrn.com/abstract=946238 .

in accordance with the TIL payment disclosure rules, as those rules are not based on the maximum interest charged under the loan but only on the fully indexed rate.[36] The maximum payment disclosed should be the maximum regular payment that could result through the application of the terms of the note. *For most ARMs, the maximum payment should be calculated by applying the maximum interest rate permitted by the note at the remaining principal balance, assuming payments will be made as agreed under the note on the earliest date that the maximum interest rate could increase.*

For payment option ARMs, the maximum payment depends on the interplay between the permissible amount of negative amortization, the highest interest rate, and the latest date at which the payments become fully amortizing. The maximum payment for payment option ARMs is triggered when the maximum interest rate is applied to the maximum loan balance for the shortest duration. This will happen when the onset of fully amortizing payments is delayed as long as possible, but still after reaching the maximum loan balance.[37] For most payment option ARMs, the maximum payment should be calculated applying the maximum interest rate to the maximum negative amortization after the longest permissible period of time for non-fully amortizing payments, typically five years. In all circumstances, HUD should require that the highest possible principal and interest payment that could ever be incurred under the note be disclosed, however calculated.

In general, negative amortization loans require substantive regulation rather than disclosure. The maximum loan balance is less intuitive for most consumers than the maximum payment. The consumers we encounter with negative amortization loans are almost always indignant when they discover that, despite regular payments, their principal balance has not declined. It is not clear that any disclosure of negative amortization can effectively alert consumers to the risks posed by negatively amortizing loans.

Nonetheless, given the danger that negative amortization loans pose for consumers, including increased risk of foreclosure, disclosure, in the absence of substantive regulation, is imperative. We applaud HUD for recognizing that disclosure of the possibility of negative amortization is too abstract to be useful to consumers: as with maximum payments, disclosure of the loan specific, dollar amount of the maximum balance is necessary to permit consumers to evaluate and compare the risks of two different loans when shopping.

[36] The fully indexed rate is only the combination of the relevant index at the time of closing plus the margin given in the note. For the purposes of APR calculation, the time of closing includes the date of closing and a prior period equal to the period in the note from the date on which the index is determined to when the changed interest rate goes into effect. Consider, for example, the fully indexed rate on a loan written at the end of May, 2008, which uses the six month U.S. LIBOR rate, with a margin of 5%, would use an index of 2.86%, which would result in a fully indexed rate of 7.86%. Yet, the maximum rate allowed by the loan would more likely be 12%. The effect on the payments would huge. On a 30 year loan for $150,000, the fully indexed rate would produce a payment of $1086, yet the maximum payment would be $1543. 12 C.F.R. §226.17, Official Staff Commentary, §226.17(c)(1)-(10)(i).

[37]This illustrates one of the cognitive difficulties consumers face in evaluating the riskiness of these new complicated products. Most consumers, as discussed above, will evaluate the cost of the loan based on the maximum payment. But for payment option ARMs, the maximum payment does not correspond to the most costly loan—since it will be more costly over the term of the loan to have a higher interest rate applied for a longer period of time.

For most loans that permit negative amortization, the maximum balance calculation is fairly simple. There is usually a cap, expressed as a percentage of the original loan balance, which limits the negative amortization. *HUD should require that the dollar amount of that cap be disclosed as the maximum loan balance.*

ii. Consumers Should Be Told The Earliest Date on Which Their Interest Can Rise

Particularly with payment option ARMs, interest rate rises can take consumers by surprise. It is not uncommon for payment option ARMs to be advertised as fixed rate loans when their teaser rate is a month, or even just a single day.[38] Disclosing the earliest date the interest rate could rise should serve as an important warning flag of otherwise undisclosed interest rate risk consumers are incurring.

iii. The Summary Sheet Should Shift the Focus From Settlement Costs and Interest Rate to the APR

The summary sheet should be changed in the following ways:

- *The reference to initial interest rate should be replaced with APR.*
- *Instead of asking if the interest rate can rise, and providing a maximum that the rate can rise to, ask if the rates can rise and provide the earliest date on which the rate can rise.*
- *Provide only a total of the estimate settlement charges, not separate lines for the origination and total settlement costs.*
- *Remove the bolding and highlighting from the total estimated settlement charges and reduce the font size to match the rest of the sheet.*

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[38] *See, e.g.,* Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007) (describing payment option ARM sold as having a fixed rate, when interest varied monthly; fixed rate is the payment rate); Complaint at 4, Fed'l Trade Comm'n v. Chase Financial Funding, Inc., No. SACV04-549 (C.D. Ca. 2004), *available at* http://www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (adjustable rate mortgage with initial minimum payment, based on interest at 3.5% amortized over 30 years, which results in negative amortization, since actual interest rate is much higher, advertised as "3.5% fixed payment 30 year loan."); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006), *available at* http://www.gao.gov/new.items/d061021.pdf (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%; interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page).

B. Early Provision of the Settlement Statement, in a Form Comparable to the GFE, Is Essential for Consumer Shopping and Enforcement of Consumer's Rights, But Must Be Done Carefully In Order to Not Undercut the TILA

HUD's proposal to require the provision of the settlement statement three days before closing should be enacted. This requirement must be widely publicized and enforceable. The burden should be shifted to the closing agents and lenders to provide automatically the settlement statement before closing. Only consumers who are both knowledgeable and consistent are currently able to see the final settlement statement before closing. The HUD-1 should be easily comparable to the GFE and should facilitate, rather than hinder, TILA and HOEPA compliance.

1. HUD Has Taken an Important First Step in Making the Settlement Statement and the GFE More Comparable and Should Go Further

Referencing the GFE lines on the settlement statement is an important step. However, HUD should mandate a summary settlement sheet that corresponds exactly to the summary sheet of the GFE. This would obviate the need for a cross walk between the GFE and the settlement statement. Consumers would then be able to compare the total numbers and see at a glance if the aggregate fees had increased or, even more importantly, whether the loan terms had been changed.

2. Final Settlement Statement Must Provide Detailed Information of Actual Fees Charged to Ensure Compliance with the Truth-in-Lending Disclosure Requirements

The revision of the settlement statement, important as it is, must not undermine the enforceability of the TILA. Enforcement of the Truth in Lending Act ("TILA") and the Home Ownership and Equity Protection Act ("HOEPA") depend on full itemization of settlement costs. Remedies for the violation of TILA and HOEPA can include significant statutory damages and the right to rescind the loan, with the result of saving a home from foreclosure. In transactions to which RESPA applies, TILA rules say that the lender need not give an itemization of the amount financed if it provides both the GFE and settlement statement.[39] The itemization of the amount financed is essential for regulators, consumers, and their advocates to determine if TILA's fundamental disclosures—the APR, the finance charge, and the amount financed—were made correctly. Mortgage lenders consistently use the GFE and settlement statement as a replacement for the itemization of the amount financed.

HUD proposes to require lenders to disclose as a lump sum their origination charges and all title services.[40] This is certainly an improvement from the perspective of consumer understanding. However, not all origination services and title services are clearly all-in or all-out

[39] Official Staff Commentary on Regulation Z, § 226.18(c)-4.

[40] 73 Fed. Reg. 14030, 14058 (Mar. 14, 2008).

of the TILA finance charge. Under the statute, for example, title insurance is excluded from the finance charge.[41] Other charges related to title insurance, including the settlement fee, courier fees, or document preparation fees, may be included in the finance charge, however, particularly if they are not bona fide and reasonable.[42] Similar inconsistencies plague other origination fees. *Absent coordination with the Federal Reserve Board on a more useful and expansive definition of the finance charge, and statutory changes to the TILA itself, the final settlement statement must not bundle either all title or origination charges*. Moreover, itemization of all title services should be included on the GFE and not just the HUD-1, so that consumers are aware of the variety of fees. Like mortgage insurance, reverse competition in this area is extensive and disclosure could provide some limit to these abuses.

Effective disclosure of costs requires bundling of all closing costs. However, the Federal Reserve Board has allowed the finance charge to become debundled.[43] As a result, HUD's improvement of disclosure in the settlement context could impede review of lender's compliance with the disclosure requirements of TILA.

C. The Closing Script Could Be Useful to Consumers if Done in Accordance with HUD's Intention, but the Script Risks Abuse

As demonstrated by HUD's consumer testing, consumers like and benefit from an oral explanation of their loan terms at closing.[44] Such information is seldom forthcoming at current closings. If the requirement were taken seriously by closing agents, it could impede the rushed closings that many consumers, particularly in the subprime market, experience and facilitate a better opportunity for consumers to understand some of the important features of their loans.[45]

However, the closing script has two critical omissions: the APR and notice of the consumer's three-day right of rescission for non-purchase money mortgage transactions. The failure to mention and correctly explain the right of rescission in the closing script will undermine the clear and conspicuous disclosure of the right of rescission as required by TILA. Again, this is another area where coordination with the Federal Reserve Board regulation of TILA is essential.

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[41] 15 U.S.C. § 1605(e)(1).

[42] *See generally* National Consumer Law Center, Truth in Lending §§ 3.9.5, 3.9.6 (6th ed. 2007.)

[43] *See, e.g.,* Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (2008).

[44] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 3-46 (2008).

[45] *Sprague v. Household Intern.*, 473 F. Supp. 2d 966, 972 (W.D. Mo. 2005) (describing closings of real estate loans in less than ten minutes at fast food restaurants and delis).

Moreover, given the wide history of fraud by closing agents,[46] HUD should take care when providing a seal of approval to the oral statements of any closing agents. HUD may be able to prescribe the words, but it is unlikely to be able to monitor the tone in which they are delivered, or whether those exact words actually were used. Two alternative scenarios are possible. In one case, a closing agent may rush through the script and downplay its importance: "This is just something the government makes me say." In another case, a closing agent could say, "You can trust me. What I am telling you has been approved by HUD. This is a government approved loan." Neither scenario results in the transparency envisioned by HUD. Both could exacerbate existing problems of misplaced trust in the settlement process.

It is not clear how delivery of the closing script would be enforced. Consumers might have a private right of action for deception under state law, but settlement agents routinely have consumers sign an acknowledgement that the settlement agent is not the borrower's agent and that the borrower agrees to indemnify the settlement agent for any misstatements. HUD should clarify that both the lender and the closing agent are responsible for ensuring the good faith delivery of the closing script and that borrowers have a right to rely on the accuracy of the closing script. Absent enforceability and clear direction from HUD, the closing script may be abused or not delivered as often as it is given in a helpful manner to borrowers. Current RESPA compliance failures make this possibility likely.

The closing script could be used by both closing agents and lenders to absolve themselves of responsibility for misrepresentation. In this respect the acknowledgment is particularly troubling. Unscrupulous or simply harried closing agents may be tempted to add the acknowledgment page to the stack of documents a borrower signs at closing with no more than a hurried, "sign here." Regardless of whether there were inconsistencies or whether or not they were explained, lenders and closing agents are likely to use the acknowledgment as a safe harbor, absolving them from all responsibility for abusive practices. The acknowledgement of the closing script could be used against borrowers.

For the closing script to function as envisioned by HUD, at a minimum make the following changes must be made:

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[46]*See, e.g.,* Nationwide v. Echeverria, 725 N.W.2d 659 (Iowa App. 2006) (title company disbursed loan proceeds to seller although seller did not have title to property and outstanding mortgage lien on property); Matter of Harris, 2006 NY Slip Op 9317 (N.Y. App. Div. 2006) (attorney disbarred after being sentenced to 18 years in prison and restitution of $100,000 in property flipping scheme); United States v. Lutz, 2006 WL 3716581 (4th Cir. Dec. 14, 2006) (upholding "willful blindness" instruction to jury when evidence showed that closer concealed the property flip from lenders by disguising loan disbursements and concealing rapid transfers of property); United States v. Wilkins, 2007 WL 896147 (E.D.Tenn. March 22, 2007) (title company explained two HUD-1s to buyer, including fact that buyer was making a false statement);American Title Co. of Houston v. Bomac Mortg. Holdings, L.P., 196 S.W.3d 903 (Tex.App. 2006), *review granted, judgment vacated, and remanded by agreement* (Mar. 16, 2007) (discussing title company alteration of HUD-1 and title report to conceal source of down payment and flip of property); David Cho, *Housing Boom Tied to Sham Mortgages, Lax Lending Aided Real Estate Fraud,* Wash. Post., Apr. 10, 2007, at A1 (closing attorneys convicted as accomplices in large property flipping scheme) United States. v. Sloan, 505 F.3d 685 (7th Cir. 2007) (reviewing restitution order entered against paralegal who participated in property flipping scheme with attorney-employer).

- *Delete the acknowledgement.*
- *Require the APR to be disclosed.*
- *Require the notice of the right to cancel be disclosed, where applicable.*
- *Clarify that lenders are responsible for the accurate delivery of the closing script.*
- *Clarify that settlement agents also are responsible to the borrower for the accurate delivery of the closing script.*

II. The Yield Spread Premium Disclosures, While an Improvement, Are Inadequate to Reduce the Abuses HUD Has Identified

Lender-paid broker compensation, as HUD describes, leads to higher settlement costs and higher broker costs, as well as higher interest rate costs.[47] In most circumstances, borrowers receive little, if any, benefit from lender-paid broker compensation. Even worse, lender-paid broker compensation appears to drive racially disparate pricing. Only where the fees are either all in or all out of the rate are consumers able to shop successfully for the cheapest loan. When consumers can compare loans with the fees all in or all out, they are comparing loans with a limited number of variables. On the one hand is a loan with a particular rate and all fees required to be paid by the borrower – which would have to come from either cash or the home equity (meaning that the fees would be paid for in the loan, and more would be borrowed). On the other hand is the same loan with all of the fees paid through the interest rate – so no additional cash would required from the borrower and the loan amount would not have to be increased to cover the closing costs -- yet the interest rate would be slightly higher. The latter loan is often called in the industry a "no-cost loan." This is somewhat of a misnomer because there are fees charged on these loans, only they are paid by the lender, who then charges a higher interest rate.

There are multiple benefits for "no-cost loans." These include the obvious – the retention of precious cash and equity by the borrower – as well as the lesser known finding that "no-cost" loans actually result in a significant reduction of all closing costs as compared to other loans.[48] *However, the key to achieving this reduction is that the lender pays ALL of the fees.* The use of a combination of methods of payments – cash or home equity from the borrower plus lender paid broker compensation – has just the opposite effect: an increase in the closing costs and loan costs.

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[47] Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-24 - 2-43 (2008).

[48] Borrowers who use "no-cost" loans and so can shop on interest rate alone pay $1,200 less than borrowers who pay some lender or broker fees in cash. This suggests that consumers have a tougher time comparing alternatives when trade-offs are involved and that mortgage loan markets are not fully transparent or competitive. Susan Woodward, *A Study of Closing Costs on FHA Mortgages,* U.S. Department of Housing and Urban Development, Office of Policy Development and Research. (2008.), available at http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf.

Disclosing lender-paid broker compensation is difficult. Most disclosures of lender-paid broker compensation are likely to confuse consumers, both because the tradeoffs are inherently complex and because borrowers are led to believe erroneously by both brokers and originators that brokers act as the borrowers' agents. We concur with HUD that the yield spread premium should not be disclosed on a separate agreement. We share HUD's concerns that a separate agreement is likely to cause confusion to borrowers. We agree that the impact of any permissible yield spread premium must be clearly disclosed on the GFE. However, HUD's use of the term "credit" to describe the lender-paid broker compensation, in the absence of substantive regulation that limits total fees, is misleading. Empirically, when there is a mix of both borrower-paid and lender-paid broker compensation, the total of all fees *increases*. When there is this combination of methods of payments, there is not a one-for-one reduction in the borrower's costs, as the common understanding of the word "credit" would convey.

Lender paid broker compensation, when combined with borrower paid closing costs, is particularly troubling because it contributes to the widespread disparities in the pricing of home mortgage loans between whites and African Americans and Latinos. These disparities exist at every income and credit level and increase as income and credit levels increase.[49] In other words, the wealthiest and most credit worthy African Americans and Latinos are, compared to their white counterparts, the most likely to end up with a subprime loan. The origination channel—whether or not a loan is brokered—accounts for most of the difference in pricing.[50]

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[49] *See, e.g.,* Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2006 HMDA Data,* Fed. Reserve Bull. A73, A97 (2007), *available at* http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf (in 2006 and 2005, African Americans and Hispanics who received higher cost loans, on average, after accounting for borrower characteristics and lender, paid 20 and 10 basis points more, respectively, than white borrowers also in the subprime market); *see also* 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, 417 (2007) (in 2005, African Americans and Hispanics who received subprime loans paid, on average, 50 and 17 basis points more, respectively, than whites in the subprime market); Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 11 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf *see also* Jim Campen, *Borrowing Trouble VII: Higher-Cost Mortgage Lending in Boston, Greater Boston and Massachusetts, 2005* at 8 (Mass. Community & Banking Council, Jan. 2007), *available at* www.masscommunityandbanking.org (highest income Latinos received high-cost home purchase loans at 6 times the rate of the highest income whites; highest income African Americans 7.6 times to receive a high-cost home purchase loan than highest income whites); Geoff Smith, Woodstock Institute, Key Trends in Chicago Area Mortgage Lending: Analysis of Data from the 2004 Chicago Area Community Lending Fact Book 10 (2006) (African-Americans and Hispanics more likely to receive high-cost loan than white borrowers, disparity increases as income increases); Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States*, 88 Geografiska Annaler, Series B: Human Geography 105 (2006) (finding geographic racial disparities in lending in Baltimore that cannot be explained by income); Stephanie Casey Pierce, Racial Disparities in Subprime Home Mortgage Lending: Can the Difference Be Explained by Economic Factors? (2006) (unpublished M. Pub. Pol'y thesis, Georgetown University), *available at* http://www.dspace.wrlc.org/bitstream/1961/3612/1/etd_smc54.pdf (a survey of 2004 HMDA data from Louisiana found that blacks were 13.82% more likely than whites to receive a high cost, first lien purchase loan); *cf.* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A138 (2006) (piggyback loans more common in minority census tracts, even holding income constant), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

[50] *See* Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2006 HMDA Data,* Fed. Reserve Bull. A73, A96 (2007), *available at* http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf (pricing disparities

Lender-paid broker compensation creates the incentives that drive much of the racially disparate pricing.[51] By encouraging brokers to overprice loans where and when they can, lenders implicitly encourage brokers to target the vulnerable and gullible and those perceived as vulnerable and gullible. Most borrowers naively believe that their lenders will give them the loan they qualify for, and are insufficiently on their guard in dealing with brokers. African Americans and Latinos are particularly likely to believe that lenders are required to give them the best rate for which they qualify. [52]

The mechanics and extent of lender-paid broker compensation reach beyond simply overcharging African-American and Latino borrowers. Lenders use broker compensation to lock African-Americans and Latinos into downwardly mobile borrowing and destructive products. For example, lender payments to brokers are often conditioned on the borrower's acceptance of a prepayment penalty.[53] Thus, brokers have an incentive not only to put borrowers into a high cost loan in order to receive additional compensation from the lender, but to make sure the borrower is locked into the high cost loan. Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest.[54]

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between whites and minorities highest for broker originated loans); Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A157-58 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (same); 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* http://www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf (same); *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, 400 (2007) ([M]uch of the explanation for why minority borrowers tend to have higher APRs than non-minority borrowers is because minority borrowers disproportionately take out subprime loans."); William Apgar, Amal Bendimerad & Ren S. Essene, Joint Ctr. for Housing Studies, Harvard Univ., Mortgage Market Channels and Fair Lending: An Analysis of the HMDA Data 27, 37 (2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-2_mortgage_market_channels.pdf (white borrowers 50% more likely than African American borrowers to get a loan from a CRA-regulated entity within its CRA assessment area; failure to get a loan from a regulated institution within its catchment area increases the cost of the loan).

[51]Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21-23 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives); *see also* 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* http://www.oag.state.ny.us/press/2006/dec/dec05a_06.html (pricing disparities between whites and minorities highest for broker originated loans).

[52]Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* http://www.trfund.com/policy/pa_foreclosures.htm , *citing* Fannie Mae's 2002 National Housing Survey.

[53]*See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (noting that payment of yield spread premiums is often conditioned on the imposition of a prepayment penalty).

[54]Loans with prepayment penalties attached have higher rates of foreclosure, and in brokered loans, borrowers generally receive no interest rate reduction in exchange for the imposition of the prepayment penalty. *See, e.g.,* Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan

HUD's Economic Analysis is an eloquent and persuasive analysis of the systematic inefficiencies caused in the mortgage market by lender-paid broker compensation. While the tradeoff table, although relatively untested, appears promising, HUD's overall proposal fails to address the defects HUD identifies. Labeling lender-paid broker compensation as a borrower credit is unlikely to make it so and poses problems for monitoring TIL compliance. Moreover, despite extensive testing of the proposed GFE, HUD has not actually tested whether or not the proposed GFE or the tradeoff table will aid borrowers in selecting the best loan for them when the interest rate or loan terms vary. Disclosure by itself is unlikely to remedy the systematic abuses of lender paid broker compensation HUD identifies.

A. Lender Payments to Brokers Should Not Be Characterized As a Credit

Describing lender-paid broker compensation as a credit used to reduce settlement costs is inherently misleading. There is no requirement that the lender payment will actually be used in that manner. HUD describes in detail much of the data that indicates that consumers get widely variable discounts on the closing costs in exchange for a yield spread premium.[55] Nothing in the proposed rule requires that brokers only be compensated through a yield spread premium or that the lender payment to the broker be offset against the total broker price charged to the borrower. Merely having the lender payment shown as a borrower credit to reduce the settlement costs will not make it function that way: brokers can still charge borrowers a separate or increased fee.

It is simply not true, as HUD proposes to emblazon on the GFE, that a lender-paid broker payment reduces upfront costs. In most cases, according to studies HUD cites, lender-paid

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Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf (finding that prepayment penalties were associated with higher interest rates unless they controlled for "borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate," in which case the difference shrank); s*ee also* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

[55]U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-25 - 2-48 (2008).

broker payments actually increase upfront costs.[56] Borrowers in controlled circumstances using the new GFE may understand that lender-paid broker compensation reduces their settlement costs. But this is at best a gross simplification; in most cases it crosses the line from simplification to distortion and deception.

The treatment of the lender payment to the broker as a credit also potentially complicates TIL review. Without guidance from the Federal Reserve Board, it is not entirely clear what effect treating the lender paid broker compensation as a borrower credit will have on the central TIL disclosures, the finance charge and the APR. The credit should be treated as an additional down-payment that reduces the principal loan amount but is otherwise neutral as to the calculation of these central disclosures. Yet without guidance from the Federal Reserve Board, the use of the word "credit" opens up a litigation minefield and likely increases costs for all parties.

A more honest and transparent disclosure would replace the language about an interest rate credit in paragraph 2 of the loan details on page 2 with the following:

MORTGAGE BROKER COMPENSATION	
Mortgage Broker Fees (see line 813 on GFE)* paid by borrower directly (included in settlement charges listed above):	$_____________
+additional fee received by broker from lender and paid by borrower through increased loan interest rate:**	$_____________
Total Broker Fees:	$_____________

The problem is not that brokers are paid out of the interest rate: the problem is that brokers are paid both out of the interest rate and out of pocket (or equity). Most consumers simply cannot aggregate interest and fees to be able to compare the cost of credit of these two loans. HUD recognizes the costs borrowers incur when borrowers must shop both on fees and rate.[57] Yet the proposal would substitute *disclosure* for substantive regulation. If HUD were to require – as part of its regulation under RESPA's section 8 (12 U.S.C. Section 2607) – that lender paid fees be actually credited to borrower's previously enumerated costs, then this mechanism might work as HUD envisions. But simply requiring a disclosure would not make the lender paid fee provide a reduction dollar for dollar to the borrower.

[56] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-25 - 2-48 (2008).

[57] *Id.*

B. The Tradeoff Table, By Providing Comparable Loan Specific Information, Should Increase Consumers' Ability to Choose How Their Loan is Priced

The tradeoff table is an important innovation and should be useful to many consumers. Lender-paid broker compensation is currently poorly disclosed and poorly understood.[58] Existing disclosures are general, not specific, and lack meaning for most consumers. As a partial result, lender-paid broker compensation results in higher total broker compensation and higher total settlement costs and higher overall costs to consumers.[59]

1. Only Actual Loans Available to the Borrower Should Be Compared.

The trade-off table is a signal improvement in the disclosure of the cost of lender-paid broker compensation. Most existing disclosure of lender-paid broker compensation is clothed in meaningless vagaries, "the interest may increase," and deceptive platitudes, "you have a choice how your broker is paid." To shop in a meaningful way, consumers need specifics.

In particular, the presentation of the monthly payment is important to allow borrowers to quantify how much more expensive any given loan is, in terms of their budget. Requiring the actual monthly payments of the alternative loans gives the consumer a familiar metric to compare the costs of loans with and without lender-paid broker compensation, on a scale accessible to most consumers.

If the originator has available a no-cost loan product for which the borrower is eligible, it would be appropriate to mandate its disclosure as one of the loans. As one of the primary advantages of a no-cost loan is the preservation of home equity, a comparison of the loan balances on both loans owed might be included as well.

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[58]Office of Pol'y & Dev., Dep't. of Hous. & Urban Dev., RESPA: Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis, FR-5180-P-01: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs, 2-53 – 2-61 (2008)

[59]U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-25 - 2-48 (2008); *see also* Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans (2008), http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf ; 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).

2. The Compared Loans Must Be Allowed to Vary by Interest Rate, Total Fees, and Loan Amount, While Other Loan Terms Are Held Constant, in Order to Provide a Meaningful Comparison of Available and Offered Loans

HUD specifies that the tradeoff be of two loans that are "otherwise identical" and available.[60] HUD is correct to require that the loans compared be otherwise identical. Comparison shopping on monthly payments works only so long as the loan terms are held constant.[61] If loan terms vary, shopping on the monthly payment can be disastrous. HUD is also right to require that the loans compared be actually loans for which the borrower qualifies: consumers are disserved when presented with hypothetical information. Hypothetical information lacks salience. Even when consumers do not automatically disregard hypothetical information, consumers can be easily persuaded to do so.

There are some potential pitfalls with the definition of "otherwise identical." The language of the proposed tradeoff table suggests that HUD, in the tradeoff table, expects originators to disclose two loans that vary only by the interest rate. While this is already a step beyond the consumer testing of the disclosure forms done by HUD, which only varied the out of pocket settlement costs incurred by borrowers, it does not reflect the economic realities of the situation. *If the lender does not pay the closing costs, then in almost all situations the borrower will have to borrow more to cover these costs. So the comparison between the two loans must reflect that the loan with the borrower paid closing costs will be for a greater loan amount.* Additionally, in the current marketplace, loans with and without lender paid broker compensation typically vary in the interest rate, the total amount of broker compensation, and the total amount of settlement charges, with the presence of lender paid broker compensation increasing all three price metrics.[62]

Thus, if HUD means that only the interest rate can change in order for the loans to be "identical," originators will be given a pass on disclosing the real cost of lender-paid broker compensation: very few loans in the marketplace vary only in the interest rate charged the borrower. Substantive regulation could require that originators provide identical loans, with and without lender-paid broker compensation, that varied only by the interest rate – but this would have to assume that the loan with the borrower paid compensation would *always* have that compensation paid in cash by the borrower. HUD has not done so. Requiring only the disclosure of identical loans without the requirement that originators provide such loans or price loans entirely through the interest rate fails to match disclosure to existing economic realities and presents a false picture of the options actually available. In order for the tradeoff table to be

[60]73 Fed. Reg. 14030, 14098 (Mar. 14, 2008)..

[61] *See* Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans 20 (*2007) ("If the loan terms being compared were held constant, this would be equivalent to finding the loan with the lowest interest rate.").

[62]U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, *RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-25 - 2-48 (*2008).

useful, the definition of "otherwise identical" should be clarified to include loans where the number and schedule of payments, the nature of the interest rate, whether fixed or adjustable, the index and margin, for any adjustable rate mortgage, and the other loan characteristics are held constant, but the interest rate and loan amount can be lower or higher than the loan reflected in the GFE.

The requirement that loans be available is critical. Disclosing hypothetical loans affirmatively hurts consumers. In addition, unless the availability requirement is included, originators will have an escape hatch for disclosing the cost of lender-paid broker compensation. This will surely happen if the only permissible difference between two loans is the interest rate, since virtually all loans in the marketplace that differ in whether the broker receives a payment from the lender also differ in total loan amount.

3. The Tradeoff Table Should Compare Loans with Lower and Higher Interest Rates and Loan Amounts, Without Suggesting a Relationship between Settlement Fees and Interest Rates

The language introducing the tradeoff table suggests that there is a one-to-one relationship between the interest rate and the settlement costs. This language is contradicted by the extensive evidence HUD presents in the Economic Analysis that lender paid broker compensation not only increases the interest rate but increases the total broker compensation and total settlement costs.[63] While the borrower may have some reduction in upfront costs for broker compensation and settlement costs when there is lender-paid broker compensation, such reduction is seldom one-for-one and is often as low as twenty-five cents for every dollar of lender paid broker compensation.[64] Often lender-paid broker compensation leads to *both* higher settlement charges and higher interest rates.

The relevant comparison for the tradeoff table is between loans with lower and higher interest rates. The promised tradeoff between settlement charges and interest rates seldom materializes, except in no-cost loans as described above. The language introducing the tradeoff table and the row that queries "How much more or less you will pay at settlement with this interest rate" embed a false and misleading assumption that there is a linear relationship between these two pricing factors. Until substantive regulation is put in place that mandates such a relationship, consumers should not be deluded into reliance on a nonexistent tradeoff. The

[63] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, *RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-25 - 2-48* (2008).

[64] Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J.L. Bus. & Fin. 289, T. 6 (2007) (average borrowers' fees reduced by 25 cents for every dollar the broker paid through a yield spread premium, compared to loans without a yield spread premium); *cf.* Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans 30 (2008), http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf (borrowers with FICO scores of 640 and below pay, on average, $3146 more over four years for every $100,000 borrowed, or roughly an additional 3% of the loan amount).

tradeoff table should present neutrally the total settlement charges, the interest rate, and the monthly payment of two alternative loans. The introductory language implying that the tradeoff is necessarily one between interest rate and settlement charges should be removed.

The language in the proposed tradeoff table must be modified as follows:

- *The columns should be labeled "The loan in this GFE," "A loan with a lower interest rate," and "A loan with a higher interest rate."*
- *Remove the text "less every month" and "more every month" in the row "How much more or less in monthly payments from this GFE" and instead highlight the reduced amount as "Less $_____ monthly" and "More $_____ monthly," to reduce the amount of reading required and make plain the direction of the change.*
- *Remove the row labeled, "How much more or less will you pay at settlement with this interest rate."*
- *Remove the second sentence and the two bullets introducing the tradeoff table.*

4. The Tradeoff Table Cannot Effectively Disclose the Tradeoffs When Lender-Paid Broker Compensation is Based on Loan Features Other Than an Increase in the Interest Rate

The availability requirement also limits the usefulness of the tradeoff table when the lender-paid broker compensation is based on loan characteristics other than the interest rate. Lenders commonly pay brokers for loans with prepayment penalties, for arranging an adjustable rate loan instead of a fixed rate loan, and for increasing the margin on an adjustable rate mortgage. In none of these cases is there an "otherwise identical" loan to be disclosed in the tradeoff table. Nonetheless, in all those situations, the borrower is still likely to overpay the broker and overpay the lender in interest.[65] In addition to the excess interest, the borrower also incurs other interest rate risks, which are hard to quantify. Given the prevalence of adjustable rate products in the marketplace[66] and the predominance of prepayment penalties in the subprime

[65] *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, 424, 427, 430 (2007) (noting higher APR for adjustable rate mortgages than for fixed for subprime loans in 2004 and 2005 and prime loans in 2005; having an adjustable rate mortgage increased the APR 17.1 basis points in the subprime market in 2005 and 3.5 basis points in the prime market in 2005).

[66] *See, e.g.,* Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 26 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (reporting that over 80% of 2006 subprime originations were ARMs).

market,[67] these limitations on what can usefully be disclosed in the tradeoff table significantly restrict its overall applicability. This has more to do with the designed complexity of mortgage products rather than a flaw in the tradeoff table. The risk of current mortgage products cannot be adequately disclosed to most consumers.

The tradeoff table is an improvement. By providing consumers with concrete, loan specific information on the cost of lender-paid broker compensation, it should help make concrete to borrowers the cost of accepting lender paid broker compensation. However, it is not enough by itself.

C. Given the Complexity and Scope of Abuses in the Use of Lender Paid Broker Compensation, Disclosure is an Inadequate Remedy and Substantive Regulation is required

Lender-paid broker compensation has contributed to the overpricing of many loans and the placement of thousands of borrowers with prime credit into subprime loans.[68] Lender-paid broker compensation often gives brokers incentives to sell consumers higher cost products and potentially riskier products. Lender-paid broker compensation in its most common form is a simple – and bad – quid pro quo: increased interest rate for increased broker compensation. Lenders may also condition payments to brokers on other features of the loan. For example, lender-paid broker compensation is sometimes pegged to a prepayment penalty being included in the loan, the product sold (fixed rate versus variable rate, for example), or the size of the margin or the initial rate for an adjustable rate mortgage. Occasionally, lenders will even pay brokers additional money for originating a no-doc loan. In all of these cases, the lender pays more as the loan becomes more profitable to the lender, without regard to the benefit or the cost to the borrower, or even the additional risk the higher cost loan creates for the ultimate holder. In each of these examples, the payment distorts the broker's incentives, is not transparent to the consumer, and is often a source of gouging.

1. Lender Paid Broker Compensation Cannot Be Adequately Disclosed To Borrowers

Lender paid broker compensation is not always in exchange for the interest rate increase. While this is often the case, it is not always so. In the case where the broker is paid a premium for steering a borrower into an adjustable rate product, there is unlikely to be a comparable loan without lender paid broker compensation. Thus, HUD's most promising innovation for disclosing the cost of lender paid broker compensation, the tradeoff table, would not be useful.

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[67] *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, 416, 418 (2007) (in 2004, 85% of all loans with prepayment penalties were subprime loans; in 2005, 91% of all loans with prepayment penalties were subprime loans).

[68] *See, e.g.,* 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 (61% of subprime borrowers in 2006 were prime eligible).

A borrower under these circumstances would not receive any meaningful disclosure of the incentives paid to the broker and the increased cost and risk would be imposed on the borrower.

There is no evidence that even using the new GFE that borrowers will understand and be able to manipulate the tradeoff between interest rate and fees. HUD did not test borrower's decision-making under the real world circumstances it assumes: where the payment to the broker increases the interest rate as well as decreasing the fees. There is no reason to think that this form—which omits the APR, the only shopping unit that bundles fees and rate—will facilitate borrowers in making the difficult comparisons between loans when both the rate and the fees vary. The tradeoff table is a good start, but a lender who pays a fee to a broker for a change in loan terms will not need to complete it. Nor does the tradeoff table, other than by providing the initial payment, help borrowers evaluate the total cost of the two loans.

HUD went through six rounds of consumer testing in developing the proposed GFE. One of the signal problems HUD faced was that borrowers were typically confused by an honest disclosure of lender-paid broker compensation.[69] The FTC had a similar problem in its testing of mortgage broker disclosures.[70] In order to achieve a form that was simple and clear, HUD, in its testing, simplified the question asked of borrowers. Borrowers were given a simple tradeoff: the same loan terms, the same loan amount, the same interest rate, the same monthly payment. The only difference was the total amount of settlement costs, with some costs borne by the lender in exchange for an increased interest rate. No testing was done comparing the cost of loans when the interest rate changed as a result of lender-paid broker compensation. This gross simplification of the economic realities of lender-paid broker compensation was apparently necessary in order to achieve a disclosure that was not confusing to borrowers.

The bottom line is – the economic realities of these tradeoffs can never adequately be disclosed to borrowers. In part that has to do with the complexity of the tradeoffs. In part that is because consumers believe—and are lead to believe by brokers—that brokers act in the best interests of borrowers.[71]

Despite widespread acknowledgment that brokered loans are often more expensive for borrowers than loans originated directly by lenders,[72] HUD was at pains to remove any anti-

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[69] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 3-39 - 3-46 (2008).

[70] James M. Lacko & Janis K. Pappalardo, Fed'L Trade Comm'n, The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment 24 (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

[71] 73 Fed. Reg. 1672, 1698 (Jan. 9, 2008).

[72] *See, e.g.,* U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, *RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 3-4* (2008).Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2006 HMDA Data,* Fed. Reserve Bull. A73, A96 (2007), *available at* http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf (origination channel accounts for most of the pricing disparity between racial groups).

broker bias in the final disclosure form used.[73] Some of the testing results suggest that HUD may have overachieved its goal and introduced a slight pro-broker bias.[74] If the goal is to facilitate consumer's identification of the cheapest loan, the relevant question is not the presence or absence of anti-broker bias, but the total costs of the loan to the consumer, including interest.

In theory, in the comparatively simple model where the lender-paid broker compensation is reflected solely in the interest rate and not in a change of products, an informed borrower could rely on a generic preference in making the decision on how to pay the broker. The borrower who expects to hold the loan for a relatively short period of time should choose, in most cases, to have the broker paid by the lender in exchange for a rate increase. A borrower who expects to hold the loan for a longer term would generally be better off financing the broker fees or paying them out of pocket. This simple analysis seldom plays out, however. A consumer is seldom offered a straight choice between all in or all out. In many cases, the broker compensation will be neither all in nor all out of the interest rate and there will be other fees and costs besides the broker's compensation to take into account. Given most consumers' limited ability to manipulate percentages and interest rates, such a task is clearly beyond all but the most financially sophisticated consumers.[75]

Most borrowers cannot compare the cost of two loans when interest and fees are disaggregated. Most consumers cannot calculate interest;[76] even fewer can begin to puzzle out the relative merits of financing a broker fee or paying for it with a yield spread premium. When borrowers are forced to compare loans with disaggregated fees, even when the interest rate is the same, more than a third cannot identify the cheaper loan.[77] Only at the point when all the fees

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[73] 73 Fed. Reg. 14030, 14046 (Mar. 14, 2008).

[74] 73 Fed. Reg. 14030, 14046 (Mar. 14, 2008) (reporting that where both loans cost the same, and borrowers were given verbal instructions on how to compare the loans, 57% picked the brokered loan and 35% picked the loan originated directly by the lender).

[75] For a review of the quantitative literacy studies on this point, see Elizabeth Renuart & Diane Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending*, 25 Yale J. on Reg. 181 (2008).

[76] Only 22% of the adult U.S. population in 1992 could even describe how to calculate interest, given a stream of payments, an amount borrowed, and a total loan amount, according to the 1992 National Assessment of Adult Literacy. The question and results are available at http://nces.ed.gov/NAAL/SampleQuestion.asp?NextItem'0&AutoR'2 Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (borrowers have difficulty calculating interest); Danna Moore, Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes and Experiences 27 (Technical Report 03-09, Soc. & Econ. Sci. Research Ctr., Wash. State Univ., 2003), *available at* http://www.dfi.wa.gov/news/finlitsurvey.pdf (same); Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, J. Monetary Econ. (forthcoming) (manuscript at 34), *available at* http://www.dartmouth.edu/~alusardi/Papers/BabyBoomers.pdf (same); Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement* Wellbeing 5, 8 (Oct. 2006), http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf (same).

[77] James M. Lacko & Janis K. Pappalardo, Fed'l Trade Comm'n*, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms* 81 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf ; *cf.* Susan Woodward, *Consumer Confusion in the Mortgage Market 2* (2003), http://www.sandhillecon.com/pdf/consumer_confusion.pdf (consumers who try to

are pushed into the interest rate can most consumers intelligently evaluate the costs of trading fees for interest.

After six rounds of careful design and testing by a firm specializing in form design, the real world complexity of the lender-paid broker compensation when borrowers must choose between loans that vary by costs and interest is still not adequately conveyed. These failures to make clear the cost of the yield spread premium or other lender-paid broker compensation reflect the complexity of the subject matter rather than any shortcoming of HUD's or of its consumer testing. *Yield spread premiums cannot be adequately disclosed. They must be substantively regulated.* Nevertheless, to the extent HUD will include a YSP disclosure on the GFE, the disclosure must include the elements discussed above—that the fee is an amount paid by the lender to the broker and that payment of such fee results in a higher interest rate paid by the borrower.

2. Lender-Paid Broker Compensation Should Only Be Permitted for No-Cost Loans

Given the extensive evidence HUD cites that fees and borrower confusion are at their highest when brokers are paid both by the borrower and the lender,[78] lender-paid broker compensation should only be permitted for no-cost loans.

True no-cost loans, where all fees are pushed into the rate, can offer significant benefits for consumers and the market. Consumers appear to maximize their shopping return with no-cost loans. Racial disparity in pricing appears to vanish in no-cost loans.[79] No-cost loans provide the proper incentives for originators and the secondary market. In a no-cost loan, the only money to be made is if the loan performs over time. Thus, no-cost loans give originators and the secondary market an increased incentive to make sure that underwriting is done at the time of origination. No-cost loans also reduce the incentive to strip equity by increasing the loan amount with junk fees. Such equity stripping does the consumer permanent harm and cannot be refinanced away, unlike a higher interest rate.

HUD should, under RESPA, define the payment of a yield spread premium, which increases the interest rate, at the same time as the borrower is being charged other up-front fees that purport to reduce the rate, as a kickback. There is substantial evidence that in these circumstances the yield spread premium increases total broker compensation and increases the

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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).

[78]*E.g.,* U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-26, 2-34 (2008).

79 U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-43 (2008).

borrower's cost, without providing any additional benefit to the borrower.[80] In these circumstances, the yield spread premium cannot reasonably be seen as a payment for other than the increased rate.

Yield spread premiums should be prohibited unless all other fees (other than escrow fees imposed in accordance with RESPA, actual government fees, and title insurance and title examination fees, if paid to an unrelated party and if bona fide and reasonable) are folded into the interest rate and no discount points are charged. Additionally, no other lender-paid broker compensation should be permitted if the borrower is making any direct payments to the broker.[81]

III. Permissibility of Average Cost Pricing and Negotiated Discounts

A. The Average Cost Pricing Rule Should Require Disclosure of Actual Amounts Paid and Should Be Tied to the Average Cost of Providing the Service Plus a Fair Rate of Return

It is a positive step that the proposed rule seeks to reduce settlement services by allowing innovative cost pricing formulas. Specifically, the rule proposes to bless specifically average cost pricing and volume based discounts as legal under RESPA.

While the basic idea here is good, there seems to be a bit of confusion in the mechanics by which the goal will be achieved with regard to average cost pricing. RESPA includes the dual roles of both *disclosure* and *prohibiting kickbacks and referral fees*, but it has not regulated the actual price charged to consumers. The rule as proposed appears to conflate the two main functions of RESPA—disclosure and prohibiting kickbacks—by establishing a pricing mechanism to determine the actual cost of settlement services. The rule is also confusing because it improperly defines the economic term "average cost pricing."

There is no problem with HUD blessing a new mechanism for settlement service providers to determine the *prices* that will be charged homeowners, so long as it will result in a reduction in these prices. Average cost pricing may be a perfectly acceptable method – even a money saving method – for some consumers. However, HUD has no authority to allow the *disclosure* of whatever price is actually *paid* by the homeowner to be anything other than the actual amount of funds that are paid by the homeowner for that service.

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[80] *E.g.,* U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 3-4 (2008).

[81] In this situation, lenders must list all charges incurred in the transaction on the settlement statement but show them as P.O.C., paid outside of closing. *See* HUD Instructions in Regulation Z, 24 C.F.R. 3500 Appendix A. If the lender provides a credit to the consumer to cover closing costs, the credit must appear on lines 204-209 of the settlement statement. See HUD Letter Regarding Disclosures on Good Faith Estimate and HUD-1 Settlement Statement, Q 12, attached to OCC Advisory Letter AL 2000-5.

1. Disclosure Must Be of the Actual Amounts Paid to Third-Party Settlement Providers

First, the disclosure of fees on the HUD-1 Settlement Statement is designed to inform borrowers of what amounts were paid to which third-party service providers. The disclosure of fees paid to third party settlement providers is also important for calculating finance charges under TILA and determining high cost loan status under HOEPA. The proposed rule, however, suggests that the HUD-1 may state an amount other than the amount actually paid to the settlement service provider. There is absolutely no reason that the HUD-1 Settlement Statement should reflect any amount other than the actual amount received by the third-party in connection with the transaction.

The proposed rule requires the settlement agent to state the “actual charges” paid by the borrower and seller on the HUD-1 or HUD-1A. The amount stated for third-party settlement services may not exceed the amount actually received by the third-party, unless the charge is based on an average cost price.

There is no justification for allowing disclosure of an amount that is different from the amount actually received by the third-party. For the vast majority of the settlement services provided in a residential mortgage transaction, the exact amount of the fee to be received by the third party for a particular service is ascertainable at or before closing. There is simply no reason to state the “average price” charged to borrowers instead of the amount actually paid. Regardless of the pricing mechanism used to determine the “price” of the service (see discussion of “average cost pricing” below), the actual amount paid to the settlement service provider must be disclosed on the HUD-1 or HUD-1A.

Additionally, HUD does not have the legal authority to permit disclosure of an amount other than that actually imposed on the borrower and paid to the third-party settlement provider. The statutory language of section 2603 provides that the HUD Settlement Form “shall conspicuously and clearly itemize all charges imposed upon the borrower…” This language does not allow borrowers to be charged one amount while settlement providers are paid another amount. Such an interpretation of the statutory language would completely undermine the disclosure provisions of RESPA.

The amounts disclosed on the HUD-1 or HUD-1A not only enable borrowers and sellers to see where their money is going, they also provide the basis for determining the finance charge under the Truth In Lending Act and high-cost loan status under the Home Owner Equity Protection Act. The specific disclosure of these amounts also is necessary to determine whether the loan is a high cost loan under many state laws. Permitting disclosure of an amount other than the actual amount paid to the third-party service provider would also undermine the purpose and function of these important federal and state laws.

Accordingly, *language in the proposed rule that would allow disclosure on the HUD-1 or HUD-1A of any amount other than the amount actually received by the third party service provider for the itemized service should be stricken*.

2. Determining the Amount Charged or Price for Third-Party Settlement Services Is a Key Component of Average Cost Pricing

Virtually every mortgage transaction involves an array of "settlement services," each of which has the potential to generate costs for the borrower. RESPA's prohibition against kickbacks, referral fees, and unearned fees recognizes that disclosure alone is insufficient to protect consumers, who tend to be inexperienced in complicated financial transactions, from overreaching by sophisticated players in the mortgage industry. RESPA's anti-kickback rule does not prohibit the payment of a fee to a third-party service provider for services actually performed or rendered. [82] Despite this prohibition RESPA has never regulated the "price" of settlement services. Nothing in the current rules or regulations limits a third-party settlement service provider from using true "average cost pricing" to determine the price of its settlement service.

True average cost pricing is based on the actual cost of providing the settlement service plus a fair rate of return. Nothing in the methods for determining the "average cost price"—subsections (A) or (B)—refers to the *cost* of the service. For example, average cost pricing for a title exam for a refinance transaction would consider the average cost, in terms of labor and incurred expenses (e.g., copies) of actually performing the title exam plus a fair rate of return or profit. On an individual basis, some title examinations may cost more, while others cost less, an average cost pricing mechanism smoothes out the variation in pricing between borrowers. Under an average cost price mechanism the same price would be charged to all consumers; the provider of the title examination would receive the same amount for each transaction; and, the amount charged would be disclosed on the HUD-1 or HUD-1A.

For the first time, HUD proposes to endorse a specific pricing mechanism for settlement services. The proposed rule purports to recognize pricing mechanisms that will result in greater competition and lower costs to consumers. Specifically, the proposed rule would allow third-party settlement service providers to charge borrowers based upon "average cost pricing." The rule also describes allowable methods for determining "average price."

While a true "average cost pricing" mechanism may be beneficial for consumers, the proposed rule improperly defines "average cost pricing", as that term is traditionally used in economics. Instead, the rule proposes using an "average pricing" mechanism. Use of an "average price" instead of true "average cost pricing" will simply allow settlement providers to average inflated prices rather than tie pricing to the cost of providing the service. Settlement services are notoriously overpriced. Many commentators have noted the existence of reverse competition in the settlement services area that leads to higher rather than lower prices.[83] Merely permitting settlement service providers to average overpriced charges does not foster RESPA's

[82] *See* 11 U.S.C. § 2607(c).

[83] Jack Guttentag, "HUD's Proposals For RESPA Reform," submitted to Rules Docket Clerk at HUD, regarding Proposed Rule on Real Estate Settlement Procedures Act (RESPA): Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; (July 29, 2002), October 18, 2002.

goals of reducing settlement charges to borrowers. It may eliminate higher costs to the service provider (e.g., more detailed recordkeeping), but there is no indication that such savings would be passed onto borrowers. As a result, consumers would not in fact realize reductions in settlement costs.

Certainly RESPA reflects Congress's clear intent that consumers should only be charged for services actually provided for their own loan transactions. At the same time, true average costs pricing could serve to reduce overall settlement costs to borrowers in furtherance of RESPA's goals. Unfortunately, the definitions of proposed "Average cost pricing" in section 3500.8(b)(2) are not consistent with the common meaning of average cost pricing.

True "average cost pricing" must be based on the cost of the settlement service and established rate of return or profit for the settlement service provider. However, a rule that simply allows for "average pricing" would be bad for consumers and completely illegal under RESPA. There is no evidence – or reason to believe – that the "average pricing" methods proposed by HUD would in fact reduce costs to borrowers. *The current description of acceptable methods for average costs pricing are inaccurate and should either be eliminated or revised to comport with true average cost pricing formulas.*

B. Negotiated Discounts Must Be Passed Along to Consumers

The proposed rule amends the current definition of "thing of value" to exclude "a discount negotiated by settlement servicer providers…provided that no more than the discounted price is charged to the borrower and disclosed on the HUD-1/1A." Currently, "discounts" are considered a "thing of value" which may not be given or accepted in exchange for the referral of settlement services. Despite the plain language of this rule, some courts have allowed discounts based on volume even though there was no evidence that savings were passed along to consumers.[84] The proposed rule to allow negotiated discounts between settlement service providers so long as the discount is passed along to the consumer would be a positive—and legal—step.

C. Changes to the Definition of Required Use Should Incorporate Loan Terms

The proposed rule to modify the definition of "required use" does not go far enough to protect consumers. As HUD has recognized, consumers have been subjected to required use of settlement service providers with steep additional costs associated. The new definition appropriately would require a true discount for all settlement services in order for an unaffiliated service provider to be legally required. However, a key component appears to be missing from this proposal: the total cost of the loan.

[84] *See, e.g.*, Lane Residential Funding Corp., 323 F.3d 739, 741 (9th Cir. 2003).

The settlement services to obtain a home loan are only a small part of the costs of the loan. The interest rate, the term of the loan, whether prepayment penalties are permitted, or a balloon payment is required, are all much more important elements of the costs of the home loan. It does not make sense for the settlement services to be capped in return for a required use, while the more critical components of the costs of the loan are not limited, especially where the service itself could be discounted while loan terms are increased.

HUD needs to amend the proposed definition of "Required Use" in Section 3500.2 to include the total cost of the loan, in addition to the total of settlement services. To the extent that the proposed rule's language regarding "any combination . . ." reflects this consideration, the inclusion of loan cost should be made more clearly.

IV. Additional Regulations and Statutory Changes Also Are Necessary

A. The Servicing Disclosure Requirement Should Go Beyond First Liens and Should Signal the Broad Role of Servicers

According to HUD, the proposed technical amendment regarding the servicing disclosure conforms Section 3500.21(b) to the current language of Section 6(a) of RESPA. However, the proposed technical amendment, and specifically the model form, is improperly limited to first lien mortgage loans. Such a limitation is contrary to the statutory language of RESPA. Additionally, the description of servicing as "the collection of payments" on the model form is too narrow and fails to communicate to the borrower the extensive nature of the servicers' responsibilities.

Prior to 1996, lenders not only had to disclose that the mortgage loan might be transferred but also had to reveal the percentage of its loans for which servicing had been transferred over a specified period of time. HUD created a model form for the required disclosures. In 1996, Congress amended section 6(a) of RESPA to eliminate the need to disclose historical servicing information. Specifically, section 2103(a) of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended Section 6(a) to read as follows:

> (a) Disclosure to Applicant Relating to Assignment, Sale, or Transfer of Loan Servicing.--*Each person who makes a federally related mortgage loan* shall disclose to each person who applies for the loan, at the time of application for the loan, whether the servicing of the loan may be assigned, sold, or transferred to any other person at any time while the loan is outstanding. (emphasis added)

Section 2602(a) of RESPA defines the term "federally related mortgage loan," in part as

> any loan (other than temporary financing such as a construction loan) which—(A) is secured by a *first or subordinate lien* on residential real property (including individual units of condominiums and cooperatives) designed principally for the occupancy of from one to four families, including any such secured loan, the

proceeds of which are used to prepay or pay off an existing loan secured by the same property…. (emphasis added)

Despite the statutory definition of "federally related mortgage loan," which includes both first and subordinate liens, the Servicing Disclosure Statement proposed by HUD (Appendix MS-1 to Part 3500) is only directed to applicants of *first* lien mortgage loans. The introductory paragraph of the model form states:

"NOTICE TO *FIRST LIEN MORTGAGE LOAN APPLICANTS*: THE RIGHT TO COLLECT YOUR MORTGAGE LOAN PAYMENTS MAY BE TRANSFERRED." (emphasis added).

Limiting the Servicing Disclosure Statement to applicants for first lien mortgage loans does not comply with the statutory language of sections 2602(a) and 2605(a). *The Servicing Disclosure Statement should be modified to comply with the statutory language and should be required for any federally related mortgage loan.*

A similar technical correction should also be made in the definition of "Mortgage servicing loan" contained in section 3500.21(a). Contrary to the statutory language cited above, the definition of "Mortgage servicing loan" is "a federally related mortgage loan…when the mortgage loan is secured by a first lien." Again, there is no statutory basis, and certainly no policy reason, for excluding servicers of subordinate liens from this definition.

The introductory language of the model form includes the following statement: "Servicing" refers to collecting your principal, interest and escrow payment, if any. Servicers responsibilities extend far beyond the simple statement provided on the form and it is important to disclose to borrowers the full nature of the servicer's activities. Given that borrowers have little choice in choosing a servicer if the servicing rights are transferred, borrowers should be better informed as to scope of the servicers activities when selecting a loan. *The description of servicing should be amended to state:*

> *"Servicers are responsible for account maintenance activities such as sending monthly statements, accepting payments, keeping track of account balances, handling escrow accounts, engaging in loss mitigation and prosecuting foreclosures. They handle interest rate adjustments on adjustable rate mortgages, collect and report information to national credit bureaus, and remit monies to the owners of the loan."*

B. Additional Changes Recommended

Following is a discussion of areas the proposed rule does not address, although some are briefly mentioned as areas where HUD will seek legislative action. We recommend that HUD use its regulatory authority to implement the following changes to the extent possible, and, where necessary, seek legislative changes (and commensurate regulatory authority under those new legislative provisions).[85]

1. The HUD-1 Should Be Required Three Days Before Closing

As HUD has recognized, and as we discuss above, the GFE and HUD-1 disclosures should be early and binding. Borrowers need an *early* and *correct* GFE disclosure so they can shop and make knowing credit commitments, and so they can reasonably rely on the terms of the deal when they arrive at the closing. In order to be binding, changes in the GFE as reflected on the HUD-1 necessarily must be limited to only a modest tolerance. The tolerance ensures that any final changes to closing costs have a minimal impact on the overall cost of the transaction.

We recognize the importance of HUD's intention to request a statutory change to require delivery of the HUD-1 to the borrower three days before closing, as this will provide the needed notice to borrowers regarding any changes to the GFE. With three days' notice, the borrower can determine whether to go ahead with the transaction and will have time to consider other options. When faced with changed loan terms at the closing table, borrowers are pressured into signing loan terms they often do not believe they can satisfy, based on false promises for better loan terms after a period of on-time payments, or out of a sense of duty or obligation. The early and binding GFE combined with an early HUD-1 disclosure will change the mortgage marketplace dynamic and give borrowers some additional information upon which to enforce the promises made by mortgage originators. This change—and all of RESPA's consumer protections—would be considerably more meaningful if these requirements were enforceable by the borrower. As noted previously, the strength of the early HUD-1 would be bolstered by better comparability between the GFE and the HUD-1. Further, as discussed below, there should be civil liability under RESPA for violating any of its provisions, including this key disclosure requirement.

2. Civil Liability under RESPA and a Uniform Statute of Limitations Would Greatly Enhance Compliance

Without a private right of action to enforce the timing and content of both the GFE and the HUD-1 under sections 4 and 5 of RESPA, a borrower's leverage to negotiate loan terms and ensure fairness in the marketplace is severely limited. Civil enforcement of each element under the new rule, especially the GFE and HUD-1 requirements, is essential in order to raise levels of compliance and thus ensure a better functioning market.

We appreciate HUD's intention to seek statutory modifications including authority for imposition of civil penalties for sections 4, 5, 6, 8, 9, and 10 of RESPA, as well as authority for the Secretary and state regulators to obtain injunctive and equitable relief under RESPA. Better

[85] In addition, as noted above, yield spread premiums should be permitted only for no-cost loans.

enforcement mechanisms should result in some better compliance with these requirements and the ability of state regulators to supplement the work of HUD is important.

Increased government enforcement, however, still leaves borrowers who were victims of "bait and switch" or other abusive lending with no recourse under RESPA sections 4 and 5 to directly challenge some of the main loan disclosures used to deceive them about loan terms. This is especially a concern in light of the new proposed GFE cover page. Without proper consequences for significant changes between the GFE cover page and the final loan disclosures, the GFE could be used as a tool to promote bait and switch regarding loan terms, as well as settlement costs, rather than for shopping. It could affirmatively aid in borrower deception because any misrepresentations would not be able to be stopped or challenged by the borrower. While undoubtedly some lenders would be deterred or punished through regulatory enforcement, the reach of regulatory measures is inevitably limited. As HUD itself points out in the proposed rule, without enforcement authority and clear remedies, consumers are less protected and the statute is much less effective. The remedy most likely to result in compliance is a private action by the borrower. Civil enforcement is a compliance incentive.

For the most part, civil actions are (and would be) brought on an individual basis. Actions under RESPA could hold abusive lenders accountable for deceptive representations. Any class actions would, as always, be limited to instances where systemic abuses in early loan disclosures were present. Moreover, statutory limitations on individual and class recoveries allow for market adjustment to potential liability.

While other causes of action for loan marketing deception may be available, they are often harder to prove, such as fraud, which requires proof of several very specific, formal elements. Claims under state UDAP (unfair and deceptive act and practices) laws also are unavailable in many instances. Only about half of the states allow state UDAP claims for mortgage abuses. Private enforcement of the new rules would create a universal and effective tool for challenging bait and switch and promoting transparent, early loan disclosure. The combination of these new substantive requirements and meaningful enforcement would truly change the incentives in the troubled mortgage market-place.

The accuracy and enforceability of RESPA disclosures is especially important because under current law early TILA disclosures are only required for purchase money loans.[86] As a result, the GFE is the borrower's only required advance, written indication of any loan costs at present. The refinancings of home loans, however, are so often the trigger for foreclosures and home loss. As the equity in the home is used to pay for the origination costs, it has become common for homeowners to be flipped from affordable purchase money loans to unaffordable first liens. As a result, reliable representations about both the loan and the settlement costs during the shopping period are essential.

Civil liability for all RESPA provisions would greatly enhance statutory compliance. Provisions regarding escrow in section 10 of RESPA would greatly benefit from the enhanced incentives. Escrow administration is too often poorly implemented and better servicers'

[86] 15 U.S.C. 128(b)(2).

practices need to be encouraged. The new servicing provisions that we recommend below also should be subject to civil liability.

A private right of action under RESPA should resemble the best provisions of other consumer statutes. It should include both actual damages and statutory damages, as well as attorneys fees. Statutory damages provide an economic incentive for lenders to comply with legal requirements; consumers essentially function as "private attorneys general" to facilitate enforcement.

Actual damages also are an important part of a civil enforcement scheme, as they provide compensation directly flowing from the harms to the borrower caused by the lender's statutory violations. Borrowers are provided redress for the consequences of the lender's actions—which is helpful in mortgage cases where statutory damages alone can not compensate the borrower for all of the harm caused by lender's or servicer's behavior. Actual damages already are available for violations of some sections of RESPA and thus expansion would be in line with the approach of the statute. Improving compliance with the provisions of RESPA for which there currently are no private remedies is key to ensuring a fair and transparent market. Only the specter of private enforcement will ensure widespread compliance.[87] HUD should petition Congress for a private right of action for consumers for all violations of RESPA.

We also recommend that HUD remove its stated prohibition against enforcing violations of section 8 through class actions. The 2001 Statement of Policy explicitly requires a court's individual review of each transaction, eliminating the efficient enforcement mechanism of class actions. Once HUD's proposed rules provide the new rules of the road, there is no reason a court cannot evaluate and enforce section 8 requirements in class reviews, as the only issue will be whether the mortgage broker actually gave the consumer the full benefit of the payment from the lender.

We also appreciate HUD's intention to seek a uniform and expanded statute of limitations for both governmental and private actions under RESPA. We recommend that this timeframe be three years—the predominant statute of limitations period currently available under the statute. Violations in loan origination disclosures often do not become apparent until the borrower faces some other loan-related trouble, such as inability to make payments, which in many instances can be traced to inaccurate loan disclosures.

[87] Any adoption of an actual damages standard should specifically reject a detrimental reliance standard, because it is hard for a borrower to show what other terms may have been available at the time and what other actions the borrower may have taken. The detrimental reliance under Truth in Lending has essentially eliminated the availability of actual damages awards under that statute.

3. Section 8(b) Should Prohibit Overcharges, Not Only Markups

Section 8(b)'s prohibition should apply to overcharges as well as markups. HUD has rightly indicated in its 2001 Statement of Policy[88] that unreasonable fees, even where a markup of a third-party fee is not involved, are prohibited under Section 8. We applaud HUD's inclusion of this approach in the Policy Statement, but unfortunately compliance with this provision has been limited. Every year, there are significant numbers of reported cases under Truth in Lending discussing unreasonable closing costs. We recommend that HUD seek to have this clarification included in statutory language to ensure greater compliance. While TILA addresses overcharges in the context of whether the fee is part of the finance charge (the focus of the aforementioned litigation), this rule, while important, only affects where a fee or some portion thereof is disclosed as part of the finance charge (and therefore as part of the APR) or as part of the amount financed.[89] A clarification under RESPA would provide an important step forward by providing substantive regulation of abusive fees.

HUD's description of why overcharges violate RESPA's section 8(b) makes the point well:

> *Since RESPA was enacted, HUD has interpreted Section 8(b) as prohibiting any person from giving or accepting any unearned fees, i.e., charges or payments for real estate settlement services other than for goods or facilities provided or services performed. Payments that are unearned fees for settlement services occur in, but are not limited to, cases where: (1) Two or more persons split a fee for settlement services, any portion of which is unearned; or (2) one settlement service provider marks-up the cost of the services performed or goods provided by another settlement service provider without providing additional actual, necessary, and distinct services, goods, or facilities to justify the additional charge; or (3) one settlement service provider charges the consumer a fee where no, nominal, or duplicative work is done* ***, or the fee is in excess of the reasonable value of goods or facilities provided or the services actually performed.***
>
> *. . . In the third situation, one settlement service provider charges a fee to a consumer where no work is done or the fee exceeds the reasonable value of the services performed by that provider, and for this reason the fee or any portion thereof for which services are not performed is unearned.*
>
> *HUD regards all of these situations as legally indistinguishable, in that they involve payments for settlement services where all or a portion of the fees are unearned and, thus, are violative of the statute. HUD, therefore, specifically interprets Section 8(b) as not being limited to situations where at least two persons split or share an unearned fee for the provision to be violated.*[90]

[88] Real Estate Settlement Procedures Act Statement of Policy, 2001-1, 66 FR 53052 (Oct. 18, 2001).
[89] 12 C.F.R. 226.4(c)(7).

[90] Real Estate Settlement Procedures Act Statement of Policy, 2001-1, 66 FR 53052 (Oct. 18, 2001).

The Statement goes on to say:

> *. . . A single service provider also may be liable under Section 8(b) when it charges a fee that exceeds the reasonable value of goods, facilities, or services provided. HUD's regulations as noted state: "If the payment of a thing of value bears no relationship to the goods or services provided, then the excess is not for services or goods actually performed or provided." 24 CFR 3500.14(g)(2). Section 8(c)(2) only allows "the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or services actually performed," i.e., permitting only that compensation which is reasonably related to the goods or facilities provided or services performed. Compensation that is unreasonable is unearned under Section 8(b) and is not bona fide under Section 8(c)(2).*[91]

A prohibition on overcharges under Section 8(b) is consistent with the purposes of the statute and the specific prohibition on unearned fees. A statutory clarification to this effect could move the market further in this direction.

4. Escrow Collection Should Be Limited to the Amount Owed and Should Continue Even Where the Borrower is 30 Days Late

Currently, servicers administering escrow accounts are permitted to collect payments so that the total paid on one year includes two extra months of funds. This practice has a particularly negative effect on homeowners who live on tight budgets, and the practice is not grounded in any reasonable expectation that such a cushion is necessary. Problems in escrow payments too often result in borrowers falling behind in their mortgage payments because the additional cost of taxes and insurance may not have been properly included in the underwriting, or because the cost of escrow has increased over time. For these homeowners, the requirement of paying more than what is required to cover the month's payments is onerous and unwarranted. We recommend that HUD ask Congress to change the rule so that only amounts owed can be collected through escrow.

Moreover, we recommend that HUD clarify that a servicer must make escrow payments even where a homeowner is 30 days late on a payment. The statute is clear that escrow payments must be made by the servicer. The regulatory exception to this rule is unwarranted and causes substantial hurdles for borrowers seeking to straighten out their payments. Specifically, one payment made 30 days late is enough to jeopardize the borrower's homeownership if taxes go unpaid and the homeowner then has a hard time catching up on that unpaid escrow bill. This is especially a concern where one unpaid late fee could result in a borrower being categorized as 30 days late, even where all the relevant monthly payments for that month were paid on time and in full and where the late fee itself was incurred for paying late but substantially before the 30 day mark. This occurs because a borrower who owes a late fee but only sends in the usual monthly payment generally will have the payment applied first to the late fee and then to

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[91] Real Estate Settlement Procedures Act Statement of Policy, 2001-1, 66 FR 53052 (Oct. 18, 2001).

principal and interest, thus leaving insufficient funds to cover the regular payment. As a result, the monthly payment is not paid in full and is considered late. Borrowers who are 30 days late generally are not on their way to default. Interrupting escrow makes returning to on-time status harder to achieve—an unnecessary result.

5. RESPA's Servicing Rules Must Be Updated

Recent servicing litigation[92] and the challenges faced by borrowers in the current foreclosure crisis make it clear that RESPA's servicing provisions need to be enhanced and updated. While HUD's current proposed rule focuses primarily on loan origination issues, some of the legislative changes it seeks look toward the post-origination phase. Escrow and servicing issues are essential to maintenance of a functioning mortgage market and to foreclosure prevention. In the current crisis, it is the servicing issues that have become paramount, yet the right to get a fair deal from a servicer is not uniformly enforceable and too often is out of reach for homeowners.[93]

First, RESPA must include a duty to provide reasonable loss mitigation prior to any foreclosure that prioritizes "home-saving" loss mitigation options over those that result in loss of the home. Any loss mitigation must be based on an affordability analysis that considers the borrowers debt to income ratio and residual income—to ensure enough actual dollars for non-housing expenses—as well inclusion of the borrower's full debt profile, including junior liens on the property.

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[92] *Islam v. Option One Mortg. Corp*., 432 F. Supp. 2d 181 (D. Mass. 2006)(servicer continued to report borrower delinquent even after receiving the full payoff amount for the loan); *Hukic v. Aurora Loan Servicing, et al*, 2006 WL 1457787 (N.D. Ill. May 22, 2006)(servicer's clerical error in recording amount of payment left homeowner battling with subsequent servicers and fending off foreclosure for nearly five years); *Rawlings v. Dovenmuehle Mortgage, Inc., 64 F. Supp. 2d 1156* (M.D. Ala. 1999)(servicer failed for over 7 months to correct account error despite borrowers' twice sending copies of canceled checks evidencing payments); *Choi v. Chase Manhattan Mortg. Co*., 63 F. Supp. 2d 874 (N.D. Ill. 1999)(home lost to tax foreclosure after servicer failed to make tax payment from borrowers escrow account and then failed to take corrective action to redeem the property); *Monahan v. GMAC Mortg. Co.,* 893 A.2d 298 (Vt. 2005)(affirming $43,380 jury award based on servicer's failure to renew flood insurance policy and subsequent uninsured property damage); *Norwest Mortgage, Inc. v. Superior Court,* 85 Cal. Rptr. 2d 18 (Cal. Ct. App. 1999)(kickbacks available in force-placed insurance encourage placement); *Vician v. Wells Fargo Home Mortg*., 2006 WL 694740 (N.D. Ind. Mar. 16, 2006) (servicers have forced-placed insurance in cases where the borrowers already had it and provided evidence of it); *Dowling V. Select Portfolio Servicing, Inc*., 2006 WL 571895 (S.D. Ohio Mar. 7, 2006) (servicers have forced-placed insurance in cases where the borrowers already had it and provided evidence of it); *accord, Barbera v. WMC Mortgage Corp*., 2006 WL 167632 (N.D. Cal. Jan. 19, 2006).

[93] The following recommendations are incorporated in detail in H.R. 5679, The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008, introduced by Representative Waters. NCLC has directly endorsed this legislation; it is a clear roadmap of some needed changes to RESPA's servicing rules. *See also* Written Testimony of Tara Twomey, National Consumer Law Center, also on behalf of National Association of Consumer Advocates, Before the Unites States House of Representatives Subcommittee on Housing and Community Opportunity, H.R. 5679, The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008 (Apr. 16, 2008), *available at* http://www.nclc.org/issues/predatory_mortgage/content/TwomeyHR5679Testimony.pdf.

Additionally, loan modification or forbearance agreements often contain a waiver of claims provision that purports to release the servicer and holder from any past or future claims that the borrower may have. Broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan; it must be banned. RESPA also should prohibit the equally abusive practice of forcing borrowers to arbitrate any disputes with the lender or servicer.

Second, the rules for responding to Qualified Written Requests do not allow a borrower to receive timely, useful information, nor do they prevent against foreclosures occurring before a response arrives. While RESPA currently requires servicers to respond to borrowers' request for information and disputes within 60 days, in practice many such inquires go unanswered. HUD should require that servicers respond to borrowers inquiries and disputes within 14 calendar days. With a shorter timeline, a corresponding statutory change could then be made to remove the requirement for servicers to acknowledge receipt of QWRs. This timeline also would make it less likely that foreclosures would occur while QWRs are outstanding. RESPA also should be amended to provide transparency to the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. Such information should include:

- whether the account is current, or if not, the date the account went into default;
- the current balance due on the loan, including the principal due, an itemization of all fees due, an explanation of the escrow balance, and whether there is any escrow deficiency or shortage;
- a full payment history showing in a clear and easily understandable manner all the activity on the home loan since the origination of the loan, including the escrow account, and the application of payments;
- the initial terms of the loan; a copy of the original note and security instrument;
- identification of the owner of the mortgage note and any investors;
- any documents that limit, explain or modify the loss mitigation activities offered by the servicer; and
- any other information requested by the homeowner reasonably related to loss mitigation activities.

Third, homeowners often have difficulty determining which address of the servicer is the correct one for sending QWRs. RESPA should provide that any QWR received by the mortgagee or servicer is considered valid, even where sent to an address other than one designated by the mortgagee or servicer for receipt and handling of such requests.

6. The Exceptions for Subordinate Liens and HELOCs Should Be Eliminated

Congress amended RESPA in 1992 to expand its coverage to subordinate liens. Nevertheless, HUD has carved out an exception in Reg. X for the Servicer Act provisions in section 2605. Regulation X states that the Servicer Act provisions apply to a "mortgage servicing loan," which generally includes all "federally related mortgage loans," but does not include "subordinate lien loans or open-end lines of credit (home equity plans) covered by the Truth in Lending Act and Regulation Z, including open-end lines of credit secured by a first lien."[94]

The stated reason HUD gave when it promulgated the exclusion was that the "the error resolution section of Regulation Z (12 CFR 226.13) provides protections similar to Section 6 of RESPA."[95] This Reg. Z section under TILA does not apply to subordinate liens which are not HELOCs (or simply not open-end credit). One court had held that the regulation is not entitled to deference because it clearly conflicts with the statute.[96] HUD should clarify that subordinate liens are covered by the servicing provisions in RESPA. Moreover, HELOCs also should be covered. Open-end mortgage credit has been on the rise and has been marketed as a useful tool for homeowners. Non-agency MBS production for HELOCs for the years 2005 and 2006 were $24.62 billion and $23.48 billion, respectively.[97] While the error resolution section under TILA does apply to HELOCs, the Reg. Z rule is focused on open-end credit issues, while the RESPA requirements are more specifically designed for mortgages. Mortgage servicing issues are unique and HELOC borrowers deserve adequate protections.

CONCLUSION

HUD has done an excellent job in moving the ball toward greater protection for consumers in the settlement process. The tweaks and adjustments that we recommend are important to ensure that the goal becomes the reality.

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[94] Reg. X, 24 C.F.R. § 3500.21(a).

[95] 59 F.R. 65442-01 (1994), *available at* 1994 WL 702481.

[96] *See* Cortez v. Keystone Bank, 2000 U.S. Dist. LEXIS 5705 (E.D. Pa. May 2, 2000).

[97] The 2007 Mortgage Market Statistical Annual, Vol. II, p. 16, Inside Mortgage Finance Publications (2007). *See also* Standard & Poors, Trends in U.S. Residential Mortgage Products: Closed-end Seconds and HELOCs Sector Third Quarter 2005 (Jan. 18, 2006)(showing a large and consistent rise in the securitizations by quarter when comparing Q4 2002 through Q3 2005, with the exception of Q1 and Q2 2005 which, nevertheless, were higher than the quarters preceding Q1 2004).