COMMENTS

of the

Center for Responsible Lending

on

Proposed Rules Regarding Unfair, Deceptive, Abusive Lending and Servicing Practices

pursuant to the

Home Ownership and Equity Protection Act

Docket No. R-1305
73 Federal Register 1672 (January 9, 2008)

April 8, 2008

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SECTION I

INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

Twelve years ago, Swarthmore economist Frederick Pryor, writing of increasing structural complexity and increasing leverage at all levels of the economy, posed some critical questions:

> "Have the higher debt ratios led to greater financial distress, that is, to more market crises and crashes or to more bankruptcies, foreclosures, and loan delinquencies? And has it also led to greater volatility….? Or, to put these questions in a more general way, has the increase in potential fragility of the financial system arising from greater structural complexity led to economic instabilities?"[1]

Just over twelve months ago, events began to unfold that suggest that complacency was not the right response to such questions.[2] There is no question that the world of mortgage lending is vastly different today than it was when the Board issued its Advanced Notice of Proposed Rulemaking (ANPRM) for these regulations nearly a year ago.[3] Public comments submitted in response were written over the summer of 2007, due in August 2007, but even as they were being read, events began to outstrip many of those analyses.

Since August 2007, those events have seriously undermined the two most common arguments for no or minimal consumer protection regulation: to "avoid unintended consequences" and to "avoid restricting access to credit," both of which are repeated several times in the Supplemental Information. Yet we now know the true "unintended consequence" of weak regulation and oversight has been the worst credit crunch in generations.

There are lessons to be learned – hard-earned and costly lessons – from the mismanagement of the subprime industry by the industry itself, from the absence of oversight and regulation by those who could have offered both, and, above all, from the failure of assumed "self-regulating" feedback mechanisms in the market that were claimed to have made regulation unnecessary. Starting with HSBC's $1.87 billion loss reserve announcement in February 2007, losses at the world's largest banks and securities firms reached $232 billion as of April 1, 2008.[4] According to the IMF, direct losses will likely top $500 billion and consequential costs will total close to a trillion dollars.[5]

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[1] Frederick L. Pryor: *Economic Evolution and Structure: The Impact of Complexity on the U.S. Economic System*, p. 110 (Cambridge Univ Press, 1996).

[2] HSBC announced that it was setting aside $1.76 billion in loan loss reserves on February 8, 2007, one of the earliest of such announcements.

[3] 72 Fed. Reg. 30380 (May 31, 2007).

[4] Yalman Onaron, *Subprime Losses Reach $232 Billion With UBS, Deutsche* (Bloomberg.Com, April 1, 2007), http://www.bloomberg.com/apps/news?pid=20601208&sid=an2o_RDeA.9A&refer=finance.

Although many lenders who engaged in these practices are gone, many others remain in some incarnation, as do the entities who fed upon these loans. Indeed, the Board has taken unprecedented measures to help some of them survive. The final HOEPA UDAP rules will be among the first opportunities for the Board to tell the industry what it expects of them in return. These rules are also the Board's first chance to tell America what lessons it has learned from this crisis.

Last December, when these proposals were first released, we expressed the view that, while they represented improvements in some respects, they were seriously deficient in other crucial aspects. That the crisis has metastasized so rapidly and virulently since then should make the case for strong reforms unarguable to all who are open to the evidence of experience.

We urge the Board to review last fall's work product anew, asking itself a new set of questions:

- *"If this rule had been in place ten, or even five years ago, is it likely to have helped avoid or ameliorate the current mortgage crisis?"* If the answer is no, then the proposal should be strengthened.

- *Are "unintended consequences" and the possibility of "restricted access to credit" the primary reasons for not proposing a stronger reform for any particular practice?* If so, we urge the Board to rethink its conclusion. One of the principal lessons of the past year is that "unintended consequences" is a universal observation applicable to any course of action -- or inaction -- that the Board takes: it is <u>not</u> an argument of persuasion in aid of any specific recommendation. *The better questions are "what are the foreseeable consequences of not doing enough?" and "what are the independent justifications for not doing more*?" Consider, too, that more lending is not always better. As with antibiotics, too much of the wrong kind can cause long-term damage both to the patient and the community. Credit must be of the right kind and designed without perverse incentives, lest it cause long-term damage to homeowners and the community. The quality of lending is even more important than the quantity of lending: the supply of subprime mortgage credit available between 2004 and 2007 was more than ample, and we are all the worse for it.

By these measures, some of the Board's proposals are welcome and necessary improvements, but others do not pass muster. For these, we urge the Board to strengthen the rules, for the protection of homeowners, the market and the economy.

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[5] Christopher Swann, *IMF Says Financial Losses May Swell to $945 Billion*, April 8, 2008, *available at* http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aK1zAj5FZ9Io.

SUMMARY OF RECOMMENDATIONS

In these comments, we discuss first the proposed definition of "higher-cost loans" which will define the scope of coverage for some of the key reforms (Section II). We next emphasize the three proposals that we believe are most in need of strengthening in order for these reforms to have the desired impact on market behavior (Sections III – V). Section III discusses the ability to pay. Section IV discusses the broker compensation proposal; our recommendation for a ban on yield-spread premiums in higher-cost and non-traditional loans is supported by our new study, released today, which shows that subprime borrowers pay considerably more for brokered loans. Section V discusses the proposal on prepayment penalties. We then discuss the remainder of the proposals in Sections VI - IX: Section VI disuses the verification of income requirement, Section VII the escrow proposal, Section VIII the appraisal proposal, and Section IX the servicing proposal. [6]

Three key provisions must be strengthened for these reforms to be effective:

- The pattern and practice requirement must be removed from the requirement that creditors assess the borrower's ability to repay, and the provision should apply categorically to non-traditional mortgages regardless of price.

- Yield-spread premiums should be prohibited for higher-cost and nontraditional loans.

- Prepayment penalties should be prohibited for higher-cost loans.

Additionally, we offer support and recommendations on other provisions:

We welcome the Board's attention to income verification, tax and insurance escrows, appraisals, and loan servicing, and offer some suggested improvements in each.

- We support the income verification rule as a necessary corollary to the ability to repay rule, but recommend that it should also apply categorically to all nontraditional loans, irrespective of whether they meet the price threshold for higher cost loans. However, we strongly oppose the safe harbor provision that effectively allows creditors not to verify income; sufficient documentation of income or assets should always be required.

- We support the mandatory escrow requirement, and recommend that it, too, apply to all nontraditionals. However, we do not believe that the one-year period is a sufficient safeguard. We recommend that it last the life of the loan without

[6] We are not commenting on either the advertising proposals or the early disclosure proposals. While these are important, we believe that informational reforms would not have prevented the existing crisis had they been in effect earlier, nor would they prevent a recurrence. We have therefore focused on reforms which are needed to change the dysfunctional market dynamics that have prevailed in this segment of the market.

any opt-out option. If the Board does not choose to do so, at a minimum the period of mandatory escrow should be long enough to make manipulation of the escrow by servicers less likely, and to ensure that homeowners are fully aware of the impact of the full cost of taxes and insurance on their budget over the long term.

- We strongly support the focus on appraisal practices, but suggest some adjustments to reflect the way the dynamics of loan origination and appraisal selection works. We recommend that "selection" of an appraiser based on expectation of meeting a target valuation should be prohibited and that illustrations of efforts to encourage or influence target values include explicit or implicit communication of the desired valuation to the appraiser. We also recommend that the rule on multiple appraisals be strengthened.

- As servicing abuses have also paid a part in contributing to the foreclosure crisis, we commend the Board for addressing these abuses. We recommend strengthening them by requiring that all payments be applied to the loan as they are made, regardless of whether there is a contention that more money may be due at the time the payment is made, and servicers should be required to engage in mandatory loss mitigation prior to foreclosing.

SECTION II

SCOPE OF COVERAGE: THE COVERAGE FOR THESE RULES SHOULD NOT BE REDUCED, BUT THE THRESHOLD MAY NEED TO BE REFINED

In its proposal, the Board has proposed the following scheme of coverage:

Applicable to higher-cost loans only: The rules regarding the assessment of the ability to pay, required verification of income, mandatory escrows, and limitations on prepayment penalties would apply only to "higher-cost loans," defined so as to include subprime loans and the higher end of the Alt-A market. (Many of the non-traditional loans in recent years have been Alt-A, rather than subprime loans.) Categorically excluded from these provisions are home equity lines of credit (HELOCs), bridge loans, and reverse mortgages.

Applicable to all loans secured by a principal dwelling: The proposed rules requiring disclosures of broker compensation to borrowers, appraisers, and servicing practices would apply to all loans secured by a principal dwelling.

The impact of the "subprime meltdown" on the financial markets since last August has made this a particularly difficult time to evaluate the reasonably foreseeable impact on the market using various alternative benchmarks and margins. Whether this is a normal course correction, soon to return to long-standing patterns, or whether this heralds a new era of more volatility in financial markets is still up for debate. For that reason, we have evaluated the proposed rules and offer general observations and recommendations.

- We believe that any coverage scheme err on the side of capturing as many loans as needed, rather than on the side of exclusion. The rules applicable only to higher-cost loans either are simple, common-sense lending practices, such as responsible underwriting and income verification, and/or they would not impact on current prime market practices much in any event because these practices are uncommon in the prime market (very few prime loans have prepayment penalties and the vast majority escrow for tax and insurance.) Although we are not arguing for expanding these rules to cover the prime market, we do believe that overly narrow coverage is likely to cause more harm than overly broad coverage.

- We recommend that for some of the protections, non-traditional loans be covered categorically, irrespective of cost. They present the possibility of substantial payment shock because of interest-only or smaller payments in the early years of the loan, often even more than the now-notorious 2/28s, and in recent years were particularly sold unsuitably due to perverse incentives in the marketplace. For that reason, we recommend that they be subject to the ability to pay rule and to the ban on yield-spread premiums that we continue to recommend.

- We suggest using a mortgage-based rather than Treasury-based threshold to account for economy-wide credit events. As the Board suggests, using comparable durations is a good idea, but there may be a need for a somewhat larger margin for ARMs of five years or less. For fixed-rate loans, we would suggest using the Freddie Mac survey rate plus 150 basis points or the Freddie Mac required net yield plus 175 bp.

<u>A. High cost definition</u>

The regulation proposes to define a higher-priced mortgage loan as "a consumer credit transaction that is secured by the consumer's principal dwelling in which the annual percentage rate at consummation will exceed the yield on comparable Treasury securities by three or more percentage points for loans secured by a first lien on a dwelling, or by five or more percentage points for loans secured by a subordinate lien on a dwelling." We support the concept of using benchmark rates with terms more comparable to the actual life of the loan in the calculation of higher-cost trigger rates. However, we recommend that mortgage-based rates be used instead of Treasury securities to ensure that any trigger rate reflects the credit risk currently in the mortgage market. We suggest using the mortgage rates reported by Freddie Mac in its Primary Mortgage Market Survey (PMMS)[7] or its required net yield (RNY). Both these rates are published

[7] Freddie Mac's Primary Mortgage Market Survey® (PMMS®) surveys lenders each week on the rates and points for their most popular 30-year fixed-rate, 15-year fixed-rate, 5/1 hybrid amortizing adjustable-rate, and 1-year amortizing adjustable rate mortgage products. The survey is based on first-lien prime conventional conforming mortgages with a loan-to-value ratio of 80 percent. Since April 1971, Freddie Mac has surveyed lenders across the nation weekly to determine the average 30-year fixed-rate mortgage

regularly and are easily accessible to mortgage lenders at any point in time. (The Board could simplify both compliance and enforcement by publishing the benchmark on its website at regular intervals.)

For fixed rate loans or ARMs of over five years, we suggest that higher cost loans be defined as those that are 150 bp over the Freddie Mac survey rate or, if the Board preferrs, 175 bp over their required net yield (the extra 25 bp is appropriate because it is necessary to pay servicing costs). This methodology will work well for fixed rate loans, because this 150 or 175 bp spread will be maintained over the life of the loan and, excluding the small impact of low upfront fees amortized over the life of the loan, APR and start rate are close to identical.

It may need to be adjusted for ARM loans, however, because the survey rates and required net yields are based off an ARM start rate, which is generally a teaser of some sort. Given collars, it takes time to build up to the fully indexed rate. And given the fact that borrowers prepay on average within the first four years, the weighted expected yield to the investor is less than the fully adjusted rate, which dominates the APR. So start rate and APR-based indexes diverge, which is not the case with fixed rate loans. Thus, for ARMs of five years or less, for example, the spread may need to be a bit higher than 150 bp above the survey rate or 175 bp above the required net yield.

If having different spreads for short-term ARMs versus fixed rate loans is not desirable, we would return to our recommendation in the comment on the ANPR, which suggests the current North Carolina standard.[8]

B. Non-traditional mortgages should be covered categorically for the rules on repayment ability, verification of income, and for the ban on yield-spread premiums that we propose.

As the federal financial regulatory agencies recognized in 2006 when they promulgated the *Interagency Guidance on Nontraditional Mortgage Product Risks*, nontraditional loan products,[9] such as interest-only loans and payment option ARMs (POARMs), pose a risk to homeowners that is very similar to the risk posed by subprime hybrid ARMs, although many of these nontraditional loans were made in the Alt-A market as opposed to the subprime market.

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rate; in 1984, the 1-year ARM was added to the survey and the 15-year fixed-rate mortgage rate was included beginning in 1991. In January 2005, Freddie Mac added a 5/1 hybrid ARM series to the survey. Currently, 125 lenders are surveyed each week and the mix of lender types – thrifts, commercial banks and mortgage lending companies – is roughly proportional to the level of mortgage business that each type commands nationwide.

[8] See Center for Responsible Lending, *Comments on Home Equity Lending*, p. 39 (August 15, 2007), *hereinafter* CRL ANPRM Comments.

[9] Nontraditional loans are those that allow borrowers to defer repayment of principal and sometimes interest (*Interagency Guidance on Nontraditional Mortgage Product Risks*).

Interest-only loans permit homeowners to defer payments of principal, and POARMs allow people to pay a minimum payment that does not fully cover either interest or principal, which can make their loan balance grow larger or "negatively amortize" during the period when the minimum payment is being made. In the past, such nontraditional loans were niche products made by lenders experienced in making them, and available to homeowners in very specific types of situations. However, in recent years, the number of consumers receiving these products skyrocketed.[10] High-volume lenders, such as Countrywide, sold billions of dollars' worth of poorly underwritten POARM loans to borrowers for whom they were not well suited, generally consumers who would not otherwise have qualified for such a large mortgage under traditional terms and underwriting standards.

What's more, many of these loans were made as stated-income loans and featured other risk-layering features such as second liens or no escrow. They were generally structured so that the payments substantially increase in five years or earlier when they hit their negative amortization cap. Unlike the hybrid ARMs, which are mostly resetting this year and next, analysts expect the spike in POARM resets to occur between 2009 and 2011.[11]

In the Interagency Guidance, the regulatory agencies emphasized the importance of strong underwriting standards for these loans, particularly with respect to ability to repay, income verification, second liens, and other risk layering features – all very similar protections to those proposed by the Board for higher-cost mortgages. As the Board prepares to release its final rules, we urge the Board not to turn the clock backward on the regulation of these nontraditional loan products. The rules for higher-cost mortgages related to ability to repay, income verification and escrows should also be extended to nontraditional loan products to remain in line with the Interagency Guidance.

C. The margin over the threshold should not be extended to 4% and 6%.

The unintended consequences of targeting reform too narrowly, as we all are seeing to our profound regret, can be considerable damage far beyond individual homeowners and individual lenders. Adding 4% and 6% to the margin for fixed rate loans would allow too many loans to be made without regard to ability to pay or with an unnecessarily costly yield-spread premium.

D. The APR is the appropriate trigger to use.

We strongly agree that the APR, not a note rate, should be the figure used to measure against the threshold. To do otherwise is to invite the "bad old days" of loans packed

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[10] By 2005, option ARMs accounted for $238 billion of loan volume, or about 8% of loans originated that year, according to Inside Mortgage Finance, a trade publication.

[11] *See* Appx. D, a chart from Credit Suisse projecting various resets through 2015.

with 7.9% of fees and charges, to bring them just under the high-cost trigger while making the note rate look as low as possible.

We understand that other commenters may recommend that the Board also adopt an alternative 5% fees and points trigger, a threshold that has been successfully used by several states in enacting their state-HOEPAs. We know that this threshold brings valuable consumer protections to borrowers, and enhances the competitive opportunities for responsible lenders, with no adverse impact on the availability of legitimate credit. We support this recommendation, as well.

SECTION III

THE "ABILITY TO PAY" IS THE KEY TO PREVENTING ANOTHER CRISIS, BUT THE REGULATION MUST BE STRONGER

Board Question: Will the proposed rule ensure that creditors adequately consider repayment ability without unduly constraining credit availability?

Summary comments and recommendations:

- A requirement that creditors consider the ability to repay will restore common sense underwriting standards and will enhance the stability of the market and sustainable, responsible lending.

- For the rule to bring meaningful reform to the market, the Board must eliminate the pattern and practice requirement.

In our introduction, we urged the Board to turn a fresh eye to the rules and to rethink its assumptions about what "constrains credit availability" and how much quality should be sacrificed for quantity. This is one proposal where that fresh eye is especially necessary.

A major problem at the core of today's crisis in the subprime and nontraditional markets is that lenders ignored common sense underwriting principles. The traditional fundamentals of lending – the "3 Cs" of capacity, collateral, and character/creditworthiness – were replaced by a model that elevated origination volume above all else.[12] Capacity, which is the ability to make the loan payments under

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[12] Structured Finance in Focus, *The Subprime Decline – Putting it in Context* p. 3, Moody's Investors Service (March 2008) ("The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market."). *See also* sources cited in Center for Responsible Lending, *Comments on Proposed Interagency Statement on Subprime Mortgage Lending*, pp. 4-5, notes 11 & 12 (May 7, 2007). *Cf* Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, p. 26-27 (January, 2008) (securitization weakens creditors' incentive to screen the loans they make), *available at* http://www2.law.columbia.edu/contracteconomics/conferences/laweconomicsS08/Vig%20paper.pdf, hereafter *Securitization and Screening*.

reasonably foreseeable terms, is central to sustainable lending, sustainable homeownership, and a sustainable mortgage market. Similarly, collateral means more than asset-based lending; while extending credit based on the value of the collateral rather than the ability to pay from available income and liquid resources has been required by regulation at least since the beginning of the decade,[13] it clearly was honored more in the breach.

Failure to take ability to pay into account is not a new element of this segment of the market,[14] but only in approximately the past three to four years did the industry drop all pretense of doing otherwise, and then magnified the consequences by increasing volume dramatically. In fact, by 2006, lenders were not only ignoring "capacity" and "collateral," but they were going beyond "asset-based lending" to "asset-based-lending based on tomorrow's possible value," as the Board itself has intimated.[15] While portrayed as a route to sustainable homeownership and asset-building for middle-class America, it was instead a foreseeable recipe for disaster.

Subprime loans and other so-called "affordability" products were in fact just the opposite. Appreciation-driven refinancing goes only so far to lower costs: income, not LTV or FICO scores, ultimately must be the source of repayment for people who actually want to continue living in those homes. And the growing gap between home values in many regions and incomes for the majority of Americans means that asset-based lending never was a sustainable model.[16] The Board notes that it is "not aware of evidence" of such loans improving credit scores to qualify for lower rate loans, nor are we. But the history of the subprime sector – and the horrendous delinquency rates on these loans – suggests that instead they condemn the homeowners to a downward spiral by damaging their third

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[13] *See, e.g.* Statement of John D. Hawke, Jr, Comptroller of the Currency, Before the Committee on Banking and Financial Services, U.S. House of Rep., p. 2 (May, 24, 2000) ("Loans predicated on home equity where the borrower does not demonstrate the capacity to repay the loan as structured would be adversely classified and further accrual of interest may be disallowed."), *available at* http://www.occ.treas.gov/ftp/release/2000-37a.doc ; codified at 12 C.F.R. § 34.3(b) in 2004. In spite of this, a recent study found no difference between banks and thrifts and the independent originators in weakened underwriting. *See Securitization and Screening, supra* note 12, at 21-22.

[14] By mid-2005, foreclosures had been initiated at least once on 21% and 23% respectively for subprime loans originated in 1999 and 2000. Nearly half of those loans had experienced delinquencies. Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* Table 4, p. 13 (Center for Responsible Lending, December, 2006), *hereafter Losing Ground.*

[15] 73 Fed. Reg. at 1687.

[16] In 2005, the average income within the 4th quintile – the second *highest* quintile – was approximately $70,000. Center on Budget Policy and Priorities, Arloc Sherman, "Income Inequality Hits Record Levels, New CBO Data Shows," December 14, 2007, *available at* http://www.cbpp.org/12-14-07inc.htm. In 2005, the median home price in California was $548,000 for an affordability index of 14%. State of California, Department of Housing and Community Development, Division of Housing Policy Development, "California's Deepening Housing Crisis," (February 15, 2006) at 2, 6.

"C" – creditworthiness.[17] And the result? Record foreclosures and "default expectations for the remaining balance of the 2006 and 2007 [subprime] mortgage pools of 48% and 43%, respectively."[18]

Although the performance records of subprime loans indicates that failure to adequately consider ability to repay has been a structural flaw in the subprime industry for most of its history, it was masked by appreciating (or at least stable) home values: the exit ramps of "distress prepayment" through forced refinance or sale were wide open.[19] Indeed, forced refinances were not only welcome, but they were part of the overall goal of increasing origination volume, as the report recently submitted to the court in regard to New Century's bankruptcy notes:

> The most common subprime product is a loan that is fixed for 2 or 3 years and then becomes adjustable. The initial rate is far below the fully-indexed rate, but the loan is underwritten to the start payment. At month 25 the borrower faces a major payment shock, even if the underlying index has not changed. This forces the borrower into a refinance, likely with another subprime lender or broker. The borrower pays another 4 or 5 points (out of their equity), and rolls into another 2/28 loan, thereby buying 2 more years of life, but essentially perpetuating a cycle of repeated refinance and loss of equity to greedy lenders.

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[17] *See Losing Ground*, *supra* note 14, at 13 Table 4, regarding delinquency rates for 1999-2000 vintages. Subsequent vintages are faring no better, as we now see. Although longitudinal studies by borrowers are difficult to trace, and therefore rare, what evidence does exists does not support the "bridge to prime" hypothesis. For example, in early 2007, CRL reviewed 106 Option One subprime loans originally written in 2004, and found that three in four refinanced into another subprime loan, while only 1 in 4 refinanced into a prime loan. "*Case Study in Subprime Hybrid ARMs Refinance Outcomes*," (Center for Responsible Lending, February 21, 2007) *available at* http://www.responsiblelending.org/pdfs/subprime-outcomes_2_.pdf. *See also* Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, Appx. B, p. 74, (The Reinvestment Fund, April 2007) (two-thirds of subprime loans refinanced into other subprime loans), *available at* http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf.

[18] Structured Finance: *Revised Loss Expectations for 2006 and 2007 Subprime Vintage Collateral*, p. 2 (FitchRatings, March 25, 2008); *see also* Scott Reckard /Tribune Newspapers: Los Angeles Times, *New Alarm: Option-ARM "Liar's Loans,"* Chicago Tribune, January 21, 2008 (reporting with respect to payment option ARMs: "Now the delinquencies are piling up. The more recent loans appear to be faring the worst, reaffirming the conclusion that lending standards had become overly lax throughout the mortgage industry in the middle of this decade . . . . A study by mortgage researcher First American Loan Performance that looked at loans bundled up by lenders and Wall Street firms to back mortgage bonds found that 8.8 percent of such option ARMs made nationally in 2005 were 60 days or more in arrears as of Oct. 31 [2007].")

[19] Although more than one in five subprime loans originated in 1999 and 2000 had foreclosures initiated at least once by mid-2005, a little more than half of them completed foreclosures. Eleven percent of loans originated in 1998-2000 were distress prepays. The 2001 vintage was on a similar track, with nearly 18% ending in either a completed foreclosure or a distress prepayment within 4 years (by mid-2005). *Losing Ground, supra* note 14, at Table 4, p. 13

> Inevitably, the borrower lacks enough equity to continue this cycle (absent rapidly rising property values) and ends up having to sell the house or face foreclosure.[20]

There could have been – should have been – a soft landing, had lenders and investors curbed their appetite as the housing bubble peaked and fewer people could realistically afford loans so large.[21] But they did otherwise. While lenders might prefer a good loan over a bad loan, the evidence suggests that they preferred a bad loan over no loan if they could find a buyer for it.

But now that safety valve, the "distressed prepay exit ramp," is closed by the drop in housing values and current shutdown of the subprime market. The affordability problem is not new – it just grew and became more apparent as the secondary market's appetite for these loans increased. Subprime originations grew from $65 billion in 1995 to $625 billion in 2005.[22] Subprime and option ARM originations in 2006 combined totaled $855 billion**.**[23]

Repayment ability is one rule, above all, that the Board must get right. With 70% of America's economy dependent upon consumer spending, monetary policy depends upon healthy borrowing, not unsustainable borrowing, lest unmanageable debt cause households to curb spending more than a slowing economy needs. As America's debt-to-disposable income ratio has risen from approximately 60% in 1980 to approximately 80% in 1994[24] to 133% today,[25] it is more important than ever that the debt be manageable for those households.

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[20] Final Report of Bankruptcy Court Examiner at 131, *In re New Century TRS Holdings, Inc.*, No. 07-10416 (Bankr. D. Del. Feb. 29, 2008), *available at* http://www.klgates.com/FCWSite/Final_Report_New_Century.pdf. A former broker recently explained in an interview with CRL that borrowers were steered to subprime 2/28s to assure repeat business.

[21] For example, between 2002 and 2006, the gap between home price and income indexes took a dramatic uptick. In 2002, the indexes crossed, with the home price index peaking at above 230 in 2006 while the income index was below 190. SMR *The Mortgage Credit Crisis*, p. 36 (2007).

[22] *Securitization and Screening*, *supra* note 12 at 6 (1995 figures), and Inside Mortgage Finance, I *Mortgage Market Statistical Annual: 2007* p. 4. (2005 figures). Securitization rates increased "from less than 30% in 1995 to over 80% in 2006." *Securitization and Screening* at 6.

[23] Inside Mortgage Finance, I *Mortgage Market Statistical Annual: 2007* at 6.

[24] Dean Baker, Center for Economic and Policy Research, *Dangerous Trends: The Growth of Debt in the U.S. Economy* (2004) at 4, Figure 1.

[25] "Household debt hit a record 133 per cent of disposable personal income [in 2007]." Stephen Roach (chairman of Morgan Stanley Asia), *Comment: America's Inflated Asset Prices Must Fall*, Financial Times, Jan. 8, 2008. We recognize that the Board has frequently used the debt service ratio to evaluate America's debt burden, but one factor that does not account for is time horizon. Belt-tightening for America's households looks quite different when the time horizon to pay credit card debt and auto debt and student loan is perhaps 3-5 years; when the time horizons on all debts start looking like mortgage-length debt, it may be harder to talk American households into more spending in uncertain times.

As the Board notes, in an understated way, "[t]here does not appear to be any benefit to consumers from loans that are clearly unaffordable at origination or immediately thereafter."[26] The costs, on the other hand, we are seeing today – and they are being borne by everyone. Yet the Board has proposed only a half-measure.

A. The "Pattern and Practice" Requirement Must Be Eliminated.

The pivotal reform proposed in these rules is that lenders must not extend "credit based on the value of consumers' collateral without regard to consumers' repayment ability as of consummation, including consumers' current and reasonably expected income, current and reasonably expected obligations, employment, and assets other than the collateral."[27] This is simply common sense underwriting and the core of responsible lending.

Unfortunately, the impact of the proposal is immeasurably weakened by importing the high-cost loan rule's "pattern and practice" requirement. In promulgating these UDAP rules, the Board is not constrained by HOEPA's statutory high-cost provisions, as we discuss in detail in Section V-A**,** below. Not being legally bound to that requirement, all reasonable considerations militate against incorporating it. There are good reasons to eliminate the pattern and practice requirement, while the articulated justification for it – litigation risk for lenders[28] – is insufficient to overcome those reasons. Further, we believe that the Truth in Lending Act already provides lenders with adequate protection from unwarranted litigation risk, making this additional shelter unnecessary.

The purpose of the rule is prophylactic. Simply put, by the time a "pattern and practice" of asset-based lending can be established, too much harm has already been done, and the prophylactic role of the rule has been lost. By the time it turns from "one by one" to a "pattern and practice," the well has already been poisoned. By the time the weak underwriting of a "too big to fail" lender like Countrywide has become manifestly a pattern, a great deal of harm has been done to their customers, neighbors and shareholders. Or, the pattern may only become clear as the lender collapses into bankruptcy, as with New Century or United Lending Companies.[29]

Although regular oversight and examination, in theory, may catch "early warning" signs, that is a separate reform likely to be a while in shaping. Still, existing safety and soundness requirements alone should have been adequate reasons for inadequate underwriting to be red-flagged, yet it appears that it was not.[30] If "pattern and practice"

[26] 73 Fed. Reg. at 1687.

[27] Proposed Rule § 226.35(b)(1).

[28] 73 Fed Reg. at 1688.

[29] New Century was the second largest subprime originator each year from 2003- 2006. Inside Mortgage Finance, I *Mortgage Market Statistical Annual: 2007*, pp. 209-215.

[30] *See supra* note 13.

is insufficient even for institutions subject to routine examination for risk, it is clearly insufficient for entities not subject to that sort of regulatory oversight.

The "pattern and practice" experience under HOEPA's high-cost rules has already proven extremely difficult to enforce. The success of HOEPA's high-cost rules has proven to lie in the aggregate effect of discouraging those loans in their entirety – the intent of that law[31] – rather than in the efficacy of its individual proscriptions. Here, the intent should be the same: to discourage lenders from making loans where the borrower cannot afford to repay. The rule must be preventative since, as the only court to have ruled on the "pattern and practice" requirement along with HUD and the Board itself all have noted, private enforcement of this provision by the intended beneficiaries – homeowners – is difficult if not impossible.

In effect, a provision conditioned on a "pattern and practice" of illegal behavior does not provide any individual consumer with a remedy if they received a loan that the lender knew they could not repay. The ability to repay requirement in the HOEPA context led the judge in the sole reported case to call for corrective amendments to the high-cost loan law.[32] In the joint FRB-HUD report to Congress, both agencies made the same observation and also called for revision of the high-cost loan law's requirement of pattern and practice.[33]

Market discipline failed due to insufficient accountability, not an excess of it. The third reason for deleting the "pattern and practice" requirement is litigation risk. Although the Board cites litigation risk as the reason for including it, we believe the same risk argues *against* including it.

[31] Shortly before the bill's passage, Comptroller of the Currency, Eugene Ludwig, described HOEPA as a "sensible response to reverse redlining" that would deter only those loans "that charge excessive interest or upfront fees, and have repayment terms that the borrower cannot possibly meet." S. Rept. 103-169, 103rd Cong., 1st Sess. 1993, reprinted in [1994] U.S.C.C.A.N. 1881, at 1907. And indeed, high-cost loans are now estimated to be less than 0.1% of home-secured refinancings and home improvement loans. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *The 2006 HMDA Data,* Federal Reserve Bulletin at A88 (December 21, 2007).

[32] *Newton v. United Co. Fin. Corp.* 24 F. Supp. 2d 444, 455 (E.D. Pa. 1998).

[33] Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July 1998), at 62-63 ("As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a "pattern or practice" of making loans without regard to homeowners' income and repayment ability. Thus, the Congress should consider eliminating HOEPA's "pattern or practice" standard, so that individual consumers will have a remedy based solely on their own loans. If the "pattern or practice" requirement is eliminated, creditors should be allowed to accommodate consumers in special circumstances provided that appropriate documentation verifying the circumstances is obtained."), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

The Board cites concerns about the rule having the unintended consequence of unwarrantedly restricting access to credit by creating civil liability in individual cases.[34] As we urged in our introduction, any proposal predicated upon this reasoning should be re-examined with an objective eye and open mind. Congress and regulators have been too protective of lenders for just this reason, with the consequence that they had too little fear of accountability, either legal or regulatory. A complex system of so-called risk-spreading on the back end ultimately provided for no market accountability, either. The real "unintended consequence" of insufficient accountability on all fronts was a lack of market discipline that fed reckless lending practices.[35]

The Board's obligation in promulgating rules under HOEPA is to protect homeowners. In fact, it is not even clear whether it is appropriate to consider litigation risk in determining whether a lending practice is unfair and deceptive — the fact is, lending without regard to a borrower's ability to repay is unfair and deceptive, regardless of whether it is part of a pattern. For the most part, the borrowers' ultimate contribution to this mess consists of "misplaced faith" in assuming that the professionals knew their business.[36] For homeowners to lack any mechanism to seek redress for the harm created by a breach of that faith – and the law – means that one of the key reforms misses its target.

Protecting lenders who write loans without regard to ability to pay from redress by their customers is not sufficient to warrant depriving the intended beneficiaries of their right to enforce the law. Moreover, such a rationale is based on a narrow frame of reference, for litigation risk comes not just from one quarter. By the time a "pattern and practice" of asset-based underwriting comes to light, the lender is exposed to litigation from its investors and commercial partners as well. A recent study of 2007 litigation arising from the "subprime meltdown" reviewed 278 federal class action lawsuits and found that 43% were borrower-related, while 44% were securities and commercial contract disputes, the latter primarily involving repurchase agreements and violations of representations and warranties.[37]

As a practical matter, in its zeal to protect lenders from civil litigation, the pattern and practice requirement may have the unintended consequence of exposing them to a "double or nothing" litigation risk. By the time they have reached a pattern and practice

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[34] 73 Fed. Reg. at 1688.

[35] *See supra* note 12.

[36] The Board notes this phenomenon. 73 Fed. Reg. at 1687.

[37] Jeff Nielsen, *Subprime Mortgage and Related Litigation: 2007: Looking Back at What's Ahead,* pp. 4, 6, 17 (Navigant Consulting, 2008)(securities cases and commercial contract cases each represented 22% of filings.). In the last quarter of 2007, the securities litigation was the growth area, *id* at 4, figure 4, a trend which appears to be continuing in 2008, Kevin LaCroix, *Storm Warning: Subprime Litigation Wave Hits Lehman, Wachovia, Schwab and TD Ameritrade*, The D&O Diary, March 20, 2008 *available at* http://www.dandodiary.com/2008/03/articles/subprime-litigation/storm-warning-subprime-litigation-wave-hits-lehman-wachovia-schwab-and-td-ameritrade/.

threshold, they are not only exposed to their borrowers, but they are also exposed to their investors and their commercial partners who, it appears, also believe they have claims against lenders for irresponsible lending patterns. Like a vaccine, exposure to individual liability from homeowners may inoculate lenders from a three-front litigation risk**.**

In addition, existing TIL law already contains adequate protection from litigation risk from borrowers, thus eliminating the "pattern or practice" condition will not expose the lenders to excessive litigation risk from borrowers. Lenders primarily fear class action risk, and Truth in Lending's private enforcement rules already include built in limitations on class actions. There is a $500,000 cap for statutory damages in a class action.[38] For actual damages, courts are directed to look to, *inter alia,* "the frequency and persistence of failures of compliance by the creditor, the resources of the creditor, the number of persons adversely affected, and the extent to which the creditor's failure of compliance was intentional."[39] In sum, there is a built-in pattern and practice requirement in TIL's class action provisions that already provides ample protection for lenders from undue civil litigation risk.

Furthermore, the general Truth in Lending law already offers lenders adequate defenses to "isolated, random or accidental acts."[40] Lenders may avail themselves of the prophylactic correction of error procedure if they discover the violation through their own audit procedures,[41] or they may demonstrate as a defense that "the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error."[42] In other words, TIL *already* provides insulation from civil liability for "isolated, random or accidental acts." It is not necessary to make this fundamental reform meaningless from the outset in order to give violating lenders a shield already present in the law.

The above limitations provide for an appropriate balance to permitting individual consumers – those most affected by the lenders' violation of this provision – to raise claims when it counts, in their individual cases. Congress has previously made clear its intent that TIL claims as a defense to foreclosure has special status.[43] We are seeing

[38] The class action cap for statutory damages for any class action or series of class actions arising out of the same failure to comply by the same creditor is the lesser of 1% of net worth or $500,000. 15 USC § 1640(a)(2)(B).

[39] 15 USC § 1640(a).

[40] 73 Fed. Reg. at 1732, proposed OSC § 226.34(a)(4)-4.

[41] 15 U.S.C. §1640(b).

[42] 15 U.S.C. § 1640(c).

[43] *See, e.g.* 15 U.S.C. § 1635(i)(1) &(2), providing a rescission foreclosure defense exception to the retroactive immunity provided to creditors in §1649 and lowering the tolerance for error in §1605(f) to $35 when a rescission claim is raised as a defense to foreclosure. *Cf.* Sen. Rpt. 103-179 (noting that the Committee did not intend that the Board's 1639*l*(1) HOEPA rule-making authority be used to limit lenders' liability for violations of high-cost loan provisions).

ample evidence daily that the consequence of reckless underwriting is foreclosure. To insert an already discredited requirement solely to prevent homeowners from using the lender's law violation to defend against the very foreclosure it caused is utterly contrary to the Board's mission. And, ironically, as we explained above, it may well, in the end, increase its litigation risk, not diminish it. We believe that eliminating the "pattern and practice" requirement is essential to the efficacy of the prohibition against asset-based lending. Furthermore, as we noted at the outset, these rules are the Board's opportunity to tell the American public that it is willing to put the individual families' rights at least on a par with the financial intermediaries whose actions have brought us to this pass.

B. Substantively, the proposed presumptions reflect an appropriate balancing of interests, and should not be weakened, but they must be applicable to loan applicants individually, not merely collectively

> **Board question: The Board seeks comment on the appropriateness of the proposed presumptions and whether additional presumptions should be adopted.**
>
> *Summary comment and recommendations:*
>
> We support the proposed presumptions, subject to the elimination of the pattern and practice requirement. We particularly support including a residual income standard, and agree that it is best not to codify a bright-line presumed DTI. We also urge that the Board require that verification records be among the documents assigned when loans are sold on the secondary market.

The proposed rule would create a presumption that the lender has engaged in a pattern and practice of lending without regard to ability to pay if there is a pattern and practice of failing to verify income, failing to underwriting to fully indexed interest rates and fully amortizing payments, and considering appropriate DTIs and residual income.

Providing specific but flexible parameters for common sense underwriting is crucial to ensuring that a prohibition against asset-based underwriting is honored in practice as well as rhetoric. We believe that the substance of the presumptions, as proposed, are workable, and represent an appropriate balance of interests. However, as with the general rule, the promise cannot be fulfilled while the pattern and practice requirement is there.

The pattern and practice requirement for the presumptions also must be deleted. We believe that incorporating the pattern and practice requirement into the presumptions weakens incentives to comply with the substantive rules embedded in the text. As we discussed above, this rule must protect individual home owners, not just homeowners in the aggregate. How many homeowners, one by one, trying to defend a foreclosure where the lender violated these rules, will not be able to establish a "pattern and practice" just as was the case in *Newton v. United Lending*?[44] As drafted, it appears that even if a new a

[44] *See supra* note 32.

homeowner established that her lender did not verify her income, underwrote her loan to a 2% teaser rate, and left her with insufficient income to pay her utility bills after payment shock hits, she could not successfully raise violation of this rule in her foreclosure defense. How many free bites at the apple will a lender get before such conduct becomes a "pattern and practice" cognizable by a court? How useful will this rule be to each homeowner who loses the family home – one by one – because this is a rule that, for all practical purposes, can only be enforced in the aggregate? How exactly is someone across town from Mrs. Newton supposed to know what happened to her unless or until a court decision is published?

We explained in the previous section that lenders have adequate protection from liability for isolated, random or accidental violations in the existing correction of errors provision and the bona fide error defense. Further, proposed §226.34(a)(4)(ii) provides the creditor adequate defense for an individual case where circumstances warrant some deviation, which the Board recognized would be adequate when it previously recommended deletion of the pattern and practice requirement for high-cost loans in 1998.[45] This should provide ample flexibility for special circumstances, such as temporary job postings to a locale.

Subject to the removal of that the pattern and practice limitation, we support the substantive elements of these presumptions.

Verification of income. The Board has recognized that a meaningful assessment of ability to pay is inextricably tied to verifying income. The upsurge in stated income loans in recent years was not the result of changing employment patterns in the country, but rather was an industry practice that made qualifying borrowers for unaffordable loans easier. Originators saved money by skimping on screening for loans bound for the secondary market, which explains the counter-intuitive result that *higher* FICO-score lo-doc loans are about 20% more likely to default than lower score loans, which are less likely to be sold.[46] Tying the verification and ability to repay requirements together through the presumption is appropriate. (The verification proposal is discussed below, in Section VI.)

Underwriting to the higher of the fully-indexed or initial rate, and fully-amortizing payments including all housing related debt: There is now irrefutable evidence that doing otherwise is a recipe for disaster. This presumption generally codifies the standard now applicable to most lenders through the federal subprime, nontraditional, and corresponding state guidances.[47]

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[45] *See supra* note 33.

[46] *Securitization and Screening, supra* note 12, at 16, 18-19.

[47] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006); Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007).

DTI: We support the Board's decision to avoid setting a presumption at a specific DTI. Although CRL was among those who last summer supported a 50% bright-line rebuttable presumption for the ease of compliance, we did so with some hesitancy.[48] We believe that events since then are sufficient proof that the 50% standard is too high for sustainable lending.

We agree that a specific DTI threshold suggests a "one-size-fits all" ability to pay underwriting, which is manifestly not workable. Given that, it is inappropriate to stand as a legal presumption. (It would be even more inappropriate – and actually counterproductive to reform – if a fixed DTI were to be cast as a "safe harbor" rather than a rebuttable presumption.) As we note below, we strongly support the inclusion of a residual income factor – it is most critical for those in the most financially precarious position. But it is difficult to reconcile a bright line presumption at a specific DTI when residual income must be given equal weight.

Further, we note that what counts as "debt" can be manipulated, despite the guidance offered in the commentary.[49] We have seen many loan applications from subprime and nontraditional lenders, filled out by both retail originators and brokers, where the monthly payments on credit card debt, for example, have been manipulated by those originators in order to hit a qualifying DTI.

But most important, we must reconsider the current thinking that a 50% DTI is a reasonable measure as a norm, instead of an outside limit That high delinquency rates have marked this industry from its early days[50] is a clear message that the standard 50% - 55% qualifying DTI it used does not work well as a "presumptively" acceptable debt ratio. The utter collapse of the loans made more recently suggests that, if any "bright line DTI" is used, it should be lower than the 50% and 55% subprime limits.[51] If the Board does include a specified DTI as a presumption, it should be one associated with sustainable mortgage lending, such as FHA standards, not with identified with unaffordable lending. A maximum back-end ratio of 41% would be a more appropriate bright line for a presumption.[52]

Residual income: We strongly support requirement for consideration of residual income. The 50% – 55% DTI ratio widely used as a qualifying DTI in the subprime market was

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[48] ANPRM Comments, *supra* note 8, at 10-19.

[49] Proposed OSC §226.32(d)(7)(iii)-2, describing debt for purposes of the 50% DTI as it relates to the prepayment penalty.

[50] See note 14, *supra* and text accompanying note 18.

[51] The average DTI on subprime originations was 42.1% in 2007 and 41.1% in 2006. Les Christie, *Subprime loans defaulting even before resets*, CNNMoney.com, February 20, 2008. Therefore, a maximum threshold of 50% or higher will cover very few loans and fail to address the affordability problem.

[52] http://www.fh-home-loans.com/debt_ratios_fha_loans.htm.

particularly absurd when applied to low and low-to-moderate income borrowers. A retired person on $1800 per month fixed income paying $600 per month fixed and recurring medical expenses at the time of application never had a chance of sustaining a mortgage that would start him – or take him up shortly – to $900 a month. A debt-to-income ratio without residual income places that retiree on the same basis as a retiree with $10,000 monthly income available. Clearly, they are not, and should not be presumed to be so**.**

C. The rule should govern non-traditional mortgages irrespective of whether they are higher-cost loans

> **The Board also "seeks data and information that would help the Board evaluate the costs and benefits of the proposal as it would affect the subprime market and any portion of the alt-A market to which the proposal may apply."**

- The rule should extend categorically to non-traditional loans irrespective of their price.

As we discussed in Section II, we recommend that non-traditional mortgages be subject to the ability to repay rule irrespective of price. The payment shock on payment option ARMs can be considerably higher than on the much-criticized 2/28s, as reset payments have to catch up both non-amortizing interest payments and the increased loan balance from negative amortization. Freddie Mac officials have said that a "typical" payment option ARM results in a 75% spike in monthly payments upon reset; often the payment shock is even higher.[53]

Nontraditional loans are structurally fragile, and succeed only with the most careful underwriting, as the default rate on the originations from recent years demonstrates.[54] We are also concerned that nontraditional mortgages are being made in quite unsuitable circumstances. We are hearing more frequently of these types of loans being sold to elderly homeowners on fixed incomes, with considerable equity in their homes. The negative amortization feature of these loans makes them quite useful "equity-stripping" loans for house-rich, cash-poor elderly. Again, the big push on these products stemmed from perverse incentives, as they were more profitable for originators. Countrywide

[53] "Freddie officials said a typical borrower who got a $150,000 loan with a starting interest rate of 5.5% two years ago might now face a reset to 12%, raising monthly payments 75% to nearly $1,500." James R. Hagerty and Damian Paletta, *Freddie Won't Buy Some Subprime Loans,* Wall St. J., Feb. 28, 2007, at A2.

[54] *See supra* note 18: Scott Reckard /Tribune Newspapers: Los Angeles Times, *New Alarm: Option-ARM "Liar's Loans,"* Chicago Tribune, January 21, 2008 (reporting with respect to payment option ARMs: "Now the delinquencies are piling up. The more recent loans appear to be faring the worst, reaffirming the conclusion that lending standards had become overly lax throughout the mortgage industry in the middle of this decade . . . . A study by mortgage researcher First American Loan Performance that looked at loans bundled up by lenders and Wall Street firms to back mortgage bonds found that 8.8 percent of such option ARMs made nationally in 2005 were 60 days or more in arrears as of Oct. 31 [2007].")

made gross profit margins on POARMs that were twice that of their FHA loans,[55] and perhaps for that reason, broker commissions on these loans were also higher.[56]

Federal and state regulators recognized the dangers of these loans even before the subprime loans, with the non-traditional guidance preceding the subprime guidance by more than a year. Codifying the guidance would even the playing field for those providers who do engage in the careful underwriting that these products require if they are to succeed. Because these products are, as one commentator says, "the most complicated mortgage product ever marketed to consumers," we believe it is appropriate that they are subject to the key protections, irrespective of cost.[57]

D. We recommend that the rule require that verification documents be among the documents assigned.

Many unaffordable, risky subprime and nontraditional mortgages were originated because of secondary market incentives.[58] We've also learned that there was too little diligence on anyone's part. To keep the machine cranked up, lenders did not spend $20 to verify income,[59] and Wall Street's review process was slack.[60] It is beyond question now that the "back-end" investor demand was a significant part of the problem, and it must now be a significant part of the solution. Since the owners of these loans, once sold, will presumably only be liable to the consumer for violations "apparent on the face of the documents" if the Board does not designate this a material violation for rescission purposes, then *at a minimum*, verification documents must be part of the loan record.[61] The mass extinction of subprime originators in the past year demonstrates that, for this rule to be meaningful for homeowners, they must be able to assert their rights under the law when and where it counts.

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[55] Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender*, New York Times (November 11, 2007) (gross profit margin of over 4% on POARMs compared to 2% on FHA loans as of March, 2007).

[56] Ruth Simon and James R. Hagerty, *Countrywide's New Scare – "Option ARM' Delinquencies Bleed Into Profitable Prime Mortgages* (Wall Street Journal, October 24, 007) (broker commissions on POARMs ranged from 1.75% to 2.5%, compared with 1.48% for standard FRM and 1.88% on subprime).

[57] *See* Marketplace Money, *The Straight Story* (October 20, 2006), *available at* http://marketplace.publicradio.org/display/web/2006/10/20/straight_story_trickle_down/.

[58] For example, in 2006 "sales of [subprime] mortgages produced profits of 2 percent, versus 0.82 percent from prime mortgages" and the figures for 2004 were 3.64% to 0.93%. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, New York Times (August 26, 2007).

[59] Gretchen Morgenson, *A Road Not Taken by Lenders*, New York Times (April 6, 2008)

[60] E. Scott Rechard, *Subprime Mortgage Watchdogs Kept on Leash: Loan Checkers Say Their Warnings of Risk Were Met With Indifference*, Los Angeles Times, (March 17, 2008).

[61] 15 U.S.C. § 1641(a).

SECTION IV

YIELD-SPREAD PREMIUMS MUST BE BANNED FOR SUBPRIME AND NONTRADITIONAL LOANS

BOARD QUESTIONS:

1. Comment generally on the costs and benefits of the proposal, including the costs and benefits of proposed solutions.

2. Should the rule be applied just to higher-cost loans.

Summary comment and recommendation:

- We do not believe that the proposed rule will bring effective and necessary change. Disclosure is not the solution to the problem of reverse competition and perverse market incentives. A prohibition on yield-spread premiums is required, and should apply to higher-cost loans and non-traditional mortgages. Data indicate that YSPs operate as a high "tax" in the subprime market, though may benefit some borrowers in the prime market.

- In the absence of a complete ban, the rule should assure that the consumer does in fact get the benefit that has been claimed (but unsubstantiated) for this charge. No loan should have both a "rate-hiking" yield-spread premium and a prepayment penalty, and the yield-spread premium should in fact act as an exchange for closing costs.

Today, CRL releases a new study of broker compensation showing that subprime borrowers pay significantly more for loans when using an independent broker rather than a retail lender.[62] The stark conclusion of this study is that families in the subprime market pay *significantly* more for their loans if they use a broker, while mortgage brokers in the prime market can provide consumers with a valuable service and are sometimes even associated with lower loans costs. The primary driver of this inequity is the use of yield-spread premiums. This distortion is compounded by their frequent tie to prepayment penalties.

In the supplemental information that accompanies the Proposed Rule, the Board provides a thorough discussion of the inadequacy of relying solely on disclosures rather than on substantive parameters to alleviate unfairness to consumers.[63] The Board also has

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[62] Keith Ernst, Debbie Bocian, and Wei Li, *Steered Wrong: Brokers, Borrowers & Subprime Loans* (Center for Responsible Lending, April 2008), hereafter *"Steered Wrong."*

[63] 73 Fed. Reg. at 1675-76

articulated clear concern about the ”potential for unfairness, deception, and abuse”[64] from yield-spread premiums in distorting the market, concerns underscored by the results of our study. In these two discussions, the Board laid out an excellent case for banning yield-spread premiums, or at minimum taking meaningful action to limit them in the subprime market. Yet, inexplicably, the Board has failed to meet its own challenge. The proposed solution relies entirely on disclosure, a solution that does not match the problem, as accurately described, and one that will have little impact on the market.

The high penetration of potentially dangerous loan products in the subprime and nontraditional markets is inextricably linked to the distortions produced by these perverse incentives in the market. Since investors were willing to pay more for ARMs with prepayment penalties – “because they locked borrowers into high-interest-rate loans with apparently predictable income streams”[65] – lenders’ commission structures rewarded sales representatives for making risky, high-cost loans,[66] and sales representatives often steered borrowers right into them.[67]

This perverse incentive has wrought its harm despite the fact that disclosure of yield-spread premiums and broker fees are already required by RESPA. These requirements, as we show today, have had no success in protecting subprime borrowers. Adding yet another variety of disclosure – especially a disclosure that is structured in a way that does not work within the existing RESPA framework – is highly unlikely to provide additional consumer protection from the perverse incentives created by yield-spread premiums.

We believe that the only effective solution to restore appropriate incentives is to ban yield-spread premiums in the subprime and non-traditional market. Our study today confirms that yield-spread premiums do appear to have some benefit in the prime market, but, like so many other features that purport to be price trade-offs, they trickled down to the subprime market as all cost and no benefit for homeowners.

In the absence of a clear ban, the alternative should not be disclosure, but concrete steps to at least assure that the claimed benefit does exist.

A. Yield-spread premiums constitute an unfair or deceptive practice.

[64] 73 Fed. Reg. at 1699.

[65] *See Countrywide’s Chief Salesman and Defender*, *supra* note 55.

[66] *See Inside the Countrywide Lending Spree, supra* note 58 (“One [Countrywide] document shows that shows that until last September the computer system in the company’s subprime unit excluded borrowers’ cash reserves, which had the effect of steering them away from lower-cost loans to those that were more expensive to homeowners and more profitable to Countrywide.”)

[67] *Id.* (“[A]ccording to [a] mortgage sales representative affiliated with Countrywide, adding a three-year prepayment penalty to a loan would generate an extra 1 percent of the loan’s value in a commission;” “”The whole commission structure . . . was designed to reward salespeople for pushing whatever programs Countrywide made the most money on in the secondary market,’ a former sales representative said.”)

The Board notes in its discussion preceding the proposed rule that yield-spread premiums are not transparent to consumers; that they constitute an incentive to brokers to sell consumers higher-rate loans than people qualify for; that consumers are largely not aware that such payments exist; and that consumers do not fully understand the implications of such payments.[68] CRL agrees with this assessment.

Consequently, as we explained in our ANPRM comments, yield-spread premiums meet all the elements of the test for being banned as an unfair or deceptive practice. There is substantial consumer injury; there are no countervailing benefits to consumers or competition; the practice is not reasonably avoidable by the consumer; and they are inherently deceptive. While we will not repeat all of the arguments we made in our ANPRM comment, it is worth highlighting two key points: subprime homebuyers using brokers pay far more for their loans; and yield-spread premiums distort the market.

1. *Yield-spread premiums harm subprime consumers because consumers using independent brokers rather than retail lenders pay significantly more for comparable loans.*

Yield-spread premiums are typically justified by the industry as a way for consumers to reduce out-of-pocket closing costs by trading those costs for a higher rate. The empirical evidence, however, does not support that finding, particularly with respect to subprime loans.

CRL's new study shows that subprime borrowers pay significantly more for loans when using an independent broker rather than a retail lender.[69] It also finds some startling information about how quickly these additional costs show up. While it may be less surprising that a brokered loan costs more over the entire life of the loan (typically 30 years), the study shows that those increased costs are evident *after just one year*, even before introductory rates have reset. And at the four-year mark, a time period chosen to reflect average loan life, the difference in costs is stark: 5k.[70]

Our data did not permit us to examine the relationship between yield-spread premiums and direct broker fees, but prior studies indicate that yield-spread premiums on subprime loans do not serve to reduce fees significantly. One study showed that borrowers only receive 25 cents in reduced fees for every one dollar paid in yield-spread premiums to brokers and that upfront fees are actually lower for retail loans than for brokered loans.[71] Most subprime loans carry significant direct upfront broker fees *along with* the yield-

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[68] 73 Fed. Reg. at 1698.

[69] *See Steered Wrong*, *supra* note 62.

[70] *See Steered Wrong*, *supra* note 62, at 3-4.

[71] Howell E. Jackson and Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield-spread premiums*, 12 Stan. J.L. Bus. & Fin. 289, 332 (2007); *see also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harvard J. on Legis. 123, 139 n.94 (2007) and sources cited therein.

spread premium. They compensate the broker at both the front and back end, essentially buying the rate down, then buying it right back up

2. *Yield-spread premiums distort normal market incentives and impede market efficiency.*

Most consumers believe that the job of a broker is to represent the borrower's best interest.[72] This is not surprising, as it is typically the way a broker sells his specialized expertise. Yet for brokers, yield-spread premiums generate a financial conflict of interest. It is a zero-sum game, wherein they maximize their own income at the expense of their customers, and the result of this conflict of interest is, as CRL's broker study shows, higher costs to consumers. It should not be surprising that brokers react to market incentives by attempting, and often succeeding in the subprime market, to do what provides them greater income.

Lenders are pulled both ways by this conflict of interest. On the one hand, many of them recognize that yield-spread premiums create a reverse competition: the lenders must compensate brokers, rather than competing for the consumers' business. Most lenders who use independent brokers, then, must offer incentives such as yield-spread premiums for higher-rate loans to attract business from those brokers. This is anti-competitive, yet the practice has flourished. And it cannot be denied that, however distasteful lenders may find themselves to be beholden to brokers, instead of customers, these premiums also can allow the lender to profit, as additional interest from the higher rate loan will continue to flow to the lender (or subsequent investors) over time, eventually earning more money for the lender than the lender paid to the broker.[73]

Banning yield-spread premiums on subprime and nontraditional loans is the only way to eliminate both the reverse competition in the marketplace and the insidious conflict of interest that pushes brokers to take unfair advantage of their clients. Results from recent state law limiting yield-spread premiums demonstrate that, like so many other recent reforms in states, it will not restrict access to responsible credit. One of the new regulations that went into effect in Massachusetts in January of this year precludes brokers from accepting compensation where there is a conflict of interest – functionally a ban on yield-spread premiums as the regulations define that conflict.[74] Shortly after implementation, Wells Fargo changed its broker compensation system from "a sliding fee

[72] In fact, at one point, the National Mortgage Brokers Association's Code of Ethics recognized that the "obligation of absolute fidelity to the client's interest is primary," quoted in National Consumer Law Center, The Cost of Credit, §11.8.2 n.286 (1st ed. 1995). However, this provision no longer appears in their Code of Ethics: http://www.namb.org/images/namb/Ethics/Code_Of_Ethics.pdf.

[73] *See supra* note 62.

[74] Commonwealth of Massachusetts Attorney General's Regulations, 940 MA ADC 8.06(17), Mortgage Brokers and Mortgage Lenders – Prohibited Practices.

based on loan's profitability to a flat 1.5% of the loan amount."[75] In short, the Massachusetts rule it appears to be working to eliminate the perverse incentive and the conflict of interest. Now that the broker does not receive greater income by convincing the borrower to accept a loan with a higher interest rate than he or she qualifies for, there is no reason to expect that the broker will even make such an effort.

B. The proposed disclosure scheme will not protect consumers from the harm caused by yield-spread premiums.

The Board proposed a rule that will require a broker to tell consumers in advance of entering into an agreement with the broker how much total compensation the consumer will owe the broker. The intention is that consumers will be able to shop for the lowest-priced broker because the pricing will be more transparent, and this shopping will put downward pressure on broker prices. Yet this approach ignores the realities of the experience of most subprime borrowers.

1. *Consumers, especially in the subprime market, face significant obstacles to shopping for the best mortgage option.*

The "rational choice theory" of economics assumes that people will acquire and use available information to choose the best option based on their own set of preferences and constraints. However, research on borrower behavior has shown that borrowers face serious barriers to effectively shopping for mortgages.

Every available piece of evidence suggests that for the most part, disclosure does not work to protect consumers in situations where the products are complex. Among the most important – though unsurprising – findings of the Federal Trade Commission study of homeowners' understanding of mortgage terms was that borrowers have more trouble understanding complex loan terms.[76] It is therefore a very real concern that it is more difficult for subprime borrowers to understand their loans than prime borrowers – "due largely to the complexities of the loans, rather than the capabilities of the borrowers."[77]

Similarly, a 2007 study by Harvard University finds that borrowers have a limited ability to analyze and compare multiple, complex mortgage products. The study finds that the complexity of mortgage pricing hampers both borrowers' ability to assess risk and to comparison shop.[78] Yield-spread premiums, and their interactions with other terms both

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[75] Binyamin Appelbaum, *Most Lenders Accept Tough New Mortgage Rules in Mass*, Boston Globe, (January 10, 2008).

[76] James K. Lacko & Janis K. Pappalardo, *Improving Consumer Mortgage Disclosures*, p-. 74-76 (Federal Trade Commission, Bureau of Economics Staff Report, June 2007).

[77] *Id.*

[78] Ren S. Essene and William Apgar. "Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans." Joint Center for Housing Studies. Harvard University (2007).

real, (as with prepayment penalties, *see* Section V, below*)*, and oft-times misrepresented, (as with the purported trade-offs), are part of that complexity.

If it is difficult for the average consumer to do this, consider the added vulnerability of those homeowners who must be even more reliant upon the professional integrity and honesty of mortgage professionals – the less educated, unsophisticated, illiterate, or those for whom English is not their primary language.

But it is not simply the most vulnerable consumers who are ill-served by a disclosure-only "reform." As former MBA President and current HUD General Counsel Robert M. Couch has explained, "Consumers rarely use these forms and disclosures to compare prices or identify the terms of the transaction because, quite simply, they cannot understand what they read nor what they sign."[79]

2. *Disclosure requirements are highly susceptible to fraud, deception and manipulation.*

Even if it were possible to design a perfect disclosure form, the difficulty in analyzing and comparing complex terms is exacerbated by aggressive and deceptive marketing practices.

For decades, mortgage originators have operated under a number of disclosure requirements, particularly those set out in TIL and RESPA, as well as adding their own disclosures to the transaction in order to limit their liability. The fact is, these multiple disclosures not only have failed to provide consumers with the information they need to make the best mortgage choice, but the proliferation of disclosures has exacerbated the information overload that consumers currently face. Indeed, the first line of defense for the overreaching lender or broker is typically a variant of the "here's the paper, and the borrower signed it."[80] Another typical problem is that disclosures required to be given in advance are given at the closing table and backdated. Or, a disclosure is made accurately, but when a consumer asks about the importance of the disclosure, the originator (usually a mortgage broker) tells them that what is on the paper is meaningless and that they will "fix" the papers later.

3. *Total broker compensation only tells the consumer how much the broker is being paid, not how much the loan costs, so the consumer is still unable to shop for the lowest-priced loan.*

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[79] Robert Couch testimony before the U.S. House of Representatives Financial Services Subcommittee (November 2003), cited in "Financial Education: No Substitute for Predatory Lending Reform," Issue Paper No. 7, Center for Responsible Lending (September 13, 2004).

[80] During prior service as a regulator, one of the authors of these comments used an informal "blizzard index" to assess the likelihood by which a blizzard of papers and so-called disclosures would have been used to minimize their usefulness to the consumer, maximize the ability of a sales person to misrepresent their contents, and then be used as a shield when caught.

A rule requiring advance disclosure of total broker compensation only tells the consumer how much the broker could ultimately get paid. It does not tell the consumer how much the consumer will pay in total for the loan over the life of the loan, which is presumably the information a consumer needs to make the most rational choice of loan. The amount paid to the broker through a yield-spread premium does not always match the amount of money that a consumer could have saved without the yield-spread. The yield-spread is generally calculated as a percentage of the total loan amount. Yet, depending on how long an individual homeowner holds a loan, if the interest rate on that loan is higher than that homeowner otherwise would have paid, over the life of the loan, the homeowner could end up paying many more thousands of dollars than he or she otherwise would have. The "Steered Wrong" study found that subprime borrowers steered into higher rate loans pay additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan.[81]

As Harvard Law Professor Howell Jackson notes, "even if consumers appreciate that they are being required to make higher monthly payments on their mortgage in order to compensate mortgage brokers, consumers tend to undervalue periodic future payments as opposed to up front cash, and may thus underestimate the significance of higher interest rates."[82]

The rule also fails to give the consumer the information needed to choose between paying a broker through up-front fees versus the back-end yield-spread premium. It does not specifically require that the broker explain the concept of yield-spread premiums at all, except to give them a nonspecific warning that broker compensation by a creditor can lead the broker to offer products "that are not in the consumer's interest or are not the most favorable the consumer could otherwise obtain." (Sec. 226.3(a)(iii)). Nor does it require explaining the relationship between interest rates and yield-spread premiums, or provide information about what alternate interest rates would be available if the consumer preferred to pay fees up front.[83]

Finally, the rule fails to mention that the borrower may also have a prepayment penalty on the loan, a feature that is often required if a yield spread is paid.

<u>C. In the absence of the effective reform -- ban on yield-spread premiums in higher-cost and nontraditional loans, the rule should, at a minimum, eliminate the perverse incentives and require a price trade off.</u>

The Board has accurately diagnosed the problem with yield-spread premiums, but offered a proposal that fails to address the consequences of abuses that result from the perverse incentives created by the payment of yield spreads. In the absence of a ban, the next

[81] *Steered Wrong*, *supra* note 62, at 16.

[82] Jackson & Burlingame, *supra* note 71, at 309.

[83] This is in contrast to the new RESPA rule recently proposed by HUD.

preferable alternative is to at least ameliorate the worst abuses, by eliminating the incentives and assuring that the purported price trade-off actually exists.

In the absence of a ban, we recommend the following:

Provide that:

> It is an unfair and deceptive practice to make or approve a mortgage loan that includes a yield-spread premium, or to collect a yield-spread premium imposed in violation of this paragraph, unless –
>
> (A) the mortgage broker receives no other compensation, however denominated, directly or indirectly, from the consumer, creditor, or other mortgage originator;
> (B) the loan does not include discount points, origination points, or rate reduction points, however denominated, or any payment reduction fee, however denominated;
> (C) the loan does not include a prepayment penalty; and
> (D) there are no other closing costs associated with the loan, except for fees to government officials or amounts to fund escrow accounts for taxes and insurance.

We do not believe that the alternative under consideration which would permit payments by a creditor to a broker as long as they are not tied to the loan rate will be of any use. This opens to the door to simply readjusting incentives – there are many other ways to place and keep consumers in disadvantageous loans. Currently, creditors also encourage brokers by paying them more for selling customers loans with prepayment penalties, or for originating a higher volume of loans.[84] These payments are in many cases even more difficult to police than yield spreads, but have equally perverse consequences.

SECTION V

PREPAYMENT PENALTIES SHOULD BE PROHIBITED IN HIGHER-COST LOANS

Board question: Does the proposal appropriately balance the costs and benefits of prepayment penalties?

Proposed comment and recommendations:

- The proposed rule will do nothing to curb the harm caused by prepayment penalties. They should be prohibited in the subprime market.

- If the Board does not ban them, limitations should at least bring some reform to the market, which the proposed limitations will not.

[84] *See infra* Section V.B.1.a.

Prepayment penalties are a pervasive and insidiously harmful feature of the subprime market. The direct and indirect costs of these market-distorting penalties to consumers – and to competition – far outweigh their benefits in the subprime market, warranting a complete prohibition.

In this section, we discuss first the latitude the Board has to address this practice as a matter of administrative law. We show that 15 U.S.C. §1639*l*(2) (hereafter the "HOEPA UDAP" authority) unequivocally gives the Board the authority to ban any practice that, under the FTC and state UDAP standards, is unfair, deceptive, or abusive and not in the best interest of refinancing borrowers, and that the authority to prohibit such acts exists independent of prior Congressional actions with respect to high-cost mortgages in other parts of HOEPA.

We then argue that the Board's current proposal does not reflect an appropriate balance of the potential costs and potential benefits of prepayment penalties.[85] We do not address some specific questions posed by the Board with respect to those proposed limitations drawn from the existing high-cost limitations, but instead argue that the Board is not only free to look to other solutions, but must do so, for those limitations will do virtually nothing to address the identified problems. The sole new limitation, a 60-day penalty-free period prior to an ARM reset, is wholly insufficient to turn these limitations into a meaningful curb on the abusive use of this feature.

Our recommended approach, which we believe is the only truly effective solution, and one well within the Board's authority, is a ban on this "exit tax" for homeowners in these higher-priced loans. The Board has the benefit of seeing the impact of millions of subprime loans with prepayment penalties since 1994, and should use that knowledge in this case. In the alternative, the minimum necessary reform is to eliminate the perverse market incentive that led to originators automatically packing loans with this feature: no loan may have both a prepayment penalty and a yield-spread premium or overage.

<u>A. The Board has the Authority to Ban Prepayment Penalties in the Subprime Market. It is Not Limited by Prior Congressional Actions with Respect to High-Cost Loans in 15 USC § 1639(c).</u>

The Board is given the authority in 15 U.S.C. §1639*l*(2) to *prohibit* "unfair [or] deceptive acts or practices" and refinance practices which are "abusive or otherwise not in the interest of the borrower" in the mortgage market. This mandate could not be clearer. Principles of statutory construction and administrative law support the right of the Board to ban prepayment penalties for higher cost loans, or, at a minimum, to design limitations more tailored for alleviating the problems they cause. The Board's freedom to act against

[85] Our ANPRM Comments included a detailed analysis of prepayment penalties in the subprime market and applied the UDAP standards to them. In these comments, we update the analysis, but have tried to avoid much repetition and so incorporate the prior comments. ANPRM Comments, *supra* note 8, at 10-19.

the unfair, deceptive and abusive use of these terms pursuant to subsection (2) is not limited by the statutory limitations of 15 U.S.C §1639(c) applicable to high-cost loans.

The Board's HOEPA UDAP authority is one of three distinct sources of regulatory authority in TIL and HOEPA. The first is the general grant for Truth in Lending, 15 U.S.C. §1604(a). This is a broad delegation, and includes the power to make

> classifications, differentiations, or other provisions, and [] such adjustments and exceptions for any class of transactions, as, in the judgment of the Board are necessary or proper to effectuate the purposes of [TIL], to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

The Supreme Court has directed courts to give great deference to the Board's rule-making and interpretations under this section as to the "interstices" or "gaps" of the statute. Indeed, its actions should be "dispositive," unless they are "demonstrably irrational."[86]

But Congress did not rely simply on this pre-existing general grant of authority to implement the 1994 HOEPA amendments, as it might have done. Rather, it added not one, but <u>two</u> separate and distinct grants of authority. One, a comparatively narrow delegation, was tied specifically to the substantive provisions applicable solely to high-cost mortgages, 15 U.S.C. § 1639*l*(1) (hereafter "high-cost loan authority"). The second grant of authority for rule-making is the UDAP authority, applicable to the whole mortgage market, 15 U.S.C. § 1639*l*(2), the broadest of the three.

These two provisions represent two distinct approaches in HOEPA, both as to the scope of authority delegated to the Board and as to the scope of market-place regulation generally. A comparison of all three of the Board's separate grants of rule-making authority demonstrates that Congress is well aware of the distinction between giving an agency *bounded* authority to make certain adjustments to specific Congressional prescriptions and giving it *broad* authority to continually monitor for evolving dysfunctions in the market and fix them without the need to return to Congress for permission.

In each of the three provisions delegating authority to the Board, Congress lays out two things: the range of actions available to the Board and the standards it is to use in deciding whether to take such action.

<u>*1. Section 1604(a):*</u> Under the general §1604 authority, the Board's options include making classifications, differentiations, adjustments and exceptions. The circumstances upon which it may take such actions are as "necessary or proper to effectuate the

[86] *Ford Motor Credit Co. v. Milhollin,* 444 U.S. 555, 565-66 (1980). This "demonstrably irrational" standard arguably is a higher deference standard than the general agency standard articulated in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 844 (1984) (arbitrary, capricious or manifestly contrary to the statute).

purposes of [Truth in Lending], to prevent circumvention or evasion thereof, or to facilitate compliance" with Truth in Lending.

2. Section 1639l(1): In HOEPA, Congress took a different direction *for high-cost loans*. Congress had conducted its own examination of the abuses then prevalent in the marketplace over the course of two years.[87] It then decided specifically which of those problems to address by legislation and precisely how to address them. The result was a statute that defined with precision what market segment to cover,[88] what additional disclosures should be made for those loans, and what practices should be prohibited or limited *for those loans*.[89]

Having made its own specific diagnosis and treatment plan for these loans, Congress did not wish the Board to weaken it, and it circumscribed the Board's ability to loosen the statutory provisions. For high-cost loans, the Board does not have the general §1604 authority – the §1639*l*(1) replaces that general authority.[90] The Board may not create any exceptions or exemptions from HOEPA's disclosure requirements, though it may exempt specific products or categories from one or more of the seven specific prohibitions and limitations in §1639(c) – (i).[91] The standards in this delegation make it clear that such exemptions are only to be for the benefit of the borrowing public, not to accommodate industry concerns about compliance burden. Only where an exemption is "in the interest of the borrowing public, and will apply only to products that maintain and strengthen home ownership and equity protections" may the Board authorize the exemption.[92]

3. *Section 1639l(2)*: Like both of the other provisions, the UDAP delegation specifies both what action the Board may take and the standards it should use in deciding when

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[87] *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. (Feb. 3, 17, 24, 1993); *Hearing on S.924 Home Ownership and Equity Protection Act, before the Senate Banking Committee*, 103d Cong., 1st Sess. (May 19, 1993); *The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs*, 103d Cong., 2d Sess. (Mar. 22, 1994); *Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance*, 103d Cong., 1st Sess. (Feb 2-4, 1993).

[88] 15 U.S.C. §1602(aa) (defining alternative price triggers for "high-cost" loans).

[89] 15 U.S.C. §1639(a) (disclosures), §1639(c)-(i).

[90] 15 U.S.C. §1604(a) ("Except in the case of a mortgage referred to in section 1602(aa) of this title…"); S. Rept. 103-169, 103rd Cong., 1st Sess. 1993, *reprinted in* [1994] U.S.C.C.A.N. 1881, at 1911. ("The discretionary authority provided in the bill for High Cost Mortgages *replaces, for these mortgages*, the existing regulatory discretion in the Truth in Lending Act.") (emphasis added).

[91] *Id.* ("It is the Committee's intention to allow exemptions for High Cost Mortgages only from the prohibitions in the legislation, not from the liability or disclosure provisions.")

[92] *Compare*§1604(a) (may make adjustments and exceptions as are necessary or proper, *inter alia*, to facilitate compliance).

that action is warranted. Unlike the Board's authority for high-cost loans under subsection (1), this delegation adds to the Board's general §1604(a) authority rather than replacing it.

Critically, Congress does not direct the Board to look to standards set in HOEPA for high-cost mortgages for this UDAP authority – it does not mandate that the Board, for example, *extend* the high-cost prohibitions to other parts of the market to curb abuses. It does not direct the Board to look to TIL or HOEPA at all, in fact. Rather, it directs the Board to FTC and state UDAP law. As Congress well knows, UDAP authority was explicitly designed to give regulators the flexibility to keep up with changing practices and conditions in the marketplace.[93]

Other than granting UDAP rule-making authority to the Board in HOEPA, Congress has not spoken about the specific problems and abusive practices that bedevil the broader mortgage market nor enacted specific solutions for them.[94] The Board's HOEPA UDAP authority under subsection (2) for new problems, and, indeed, for evolutionary variations on old problems, then, exists entirely in the silent "gaps" or "interstices" of the statute, where the Board's actions should be "dispositive" unless demonstrably irrational.

Congress gave the Board an ongoing duty to continue the task it had begun in 1993-94 of monitoring the market to identify new and evolving areas of abuse, presumably to save itself the "endless task" of continually defining and prohibiting those acts. The Board was directed to conduct periodic examinations of the marketplace to examine "the adequacy of existing regulatory provisions and legislative provisions and the provisions of [HOEPA] in protecting the interests of consumers, and low-income consumers in particular."[95]

Congress also did not instruct the Board to come back and ask for permission to act. Rather, the intent was for the Board, through these hearings, to develop an understanding of the market. If existing legislation and regulation is not sufficient unto the task, it should use this "flexibility to address future problems *before legislation is necessary* and before consumers have lost their homes."[96]

By directing the Board to UDAP standards, Congress did not limit the Board's options to borrowing from ideas found in HOEPA's high-cost provisions or to TIL in general.

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[93] *See, e.g.* H.R. Conf. Rep. No. 1142, 63d Cong. 2d Sess. 19 (1914), *quoted in FTC v. Sperry & Hutchison Col*, 405 U.S. 233, 240 (1972) ("It is impossible to frame definitions which embrace all unfair practices. There is no limit to human inventiveness in this field . . . . If Congress were to adopt the method of definition, it would undertake an endless task.")

[94] The only other federal consumer protection statute specifically aimed at the broader mortgage market is the Real Estate Settlement Procedures Act of 1974, 24 C.F.R. 3500, which is silent as to prepayment penalties.

[95] P.L. 103-325, Title I, § 158.

[96] HR Conf. Rep. 103-652 at 1995 (emphasis added).

Instead, this broad delegation reflects Congress' recognition that it does not have all the answers for all time: ". . . prescience, either in fact or in the minds of Congress, does not exist. Its very absence, moreover, is precisely one of the reasons why regulatory agencies . . . are created, for it is the fond hope of their authors that they bring to their work the expert's familiarity with industry conditions which members of the delegating legislatures cannot be expected to possess."[97]

Thus, there is no legal basis in HOEPA for the Board to restrict itself in its UDAP rule-making to the same prepayment penalty rules applicable to high-cost loans. Quite the opposite, in fact – prepayment penalties were explicitly identified as a practice which "may be appropriate" for the exercise of this 1639*l*(2) authority.[98] That Congress prescribed one solution for one category of loans in no way requires the Board to prescribe the same solution for a different category of loans and in different market circumstances.[99]

It is clear, then, that UDAP and related standards must be the sole measure by which the Board is to assess the role that prepayment penalties have played in distorting a fair and competitive marketplace since 1994. If prepayment penalties as they operate in the market meet these standards, then the Board not only has the express authority to ban them completely, it has a *duty* to do so.[100]

The case for eliminating prepayment penalties from the subprime market entirely, far from being "demonstrably irrational," is quite the opposite. It is a rational – and authorized – response to a significant abuse in the subprime market.

B. Prepayment penalties in the subprime market meet the standards necessary for the board to ban them under its udap authority.

1. The Board's proposal does not appropriately balance the costs and putative benefits of prepayment penalties in the subprime market.

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[97] *Mourning v. Family Publications Services,* 411 U.S. 356, 372 (1973), quoting *American Trucking Assns v. United States*, 344 U.S. 298, 309-310 (1953) (citations omitted).

[98] H.R. Conf. Rept. 103-652, *reprinted in* U.S.C.C.A.N. [1994] 1977 at 1991-92

[99] *Cf. Mourning v. Family Publications Services,* 411 U.S. 356, 372-373 (1973) (references in TIL to one category of transactions (those involving finance charges) do not limit the Board's authority to issue deterrent regulations that apply to another category of transactions (those without finance charges),) ; . *American Financial Services Ass'n v. Federal Trade Commission*, 767 F.2d 957, 966. (D.C. Cir. 1985) (efforts to "cabin" and narrowly circumscribe UDAP regulatory authority to define unfair practice have been rebuffed: "neither the language nor the history of the [FTC] Act suggests that Congress intended to confine the forbidden methods to fixed and unyielding categories.")

[100] 15 U.S.C. §1639*l*(2)("The Board, by regulation or order, *shall prohibit [such]* acts or practices . . .") (emphasis added).

Our ANPRM comments argued that prepayment penalties met the FTC unfairness test: they cause consumers considerable injury, in the form of lost equity and increased risk of foreclosure; the costs are not outweighed by benefits to consumers or competition, as the benefits are overstated; and the costs are not avoidable, due to distortions inherent in the subprime model itself.[101] They also highlighted the relationship between these penalties and yield-spread premiums that created a perverse incentive, resulting in borrowers paying more on both the front and the back end for these loans. Yet the Board's proposal does nothing to sever this tie or neutralize the incentive to sell more risk and more cost to homeowners.

The Board's balancing assumes the following benefits to consumers from prepayment penalties:[102]

- _Choice:_ At least in theory, an individual consumer has a choice to accept or reject a prepayment penalty;
- _Price trade-off:_ At least in principle, the individual consumer's voluntary choice to accept a prepayment penalty would be made based on a trade-off for a lower interest rate on the note;
- _Secondary market liquidity:_ Overall, the subprime market may benefit by making cash flow more predictable and increasing liquidity in the secondary market: "a more liquid secondary market may benefit borrowers by lowering interest rates and increasing credit availability."[103]

The injury and countervailing costs to consumers identified by the Board are:

- the penalties can prevent borrowers from exiting high-cost or unaffordable loans;
- if borrowers are able to pay the penalty and refinance, the penalty itself represents lost equity, which is compounded by the fact that it is financed in the subsequent loan(s);
- the value of the "voluntary choice" to take a loan with a prepayment term is questionable because there is a lack of transparency about the cost, a lack of understanding of the cost, and it is "questionable" whether consumers can accurately assess and weigh contingent costs;
- the lack of transparency is magnified by market distortions which create incentives for originators to impose prepayment penalties for their own benefit.

a. The benefits articulated are overstated, or assumed with little or no supporting evidence.

[101] *See* CRL ANPRM Comments, *supra* note 8, at 10-19.

[102] 73 Fed. Reg. at 1693-94.

[103] *Id.*

We believe that these purported benefits are overstated. Some, in fact, are almost entirely illusory and not supported by credible evidence.

Choice: We are unaware of empirical evidence to support the argument that subprime borrowers choose prepayment penalties, and the Board cites none in its supplementary information. (Indeed, it carefully couches this alleged benefit, saying that "[i]n principle, a lender may offer a choice . . .").[104] But at least three factors undermine the notion that borrowers choose this term. The first factor is the lack of consumer understanding about prepayment penalties and their costs and effects.[105] Second, evidence obtained by regulators during the course of investigations of dominant market players found that prepayment penalties were "packed" into loans, not chosen by borrowers.[106] Finally, and perhaps most telling, the extraordinarily high penetration rate of prepayment penalties in the subprime market defies the notion that could be achieved by choice. They are rare in the prime market, where the alleged price-trade-off may be a good buy, but standard in the subprime market where the borrowers have every incentive to get out of higher-cost loans as soon as possible. Taken together with lenders' desire for the penalties, and the perverse incentives they give originators to push these penalties, the weight of the evidence is that the choice is on the supply side, not the borrower's.[107]

Our earlier comments noted that nearly 70% of subprime loans included prepayment penalties, compared to only about 2% in the prime market.[108] Despite the disruptions in the subprime market since then, these penalties continue to be a standard term. Fully two-thirds (66.6%) of the subprime MBS market share for 2007 included prepayment penalties, down only slightly from 69.1% in 2006.[109] Even as overall subprime originations plummeted since August 2007, 47% of asset-backed securities issuances of 4Q07 included payment penalties.[110]

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[104] 73 Fed. Reg. at 1693.

[105] *See* 73 Fed Reg. at 1694 and Section V-B-2, below, for further discussion.

[106] States' investigations of both Household (settled 2002) and Ameriquest (settled 2006) included abuses of this nature. Together, these two were the top originators for five years, from 2001 through 2005.

[107] We have previously explained that lenders encourage brokers to put borrowers in loans with prepayment penalties by tying maximum yield-spread premiums to the maximum prepayment penalties, *see* Sec. III, *supra.* The lenders, in turn, want the prepayment penalties because they are lucrative for the lender. And they are lucrative for the lender, because investors pay more for them. *See, e.g.* Gretchen Morgenson, *Inside Countrywide Lending Spree,* New York Times (August 26, 2007)(Countrywide's margin on loans with three year prepayment penalty could reach 15% of the loan; loans so lucrative because investors paid more for them.)

[108] CRL ANPRM Comments, *supra* note 8, at 13.

[109] *Inside B&C Lending,* p. 3 (February 15, 2008).

[110] *Id*.; *Inside B&C Lending,* p. 2 (January 18, 2008).

Current rate sheets demonstrate that, for the majority of states,[111] prepayment penalties are still the norm in the subprime market but not in the prime market.[112]

- Chase Bank rate sheets for subprime mortgages for mid-March 2008, include a base three-year prepayment penalty in the par rate for the majority of the country.[113]

- Citi Mortgage non-prime rate sheet and Citi Residential Lending (fka Argent, Ameriquest's broker channel) rate sheets for the same period automatically include a prepayment penalty in the par rate.[114]

- Citi Mortgage rate sheets for prime loans of all types, by contrast, make no mention of prepayment penalties. They are not automatically included in the par rate, and are not even mentioned as a "choice" for prime borrowers to use to reduce the rate.[115]

Price trade-off: The corollary to the argument that borrowers choose terms that limit their ability to get out of these higher-priced loans is that they get some value in return: the value obtained, in theory, is a reduced interest rate. Here, too, the weight of the evidence is to the contrary. In our previous comments, we noted that a conservative estimate is that "borrowers will pay $2 in prepayment penalties for every $1 in interest rate benefits on hybrid ARMs."[116] Even the one study which posits a price trade-off

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[111] There is no explanation as to what distinguishes the states in which the prepayment penalty is standard from those in which it is neither included nor offered. There appears to be considerable overlap among the latter with those in which state mini-HOEPA laws capture prepayment penalties in the points and fees trigger or are banned for state mini-HOEPA laws.

By contrast, these lenders automatically include prepayment penalties even in some states with bans on prepayment penalties that are not part of mini-HOEPA laws, e.g. Iowa. These lenders can avail themselves of the OCC's preemption of state laws on prepayment penalties, though the OCC has only expressly preempted one state mini-HOEPA law, the Georgia Fair Lending Act.

[112] *See*, App. B-1, Chase Subprime Rate Sheets Region 1 (March 10, 2008); App. B-2, Citi Residential Lending (March 19, 2008); App B-3 – Citi Mortgage Rate Sheet (March 10, 2008), p. 8. App. B-1 consists of Chase Subprime Rate Sheets Region 1, consisting of 38 states. App. B-2 is Citi Residential Lending's non-prime rate sheet. Citi Mortgage's March 10, 2008, non-prime product has an automatic 3-year prepayment penalty for most states, App. B-3, p. 8, while its prime rate sheets make no mention of prepayment penalties either as a feature of the standard product or even as an available adjustment. App. B-3, pp. 1-7.

[113] App. B-1 – Chase Subprime Rate Sheets Region 1 (March 10, 2008).

[114] App. B-2 – Citi Residential Lending (March 19, 2008); App B-3 – Citi Mortgage Rate Sheet (March 10, 2008).

[115] App B-3 – Citi Mortgage Rate Sheet (March 10, 2008).

[116] CRL ANPRM Comments, *supra* note 8, at 16**,** *citing* Michael Calhoun, *Comments, p. 5* (discussant on Elliehausen, Staten, and Steinbuks, *The Effect of Prepayment Penalties in the Pricing of Subprime Mortgages,Sept. 2006), at session, "Are Legislative Remedies to Limite Predatory Lending Really*

works out to a benefit less than 20% of its purported benefit.[117] Overall, prepayment penalties in the subprime market represent an overall net loss to homeowners, costing borrowers more at the front end and the back end. As we noted in our earlier comments, "we now know that borrowers with prepayment penalties are not only trapped, they are paying more for being put in that trap by a poorly functioning market."[118]

If prepayment penalties are merely a price trade-off, [119] then state bans or tight restrictions should lead to somewhat higher interest rates in those states. They do not. Our earlier comments noted the results of our empirical study of the impact of state consumer protection laws on both the flow and price of credit. We explained there that in some states, prepayment penalties were the only consumer protection provision the impact of which was measured.

> [T]he interest rates on fixed rate mortgages in all eleven states [in which prepayment penalty protections were the only protection measured] *were lower* than interest rates in control states that did not significantly restrict prepayment penalties. On ARMs, the six states with the most protective laws had interest rates that were *lower* than those prevalent in the control states, and there was no difference in the remainder.[120]

Remedies," The Federal Resreve System's Fifth Community Affairs Research Conference (March 29, 2007).

[117] The one study which posits a benefit does so based on a database of subprime loans made from 1998 to 2004, contributed by 8 subprime lenders, together responsible for nearly a quarter of 2004 subprime originations., *see* Elliehausen, et al, op cit, at 2. The contributors are not identified, and we are concerned that the data from a self-selected and limited group of originators may create some selection bias, making it an unsuitable database, or at least one which must be treated with great caution. We note that three major originators with dominant market shares over that six-year period were the subject of law enforcement actions, Household, Associates and Ameriquest. These actions resulted collectively in over $1 billion in penalties and restitution. Additionally, at least two other major lenders during the early years of that period utilized a similar business model to two of the law enforcement targets but collapsed in bankruptcy. If the Board is to consider studies from this database in its decision, we urge that, at a minimum, it consult with regulators familiar with the business models and practices in which these lenders engaged during the period, to determine whether the illegal practices might have affected outcomes reflected in loans in that database making it unreliable for some purposes.

[118] CRL ANPRM Comments, *supra* note 8, at 15.

[119] If prepayment penalties truly were merely a rate trade-off, up to the borrower to choose, then the market should be neutral about which choice the consumer makes. Its prepayment risk would be covered, whether by the penalty or by the higher rate. That they are not neutral about the borrower's choice, and in fact stack the deck against the borrower choosing to avoid the penalty, is strong evidence that the prepayment penalties are not simply alternative ways for borrowers to pay for an embedded risk.

[120] CRL ANPRM Comments, *supra* note 8, at 18, n.51.

The explanation lies in the link between this "rate reduction" term and the simultaneous rate-hiking yield-spread premium.[121] Lenders and the secondary market have encouraged prepayment penalties by limiting the brokers' compensation (the yield-spread premium) if the loan delivered by the broker did not have a prepayment penalty. The broker, therefore, has an interest in affecting – or even denying – the homeowner's "choice" about this so-called price trade-off.[122] Although there are fewer rate sheets to examine in this moment when subprime lending originations are down, the practice appears to continue. As recently as February 2008, Bear Stearns' rate sheet told its brokers that their maximum 1% yield-spread premium would be cut in half on loans without a prepayment penalty, and Chase retains the perverse link for its larger loans.[123]

Sadly, the Board's proposals on both prepayment penalties and yield-spread premiums will not do anything to interfere with the present market dynamics, so the price trade-off is overstated, if not almost entirely illusory.

Finally, we do not believe that a ban would significantly increase the cost in any event. It costs a homeowner more to buy-out a prepayment penalty than it does if the price of that risk is embedded in the par rate. That is clear from comparing a given lender's pricing in states where they do not include prepayment penalties because of state law. A rate sheet appended to our ANPRM comments added a rate bump of .400% for loans without a prepayment penalty due to a state law ban, while a consumer in a state where they were allowed would have to pay a full 1% more to get it waived.[124] Chase's par rate in states with "no prepayment option" are .500% higher than the par rate in states where a prepayment penalty is automatically included, but it costs the borrower in those states an additional .875% to get the penalty waived.

Note rate, $200,000 5/25 ARM loan, comparable borrowers/[125] no prepayment penalty	
Virginia *Homeowner buy-out required*	9.125% *(8.25 par + .875 buyout)*
North Carolina *No buy-out required*	8.75%

[121] Yield-spread premiums are the only rate-hiking feature directly linked to prepayment penalties, but it has been standard in the subprime industry to load these loans up with other layers of risk which also raise the price of the loan, such as high LTVs and stated incomes. The only one of these addressed seriously by the Board's proposal is the stated income product.

[122] *Id*. at 13-15.

[123] *See* App. B-1, Chase Region 1 Rate Sheet; App. B-4, Chase Region 2 Rate Sheet; App. B-5, Bear Stearns Rate Sheet.

[124] CRL ANRPM Comments, *supra* note 8, at 14, n.38.

[125] *See* Chase Rate Sheets, Apps. B-1 and B-4.

As the Board discusses in the supplemental information, there is almost no possibility of a consumer making an informed choice about this alleged trade-off, below and nothing in the proposed rules would change that. Integrating the price of prepayment risk into the par rate on a uniform basis increases transparency and makes comparison shopping possible. And the evidence from the effect of state laws indicates that, on balance, homeowners in this higher-priced market will still come out ahead.

Secondary market liquidity: The last benefit hypothesized is that the penalties may make cash flow to investors more predictable and therefore more liquid: "A more liquid secondary market may benefit borrowers by lowering interest rates and increasing credit availability."[126] Though this market has been so fluid it flooded, there is no evidence that these penalties are responsible for lowering rates or increasing availability

The previous section and our ANPRM comments discussed the empirical data assessing state laws that offered natural controls as to the impact of prepayment penalty restrictions. In addition to finding no evidence that prepayment penalties lowered costs for borrowers in states where they were allowed, they also found no evidence that credit flow decreased in states where they were banned or severely restricted.[127] The specific benefits related to the secondary market that the Board identified in the supplemental information are theoretical only and contradicted by the empirical evidence.

Furthermore, the past year has given us another natural experiment relating to secondary market liquidity. Too much liquidity seeking the *wrong kind o*f lending – risky lending – ultimately creates its own liquidity crisis. If particular practices attract too much *misdirected* liquidity, the economy as a whole will suffer.

Benefit to competition: While not a factor not discussed in the supplementary information, the FTC unfairness standard requires assessment of costs and benefits to consumers or competition. It is difficult to perceive a benefit to competition from a term that locks consumers to one provider when another provider could gain a customer by providing a better deal. "Lock-in" terms, by their nature, are anti-competitive.

b. The costs to borrowers and to competition far outweigh the unproven benefits.

The dollar cost to homeowners in equity lost, through penalties paid, and financed into future loans is just part of the story. The cost in the form of increased risk of default

[126] 73 Fed. Reg. at 1693-94.

[127] *See* Wei Li and Keith S. Ernst, Center for Responsible Lending, *The Best Value in the Subprime Market: State Predatory Lending Reforms* 13-17 (Feb.2006). *See also* CRL ANPRM Comments, *supra* note 8, at 18-19, text accompanying notes 51 and 52.

and foreclosure is an even greater cost,[128] more apparent now than ever as home values decline around the country.

Increased risk of foreclosure: As more and more borrowers find their loans unaffordable, prepayment penalties make it more difficult – if not impossible – to look for an early exit from the loan into an affordable one. The payoff balance is swollen by a prepayment penalty, increasing the LTV, at the same time that the falling home value increases it still further.[129] At best, that double-hit on the homeowner's new LTV will increase the cost of a refinance; at worst, it makes the refinance impossible and ends in foreclosure.[130]

Disproportionate impact on minority neighborhoods: Congress specifically singled out practices which contribute to "reverse redlining" as appropriate for regulation under 1639*l*(2). Our ANPRM comments noted that "the odds of avoiding a prepayment penalty on a subprime loan are significantly better for borrowers who live in predominately white neighborhoods."[131] Homeowners in predominately minority neighborhoods have 35% greater odds of being charged a prepayment penalty than those living in neighborhoods with less than 10% minority population.[132] Of course, the sorry tale that foreclosure maps from cities around the country tell about the disproportionate impact this crisis is having on communities of color is not exclusively the result of prepayment penalties. But we ignore the link between prepayment penalties and *higher* interest rates, and between prepayment penalties and increased foreclosure rates at our peril.[133] (Some of these maps are appended as Appendix C.)

It is not a close call as to whether the benefits to consumers and competition outweigh the costs of prepayment penalties. The first two prongs of the "unfairness" test are clearly met.

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[128] *Cf.* L. Randall Wray, "Lessons from the Subprime Meltdown," p. 8 (Levy Economics Institute Worrking Paper No. 522, December 2007), noting that "for many borrowers, there is no interest rate that can compensate for risk, because the higher the interest rate charged, the greater the probability of default."

[129] *See, e.g.* Lawrence Summers, Prevent US foreclosures, Financial Times (Feb. 24, 2008) (home prices have fallen by 5% to 10% nationwide, and market experts predict that prices will decline by an additional 20%.)

[130] *See Losing Ground*, *supra* note 14 at 21; *see also* Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures :The Special Case of Prepayment Penalties and Balloon Payments* (Center for Community Capitalism, University of North Carolina at Chapel Hill, January, 2005) at 25 (finding that prepayment penalties, all else being equal, increase risk of foreclosure).

[131] Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans,* p. 7 (Center for Responsible Lending, January 2005).

[132] *Id*. at 1.

[133] *See* text accompanying notes 120-121 regarding the link between prepayment penalties and higher interest rates. For the link between prepayment penalties and foreclosure rates, see Quercia, *et al*, *supra* note 130.

2. The lack of transparency, the complexity, and the perverse market incentives complete the case for banning prepayment penalties under the FTC analysis.

Evaluating repayment penalties under the third prong of FTC's unfairness analysis – whether a practice is "reasonably avoidable" by the consumer – overlaps to some extent with the deception analysis. The Board noted that prepayment penalties may be a term that highlights the limits of disclosure.[134] Not only is there little understanding even that the penalty may be charged at all, there is no understanding of its cost. Even if the cost were made more clear, all of the information necessary for a homeowner to weighing the cost against the supposed benefits purchased – the rate trade-off – is a very sophisticated and complex analysis.

It is one of the ironies of this crisis that the "plain vanilla" loan has been the standard in the prime market, while the standard loan in the subprime loans is much more complex.[135] We noted above that a recent FTC study found that it is more difficult for subprime borrowers to understand their loans than prime borrowers because of the complexity of the loans, not the competence of the borrowers.[136]

In the FTC study, prepayment penalties were among the least understood terms. *Two-thirds* of mortgage customers in the study "did not recognize that they could be charged a prepayment penalty if in two years they refinanced with another lender."[137] And *95%* could not identify the amount of the prepayment penalty.[138] Given the lack of transparency about the cost of prepayment penalties, the real surprise, perhaps, was that even 5% could identify the amount of the penalty. (So surprising, in fact, that the authors speculate that those respondents may have cheated.[139])

Even when given an improved disclosure,[140] 42% of respondents could not identify the amount of the penalty, and 44% did not understand that they'd have to pay a prepayment penalty if they refinanced in two years.[141]

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[134] 72 Fed. Reg. at 1694.

[135] Even in 2007, more than half the subprime loans were ARMs and had prepayment penalties, *See* CRL Comments on Proposed Interagency Statement on Subprime Mortgage Lending, p.5, Table 1 (May 7, 2007). Given the link between prepayment penalties and yield-spread premiums, it is likely that more than half also had yield-spread premiums. These multiple risk – and cost – factors obviously add to the difficulty of comprehension.

[136] *Id.*

[137] Lacko & Pappalardo, *Improving Consumer Mortgage Disclosures, supra* note 76, at ES-7

[138] *Id.* at ES-10

[139] *Id.* at 109, n.138.

[140] A prototype form designed for the project disclosed: "A penalty of four percent (4%) of the prepaid loan balance with be charged if the loan is paid off during the first five years. An immediate refinancing of the loan would result in a penalty of $7,017.00." *Id*. at H-19.

Left out of this study entirely was the predicate for prepayment penalties – that they are a freely chosen "trade-off" for a lower interest rate. Empirical evidence does not support the notion that there is such a trade-off, but assuming *arguendo* the existence of a price trade, there was no suggestion of how borrowers would "choose" between being locked into the loan for a period by an exit tax of as much as $7,017 and reducing the interest rate by 0.875% or 1.00 %. A difficult evaluation as a single-variable choice, it would be an extremely complex choice process as a multi-variable choice, even assuming that the incentives of the market were not skewed. Just as nothing in the Board's proposal would correct the perverse incentives by severing the tie between yield-spread premiums and prepayment penalties, nothing would improve any of these informational problems, either.[142]

C. The Prepayment Penalty Abuses in the Subprime Market Will Not Be Curbed By The Proposed Limitations.

1. Borrowing HOEPA's high-cost loan limitations from will do nothing to address the identified problems with prepayment penalties in today's higher-cost market.

The Board seeks comments on several aspects of the proposed limitations on prepayment penalties for higher-cost loans.[143] The questions posed ignore the larger issue, which is whether extending the high-cost limitations to the higher-cost market will address the problems created by these penalties. The answer is no, and we strongly urge the Board to discard this proposed set of limitations entirely. We believe the Board is legally free to do so, *see* Section V-A, above, and we believe that it must do so if it wishes to have any long-term impact. As a matter of sound regulatory policy, to protect homeowners, competitors, and a safer and sounder marketplace, it should do so. However, if the Board decides instead to limit them, we urge it to look to somewhere other than high-cost rules for the model.

There is an almost complete disconnect between the borrowed limitations enacted nearly fifteen years ago and the current abuses. They do not address any of the perverse incentives in the market, nor do they reduce the complexity or add to the transparency. The Board's explanation as to how the limitations apply to the problems is weak and

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[141] *Id*. at ES-10.

[142] As the Board's revision of Reg. Z's general disclosure requirements move forward, undoubtedly improvements to this disclosure will be on the list. The changes, however, are likely to come in years, not months.

[143] 1) Should the 5-year term for permitted prepayment penalties be shortened? 2) Comment on the proposal to strengthen the income verification requirement. 3) Comment on the potential effects of the same-creditor restriction in a market where most loans are sold. 4) Comment on earlier time limits for adjustable rate loans. 73 Fed. Reg. 1695-96.

cannot stand scrutiny as a reasonable response. And the one addition – a 60-day penalty-free period prior to ARM resets—cannot rescue the proposal.

Those limitations are unlikely to change the market, for the simple reason that they were enacted in 1994 primarily to allow the prepayment penalties as practices by the then "legitimate" subprime lenders to operate as usual.[144] HOEPA's prepayment penalty provisions, as a practical matter, reflect more a codification of then-existing practices than an effort to curb abuses. That makes them a singularly unhelpful guide for a regulation aimed at eliminating the corrosive impact they have in today's market.[145]

The 50% DTI requirement would cover few loans and would be difficult to enforce. The Board's justification for the 50% DTI limitation is that, while "not a perfect measure of affordability," it "*may* tend to reduce the likelihood that an unaffordable loan will have a prepayment penalty, which would hinder a consumer's ability to exit the loan by refinancing the loan or selling the house.[146]

Unfortunately, since 50% DTI is, officially, at least, already at or very near the top end of qualifying borrowers for subprime loans, this prong will cover very few loans, making it inconsequential.[147] Furthermore, as we discussed in Section III, the astonishing rate of default and delinquency, in the absence of flipping, churning and selling as exit strategies, are a strong indication that 50% DTI is by no means a good rule of thumb for affordability.[148] Having been discredited by experience, it should not be extended.

This prong also is one that makes enforcement of the provision difficult. Most consumers, who have been the primary enforcers of HOEPA, do not know what their DTI was at consummation, so their counsel does not know whether there is a violation or not. Further, it is a malleable figure. While the proposed commentary provides some

[144] The bill reported out of the Senate Banking Committee had included an almost complete prohibition, permitting a prepayment penalty only for loans paid within the first 90 days from origination. *See* 103rd Cong. 1st Sess., S.1275, § 129(c). Subsequently, some of those same players were among the targets of major law enforcement actions over practices including those related to prepayment penalties. And, had the 1639(c) "restrictions" been applicable to "higher-cost loans," they would have had no deterrent effect on the prepayment penalty abuses alleged in the Household or Ameriquest enforcement actions, nor would they have given regulators any additional enforcement tool. Those abuses, like today's, primarily involved "packing" prepayment penalties into a loan without the borrower's knowledge.

[145] *Id. See also,* note 106, *supra.*

[146] 73 Fed. Reg. at 1694.

[147] *See generally* Section III-B on DTIs.

[148] Even with average DTIs lower than 50%, "Borrowers were taking on more than they can afford." *Id.*; *see also Losing Ground, supra* note 14, at 13, Table 4.

guidance, subprime lenders would continue to have the flexibility to work backwards from a target DTI, just as they have been doing.[149]

The same creditor prohibition does not offer sufficient protection. This prohibition has some limited value as to portfolio lenders, particularly ones who "flipped" their borrowers frequently. But it offers no protection in the "churning" context —where a broker or loan officer from another company makes a sales call to another company's customer to offer a "better deal" from a different lender. Since the majority of higher-cost loans were sold on the secondary market this, too, is of limited use.

The five-year limit is a step backward, not forward. The proposal to codify a five-year limit is a step back even from the market, which has moved to a two- or three-year standard. Given that more than 90% of subprime loans with prepayment penalties in recent years were for two or three year terms and less than one half of one percent had a term that was longer than five years,[150] it is difficult to see what this rule would be restricting. Effectively, it would loosen, not limit, the practice.

The 60-day ARM reset exception to the five- year term would be only a minimal improvement; the events of the past year suggest that borrowers should be free to exit ARM loans at any time. The only new limitation would *require* the penalty to expire 60 days prior to a principal or interest payment adjustment. State law enforcement has already taken the position that prepayment penalty terms longer than ARM resets violate state unfair and deceptive practices**]** so, except for preempted entities, this, too, adds little by way of additional consumer protection.

Further, the 60-day period is too short. Many hybrid ARMs refinanced before the final 2 months before reset. Many exploding ARM borrowers did not even realize they had an ARM, and sought to refinance early upon learning of it. Cold calls offering refinances – whether good or bad ones – usually start six months before reset, as originators trolling records looking for likely candidates for reset refinances do not want to wait until the last minute – and lose out to other originators doing the same thing. Or an early refinance might be prudent because of fluctuations in interest rates or housing prices. Last, but most certainly not least, early defaults on adjustable rate mortgages demonstrate that these loans do not wait until reset to cause their damage.[151] A 60-day expiration is too minimal to accomplish much. In other words, the same forces that make prepayment

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[149] Proposed OSC 226.32(d)(7) says that a creditor "may" look to "widely-accepted governmental and non-governmental underwriting standards" to classify debt and income. But those who have reviewed many loan applications know, for example, just how flexible the amount to include for credit card debt is.
It is also ironic that one of the reasons cited for not having a DTI standard in the ability to pay provisions is the difficulty in defining "income." 73 Fed. Reg. at 1689.

[150] These figures come from CRL calculations of subprime 1st lien subprime mortgages originated in 2000-2007 that were included in a proprietary loan-level dataset including millions of securitized subprime loans.

[151] State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance*, Data Report No. 1 (February 2008).

penalties problematic – and hence rare – in the prime market hold even more true in the higher-cost market.

A complete ban is the real solution, but even in the realm of incomplete solutions, the HOEPA high-cost model is particularly ineffective.

2. In the absence of a ban on prepayment penalties in higher-cost loans, the restrictions should address the fundamental problems in the market.

In the event the Board does not ban prepayment penalties, then restrictions should relate to the specific problems identified by the Board. Without reform of the driving incentives, disclosure would never be an adequate to curb the abuses under the best of circumstances.

To rid the market of perverse incentives: Sever the link between prepayment penalties and yield-spread premiums or other rate-rising factors. No loan may contain both a prepayment penalty and a yield-spread premium. The prohibition should also apply to prohibit prepayment penalties and retail overages, although the problem is most severe with independent brokers.

To bring the maximum time in line with market practices and allow homeowners to seek better terms: The maximum time limit should be two years, except where earlier expiration is required for payment adjustments,

To recognize that the sound reasons to escape an ARM before reset does not watch the prepayment period clock, they should be allowed only in fixed rate loans. If the Board does not ban prepayment penalties in the subprime market, at a minimum, it should restrict them to fixed rate loans. The risks of ARMs are too great to trap borrowers in them for any prescribed period.

SECTION V

INCOME VERIFICATION

Summary comment and recommendation:

- The income verification standard should be applied categorically to all nontraditional loans, irrespective of whether they meet the price threshold for higher cost loans.

- The safe harbor provision that effectively allows creditors not to verify income should be removed.

- Sufficient documentation of income or assets should be required even when it is more difficult to substantiate.

We are very pleased to see the proposed rule regarding verification of income. The proliferation of "stated-income" and "no-doc" loans contributed significantly to the current mortgage crisis.[152] Income verification is among the most fundamental principles of responsible lending and is a necessary corollary to an effective rule regarding ability to pay. Requiring creditors to ensure that a potential homeowner actually has the income represented in the application is a crucial part of supporting homeownership and preventing foreclosure.

However, we also believe that, to ensure that creditors no longer engage in such irresponsible underwriting practices, the Board should make two key revisions to the proposed rule: 1) apply the income verification standard categorically to all nontraditional loans, irrespective of whether they meet the price threshold for higher cost loans; and 2) remove the safe harbor provision that effectively allows creditors not to verify income. We also suggest that in instances where the borrower legitimately cannot verify income through standard payroll or tax forms, the Board nonetheless require creditors to obtain bank statements or other reasonable third party verification to support income or assets relied on. We further suggest that the Board clarify that, when verifying income, a creditor should use the best available documentation from the approved list.

We will address these four recommendations in turn and then explain why we agree with the Board's proposal to require income verification for subordinate-lien loans; and why we believe that required income verification will not unduly restrict access to credit; and why a rule more flexible than the one proposed would undermine consumer protection.

A. Required income verification should apply to all nontraditional loans, regardless of the cost of such loans

We believe it is crucial that the income verification requirement be extended categorically to all nontraditional loans, such as payment option ARMs and interest-only mortgages – irrespective of whether they meet the price threshold for higher cost loans – because of the special risks nontraditional loans present.

The structural complexity of nontraditional loans makes them extremely different from traditional loans, regardless of the credit rating of the borrower. The features found in nontraditional mortgages, such as hybrid ARMs or interest only provisions, are multiplier effects on the riskiness of the loan.[153] These features are inherently risky not only

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[152] *See, e.g. Securitization and Screening*, *supra* note 12.

[153] The increased risk associated with nontraditional loans has been widely recognized by the Board and other agencies. The Interagency Guidance on Nontraditional Mortgage Product Risks states: "The Agencies recognize that many of the risks associated with nontraditional mortgage loans exist in other adjustable-rate mortgage products, but our concern is elevated with nontraditional products due to the lack of principal amortization and potential accumulation of negative amortization." Interagency Guidance on Nontraditional Mortgage Product Risks, 70 FR at 77, 250 (Dec. 29, 2005).

because of their ability to create payment shock and negative amortization;[154] they are also risky because of their complexity. Performance of these loans originated in recent years indicates that it is the rare party parties – of any income level or on either side of the negotiating table – that has fully grasped the risks associated with these loans. Stated income loans are also inherently riskier than loans for which income is verified, regardless of the credit rating of the borrower. Regulators have stated, "[T]hey should be used with caution"[155] and "only if there are other mitigating factors such as lower LTV and other more conservative underwriting standards."[156]

Therefore, allowing stated income (i.e., riskier) underwriting for nontraditional (i.e., potentially riskier) loans enables risk layering – a practice that has been strongly discouraged by the Board and other agencies.[157]

It is important to consider that, while the market for hybrid ARMs has shrunk significantly, creditors are continuing to make nontraditional loans available.[158] And while most attention in the subprime market has been focused on the 2/28 "exploding ARMs," underwriting on the nontraditionals by new entrants to this market has been equally reckless, to judge by performance. Moreover, the incentives driving many higher costs loans to be underwritten as stated income loans – higher broker compensation for a "no doc" loan; higher broker compensation for a larger loan; a borrower's desire to borrow more – are far from absent among lower cost mortgages.

The Board has weighed the costs and benefits of requiring income verification and "believes the regulation is sufficiently flexible to keep these costs to reasonable levels relative to the expected benefits of the proposed rule."[159] The stakes are high, and not only for the borrower. The Board recognizes that offering no doc loans "increases the risk that credit is extended on the basis of inflated incomes and assets, which, in turn, can injure not just the particular borrowers . . . but their neighbors, as well"[160] and that it

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[154] *See* 70 Fed. Reg. At 77, 255: "More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry significant risk of payment shock and negative amortization that may not be fully understood by consumers."

[155] 70 Fed. Reg. At 255.

[156] 70 Fed. Reg. At 253.

[157] "Nontraditional mortgage loans combined with risk-layering features, such as reduced documentation and/or a simultaneous second-lien loan, pose increased risk." 70 Fed. Reg. At 253.

[158] At least until very recently, at least one major lender was reportedly continuing to market POARMs. Rick Rothacker, *Wachovia Mortgage Program Stirs Concerns* The Charlotte Observer (March 31, 2008). We would note that if indeed there is little appetite for this product, then extending this and other protections to it should have little impact.

[159] 73 Fed. Reg. 1692 (proposed Jan. 9, 2008).

[160] 73 Fed. Reg. 1690 (proposed Jan. 9, 2008).

"raises the risk of distress sales and foreclosures, concentrations of which can depress an entire community."[161]

We believe that the marginally lower lender origination costs achieved by allowing stated income nontraditional loans are overwhelmingly outweighed by the negative consequences of allowing the layering of stated income underwriting on top of the potentially risky features already inherent to nontraditional loans. We believe that such risk layering is a recipe for disaster that should not be sanctioned, particularly at a time when, for many homeowners facing the need to refinance out of an unaffordable loan, nontraditional loans may be their only option.

B. There should be no safe harbor for creditors who do not verify income

We *strongly* oppose the safe harbor exception that would protect creditors who do not verify income if the amounts of income or assets relied on were not materially greater than the creditor could have verified at the time the creditor extended credit or where failure to verify would not have altered the creditor's decision to extend credit. Indeed, we do not understand the purpose of this "no harm, no foul" safe harbor, other than to permit creditors to continue to make stated-income loans. As any regulator knows, resources for enforcement are always at a premium. Moreover, given the existing limitations on class actions, very few homeowners who receive illegal loans will ever have the ability to challenge those loans. Thus, it might make economic sense for creditors to continue to make these liar's loans and pay up only in the few instances where they are challenged. We recommend, therefore, that the safe harbor should be removed; to include it allows the exception to swallow the rule.

C. Sufficient documentation when income more difficult to substantiate

With respect to the fourth element of the proposal – that it is not intended to limit creditors' ability to adjust their underwriting standards for borrowers who for legitimate reasons have difficulty documenting loan income[162] – we suggest that, in such instances, the Board nonetheless require creditors to obtain sufficient documentation to substantiate the income and assets relied on, i.e., bank account statements or other reasonable third party verification. There is no reason, merely because an applicant is self-employed or otherwise does not receive standard income documentation, not to require basic measures to ensure underwriting soundness. To not require such measures would create an incentive for creditors to too easily accept, or for borrowers to easily offer, a false statement that one is self-employed or cannot easily verify income.

D. The board should require that the creditor obtain the best evidence of borrower's income

[161] 73 Fed. Reg. 1691 (proposed Jan. 9, 2008).

[162] 73 Fed. Reg. 1692 (proposed Jan. 9, 2008).

We suggest that the Board require the creditor to obtain the best evidence of the borrower's income. For example, if an applicant receives a W-2 and also has several bank accounts, the creditor should use the W-2 as the best evidence of income rather than relying solely on the bank account statements.

E. The board should not exclude subordinate-lien loans from the income verification requirement

> **Board Question: Should the Board make an exception for subordinate-lien loans?**

We strongly urge the Board not to make an exception for subordinate-lien loans. The reasoning the Board offered for considering exempting subordinate-lien loans – that a verification requirement for such loans may, in some cases, increase costs without providing meaningful protection to consumers – is no stronger an argument for stated income subordinate-lien loans than for stated income first-lien loans. The Board suggests that a record of making timely payments on a first-lien loan may be a significant indication of a borrower's ability to repay a subordinate-lien loan, making income verification for the second loan less necessary. But a borrower's ability to repay one loan is no meaningful indication of the borrower's ability to make timely payments on *additional debt*. In fact, subordinate debt generally performs worse than first-lien debt, and a borrower who is also repaying subordinate debt is more likely to default on his or her first-lien debt. In short, a borrower can lose their home as easily on a subordinate-lien loan as on a first-lien loan, and the Board has offered no convincing argument for treating the two categories of loans differently.

F. Required income verification requirement would not unduly restrict credit.

> **Board Question: Would required income verification reduce access to credit for certain borrowers?**
>
> This is the wrong question. The right question is whether a rule like this is an ounce of prevention, that might have averted the current need for a ton of cures. The answer to that question is yes.

Income verification is an essential element of common sense underwriting. As we have noted previously, sound underwriting does not unduly restrict credit; rather it safeguards homeownership.[163] If the Board asks the question "would this requirement have helped ameliorate or prevent this crisis?" the answer is an unequivocal yes.

The easy availability (and profitability – until the merry-go-round stopped) for no-doc loans is what made it easy to write unaffordable loans and sell them to the world. Looking at loans likely to be sold on the secondary market, researchers recently found

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[163] Center for Responsible Lending, Comments On Proposed Interagency Statement on Subprime Lending, 72 Fed Reg. 10533 (March 8, 2007), at 14 (May 7, 2007).

that lo-doc loans for higher FICO score loans were 20% *more* likely to default than ones below the typical secondary market cut-off.[164] In effect, lo-doc status creates a moral hazard, which reduces originators' incentives to screen, and to off-load the consequences. Further, we now find that the increased cost of verification is only marginal – as little as $20.[165] There never was a legitimate reason for the proliferation of lo-doc loans, and the marginal additional cost should prevent no one who could afford a loan from getting it.

As we stated in our Comments on these proposed rules,[166] restricting stated income significantly impacts only those borrowers whose ability to obtain the offered loan depends on an inflated income. These borrowers should not be approved for the loan regardless.

Those relatively few borrowers whose income is not reflected in W-2s, 1099s or tax returns can readily provide verification of their income through bank statements or other reasonable third party verification. Their access to credit will not, therefore, be affected by required income verification.

G. A "more flexible" rule would undermine consumer protection

> **Board Question: Could the rule be made more flexible without undermining consumer protection?**

Lastly, we point out that a rule any narrower or more flexible than the one proposed, such as the example provided in the proposed rule – which prohibits creditors from "influencing customers to inflate incomes" – would be too subjective to be meaningfully enforced and would therefore not serve to prevent abusive practices. The most effective approach is to require income verification, without a safe harbor, for all higher cost and nontraditional mortgages.

SECTION VII

ESCROWS ARE CRUCIAL BUT THERE SHOULD NOT BE AN OPT-OUT

> **Board questions: Do the benefits of the proposal outweigh the costs, and should the time period for mandatory participation be different than one year?**

- We support the mandatory escrow, and urge that it be extended to cover non-traditional loans. We recommend that participation be mandatory for

[164] *Securitization and Screening, supra* note 12**.**

[165] Gretchen Morgenson, *A Road Not Taken By Lenders*, New York Times (April 6, 2008).

[166] CRL ANPRM Comments, *supra* note 8, at 35.

the life of the loan, or at least for seven years or until a certain equity threshold has been reached

A. Mandatory escrow will benefit both consumers and lenders.

We applaud the Board's decision to require escrow for taxes and insurance for higher-cost loans. The failure to escrow is an unfair and deceptive practice that occurs mainly in the subprime market[167] and contributes to high rates of foreclosure.[168] By creating artificially low monthly payment figures, the failure to escrow deceives consumers about the actual cost of these mortgages relative to those offered by competitors that do escrow and lures them into refinancing into less advantageous loans.[169] The failure to escrow for taxes and insurance also puts subprime borrowers – borrowers most in need of help with financial discipline – in the position of facing an unexpected tax bill, and brokers later target these borrowers for new high-cost refinancings.

Moreover, homeowners who do not escrow are much more likely to be subjected to the unnecessarily high cost of force-placed insurance.[170] Because lenders can generate significant fees from force-placing insurance, the lack of an escrow requirement provides an opportunity for them to increase their revenue. Fannie Mae has expressed concern over this practice, warning lenders who might "make a practice of rarely or never establishing escrows for blemished credit borrowers with the intent of understating the true cost of financing and generating fees out of activities like lender-placed insurance."[171]

Mandatory escrow will benefit both consumers and lenders. Requiring escrows will increase the transparency of the mortgage transaction and make sure that the borrower is

[167] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.,* Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[168] *See Losing Ground*, *supra* note 14, at 27.

[169] *See*, *e.g*,. States' settlement agreement with Ameriquest, IV-B-5, http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_SETTLMNT_FINAL.pdf; State of Iowa v. Household International, *Consent Judgment* Para. 9(E)(1), *available at* http://www.state.ia.us/government/ag/latest_news/releases/dec_2002/hhconsent.pdf; Federal Trade Commission vs. Citigroup, et al. Civ. No 1:01-CV-00606 (E.D. Ga., filed), Complaint, Para. 18-19, http://www.ftc.gov/os/2001/03/citigroupcmp.pdf.

[170] *Cf*. Federal Trade Commission "Facts for Consumers" available at http://www.ftc.gov/bcp/conline/pubs/homes/mortgserv.shtm ("It's important to maintain the required property insurance on your home. If you don't, your servicer can buy insurance on your behalf. This type of policy is known as force placed insurance; it usually is more expensive than typical insurance; and it provides less coverage.")

[171] Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05.

fully aware of the true costs associated with the mortgage. It will also place all lenders on equal footing: responsible lenders that already escrow would not be unfairly undercut by more reckless lenders. Lenders will no longer be able to use the absence of escrows to mask the true costs of the loan, and borrowers would be less vulnerable to the threat of having to refinance to cover unanticipated tax payments when they come due.[172] Mandatory escrows will also make it easier for borrowers to accurately compare the true monthly costs of the loans they are offered.

<u>B. Escrow should last for life of loan without any opt-out option because an opt-out option undercuts its effectiveness.</u>

Given the Board's recognition of the dangers posed by the failure to escrow, the one-year opt-out seems both surprising and unnecessary. Indeed, it is hard to imagine what party would prefer an opt-out. The only potential beneficiaries of an early opt-out are unscrupulous lenders or servicers planning to promote the opt-out option in the hope that they will then still have the opportunity to charge fees for force-placed insurance. We recommend that the escrow requirement last for the life of the loan. In the alternative, the mandatory escrow should cover a period sufficient to habituate such payments and provide some safeguard against manipulation by the servicers. The Board may wish to consider the alternatives of seven years (the period selected by the Board for the underwriting time horizon) or when the loan to value balance reaches 80%.[173] Many homeowners may be faced with payment adjustments around that time in any event, if they had been paying private mortgage insurance, so it may be a logical time for reassessment. The rule should be clear that the homeowner, not the servicer, should decide whether to continue the escrow at the end of a mandatory period.

SECTION VIII

APPRAISALS

Board questions: The board seeks comment on the appropriateness of the examples.

- We suggest that the selection of appraisers based on the expectation of a target value be prohibited, and offer additional examples of actions that would violate the rules.

We welcome the Board's decision to address appraisals, which have contributed so much to today's crisis. These easy appraisals made it common for loans labeled 95% LTV to

[172] One attorney with considerable experience with subprime foreclosure defense reports that one of the reasons many 2/28s refinanced prior to reset was attributable to the tax bill coming due. That bill, of course, does not wait for the twenty-fifth month.

[173] *Cf.* The Homeowners Protection Act of 1998, 12 U.S.C. § 4902.

actually be over 100% LTV loans at origination, assuring that the homeowners would not be able to refinance their way out of a bad loan, no matter what their own credit performance was – except with another lender equally reckless about underwriting. We suspect the problem was particularly acute and commonplace earlier, in areas where the property values were not appreciating rapidly: without those inflated appraisals, the volume of originations would have had to slow in those regions.[174] Since a growing origination volume was the driver, all too many of the subprime lenders had an interest in getting appraisals that "hit the number." Because this has likely been a contributor to distorting property valuations, we particularly welcome the application of this rule beyond the higher-cost market.

This community of interests means that the dynamics are far more subtle than an anti-coercion rule would suggest. Though legitimate and honorable appraisal professionals are frustrated by the pressure,[175] the sorry fact is that loan originators – both retail and broker – learn quickly which appraisers need no coercion. Much easier than trying to influence or coerce the honorable appraisers is simply to have a few cooperative appraisers on the rolodex and keep them very busy. It is perhaps for this reason that state anti-coercion laws upon which this rule is based did not stem this tide.[176]

An effective rule must therefore focus on the incentives and on the subtleties of the communications between the originator and the appraiser. For this reason, we believe that the rule and commentary should be augmented to assure that these cooperative relationships are as well-covered as the coerced relationships.

While it is possible that this kind of relationship could fall under the rubric of "influence or otherwise encourage" an appraiser, there is nothing in the rule or proposed commentary which addresses the way these relationships actually work. We suggest the following additions and changes to the proposed rule and commentary:[177]

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[174] That is a factor in the high subprime foreclosure rates in states like Iowa, which ranked third or fourth in rates of subprime foreclosure filings in 2004-06. With the rate of property appreciation slower there, so the trend toward rising principal loan balances bumped up against 100% LTV much sooner than in the bubble regions, meaning the "exit ramps" for troubled loans were closed off earlier.

[175] The Board cites the testimony of Alan Hummel regarding this widespread practice, 73 Fed. Reg. at 1701, n.64.

[176] For example, most of the subprime loans reviewed by one of the authors during a prior stint in law enforcement – both retail- and broker-originated by many different creditors – had appraisals done by the same four or five appraisers. One originator interviewed admitted that "everybody" writing loans in the region knew who to call to get the desired appraisal. Those appraisers do reach the attention of disciplinary bodies – eventually – but they have already done a lot of damage by that time. And, like brokers, they present the "whack-a-mole" problem, which is why originator liability is necessary for these kind of rules to be effective.

[177] It appears as though the examples may have been moved from the proposed commentary to the rule. (*see* 73 Fed. Reg. at 1701). The additions we proposed would be suitable for commentary, but if the other examples are codified, we do not believe these should be treated differently, lest they be deemed less crucial by creditors and courts. Notwithstanding Milhollin, not all courts have treated the commentary with

1. *Prohibit "selection" of an appraiser based on expectation of meeting target valuation:* We recommend that § 226.36(b) include a prohibition against "selecting an appraiser with the expectation of obtaining a misstated or misrepresented value."

The list of examples in proposed 226.36(b)(i) should amplify this to include, as an example of "influence, encourage, or select" an appraiser based on target values, that a creditor or broker "have a pattern of selecting specific appraisers based on expectations that valuations given will meet or exceed fair market value in order to support approval of a target loan amount.

2. *Prohibit the communication of desired valuation to the appraiser:* While explicit requests from originator to appraiser to meet a target are not unknown, they are rare. The signals are usually more subtle. Appraisal orders, for example, which include the projected loan amount signal the target number for the desired valuation. Sometimes the order also includes an "estimated" value of the property, which, together with the loan amount request, can act as code for the desired LTV.[178] (But even if the estimated valuation is not included, many appraisers are familiar with a particular lender's stated LTV policies, and, with only a requested loan amount, can provide a valuation that provides an acceptable LTV ratio to support the loan.)

We are aware of no legitimate reason for an appraiser to know the projected loan amount. We recommend adding an example of influencing or otherwise encouraging misstated or misrepresented valuation: for the originator to "communicate a desired valuation directly or indirectly." The Commentary should expand on this by stating that conveying information on the projected loan amount is one example of such prohibited communication.

3. *Strengthen the rule on multiple appraisals:* As an example of what is *not* a violation, the proposal lists obtaining multiple appraisals so long as "the creditor adheres to a policy of selecting the most reliable appraisal rather than the appraisal that states the highest value."[179] We have found to our profound regret that "policies" are not what is important – it is the practices that count. This provision will give cover, rather than deterrence, for originators who shop for target value on appraisals.

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deference equal to the rule. *See, e.g., Rand Corp. v. Yer Song Moua,* No 07-510, 2007 WL 1576732 (D. Minn. May 30, 2007).

[178] In a purchase loan, an appraiser will know an "estimated property value" because the sales price is presumably the market value. However, there is no reason for the appraiser to know the requested loan amount: the prospective buyer could be putting down a sizeable down payment or no down payment, but that should not affect valuation.

[179] Proposed § 226.36(b)(ii)(D).

It would be more effective to list "obtaining multiple appraisals, unless there is a reasonable, documented basis for believing the first to be in error**,** or unless legitimately required by program requirements" as an example of encouraging misstated appraisals.

We understand that there may be legitimate reasons to seek more than one appraisal, for example, when property values are in rapid flux, or where certain loan products require a second appraisal. The Commentary can provide examples of what constitutes a reasonable basis. We also are aware that loan applicants themselves sometimes wish to obtain an independent appraisal. Here, too, the commentary could explain that lenders may consider such appraisals. (Though, of course, there should be an explicit admonishment that originators should not obtain such "applicant requests" as a way to evade this requirement.) Either the example in the rule or the Commentary should further provide that the applicant must be told about all appraisals obtained, and their valuations, and further than subsequent appraisers cannot be informed of other appraisals on the property.

SECTION IX

SERVICER RULES ARE IMPORTANT BUT NEED TO BE STRENGTHENED

We are pleased that the Board recognized the need to address servicing problems related to mortgage loans. As the Board has observed, because consumers cannot shop for services, there is no ability for market forces to play a role in curbing abuses. This situation is precisely the type of practice that Congress intended the Board to deal with when it provided the authority in 15 U.S.C. 1639 (l)(2)(A) that the Board must prohibit unfair acts or practices in connection with mortgage loans. However, the proposed rules do not go far enough, and they leave out the crucial requirement that services engage in loss mitigation for every loan.

A. The rule regarding prompt crediting of payments is crucial, but must be clarified.

A very common problem for homeowners is that their mortgage loan servicer fails to credit certain payments to their loan. When payments are not promptly and properly credited, many services compound the problem by imposing late fees and reporting the homeowners as late to the credit rating agencies.[180] The requirement that payments be credited promptly should solve this problem. However, the Board should clarify that *all* payments must be applied to the loan as they are made, regardless of whether there is some contention that more money may be due at the time the payment is made.

Proposed regulatory language:

B. Disclosure of servicing fees does not protect homeowners from unreasonable fees.

[180] *See, e.g., 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).

As noted above, homeowners do not have a choice of which servicer services their loans. To the extent disclosures are useful in the mortgage context at all, which is a doubtful proposition to begin with, they play no useful role at all in a situation where a consumer cannot shop. Therefore, instead of a disclosure requirement, the Board should prohibit servicers from imposing any fees, charges or assessments unless the fee is authorized by governing state and federal law; agreed to in the Note, and reasonable in amount.

Proposed regulatory language: *Servicers of mortgage loans may not impose any fees, charges or assessments unless they are:*

(1) authorized by governing state and federal law;
(2) agreed to in the Note; and
(3) reasonable in amount.

C. Servicers should be required to engage in mandatory loss mitigation prior to foreclosing.

Despite the current mortgage crisis, many loans still proceed to foreclosure without loss mitigation efforts.[181] It has become clear that there are a number of reasons for this lack of loss mitigation activity. One reason is that the way servicers are compensated by lenders pushes toward foreclosure. As reported in Inside B&C Lending, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." In fact, "it costs servicers between $750 and $1,000 to complete a loan modification."[182] So, even when a loan modification would better serve investors and homeowners, loan servicers typically have an economic incentive to proceed as quickly as possible to foreclosure.

But even those servicers who want to do loss mitigation face significant obstacles. One such obstacle is the fear of investor lawsuits, because modifying loans typically affects various tranches of securities differently, which raises the specter of investor lawsuits when one or more tranches lose income. Another is the existence of so many second liens on homes. When there is a second mortgage, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure.

To provide servicers either with incentive or with "cover," the Board should propose a rule to ensure that servicers attempt to engage in reasonable loss mitigation attempts prior

[181] *See* State Foreclosure Prevention Working Group, *supra* note 151.

[182] Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007) (Quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).

to proceeding to foreclosure on a home mortgage.[183] The Federal Housing Administration,[184] Fannie Mae,[185] and Freddie Mac[186] all have such a requirement, and recognize the financial loss to their investors as well as the devastation to homeowners from foreclosure, and the federal banking agencies also have issued encouragement for loss mitigation.[187] Furthermore, most Pooling and Servicing Agreements governing the trusts in which most home mortgages are held permit loss modification.[188]

In proposing mandatory loss mitigation, we are mindful of the fact that loss mitigation alone may not be not enough to meet today's needs. As the foreclosure crisis deepens and public scrutiny of servicers increases, the amount of loss mitigation taking place is definitely rising. However, most of this loss mitigation activity appears to consist of temporary workouts or forbearances, rather than the permanent loan modifications that would be needed to keep many current homeowners in their homes.[189] We do not yet have a specific idea on how to mandate effective loss mitigation, but as the results of the Hope Now Alliance and other voluntary efforts become known, we are hoping that data will suggest an answer. For now, even mandatory loss mitigation would be an excellent start.

Proposed regulatory language: *It is an unfair practice for a lender to proceed to foreclosure on a home mortgage unless reasonable loss mitigation alternatives have been attempted.*

CONCLUSION

[183] Reasonable loss mitigation activities generally include a range of alternatives: (1) A delay of the foreclosure sale to allow time to work out a foreclosure avoidance agreement; (2) A repayment plan to cure a default by allowing the homeowner to make scheduled monthly payments as they are due, together with partial monthly payment on the arrears; (3) A forbearance plan to provide a more formal agreement to repay the arrears over a period of time while making regular monthly payments; (4) A temporary interest rate reduction for homeowners who have financial problems which appear to be temporary in nature, but which preclude full payment of the mortgage for a foreseeable period of time; (5) Deferral of missed payments by which missed payments are no longer treated as missed but are instead added to the end of the loan obligation; (6) A permanent modification of the loan, which can include one or more of a combination of interest rate reduction, extension of the loan terms, reamortization, and cancellation of principle.

[184] U.S. Dep't of Hous. & Urban Dev., Loss Mitigation Program-Comprehensive Clarification of Policy and Notice of Procedural Changes, Mortgagee Letter 00-05, at 1 (Jan. 19, 2000). *See also* Wells Fargo Home Mortg., Inc. v. Neal, 2007 WL 1310141 (Md. May 7, 2007).

[185] Fannie Mae Single Family Selling and Servicing Guide, Part VII, Chapter 3.

[186] Freddie Mac Single Family Servicing Guidelines 65.1.

[187] The federal banking regulators have encouraged financial institutions to work with "financially stressed" borrowers. FFIEC, "Statement on Working with Mortgage Borrowers," April, 2007. This seems intended to specifically permit and facilitate loss mitigation techniques to avoid foreclosures. This is good in so far as it goes, yet there no *requirements* on these financial institutions to avoid foreclosures through loss mitigation. Further, many home mortgages are not serviced by federally regulated financial institutions.

[188] American Securitization Forum, Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007; Kenneth Harney, Mortgage Mod Squad, Washington Post, April 14, 2007, at F01.

[189] *See* State Foreclosure Prevention Working Group, *supra* note 151.

We believe that the Board has an opportunity to take meaningful steps to assure the country that strong consumer protections are by no means incompatible with a sound and vibrant home mortgage market. In fact, they are necessary for it to flourish. We hope that the Board will take the lessons of the last year to heart, and add the strength that these rules need to restore integrity to this market.