CENTER FOR RESPONSIBLE LENDING

VIA ELECTRONIC MAIL

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
Attention: Docket Number OP-1253
20th and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

Re: Center for Responsible Lending comments on Home Ownership and Equity Protection Act Hearings [OP-1253] "Public hearings on the home equity lending market and the adequacy of existing regulatory and legislative provisions in protecting the interests of consumers" submitted to the Board of Governors of the Federal Reserve System (FRB).

Ladies and Gentlemen:

The Center for Responsible Lending (CRL)[1] appreciates the opportunity to comment on the home equity lending market and the adequacy of existing regulatory and legislative provisions in protecting the interests of consumers. CRL was honored to have panelists participate in the 2006 Home Equity hearings. Although some legislative and regulatory efforts have been successful, current market activities call for heightened vigilance by the FRB. While we will discuss trends and realities that impact the mortgage market as a whole, our comments will focus on the subprime marketplace. As set out below, the current subprime market is presently producing many mortgages that place consumers at unnecessarily high risk of failure, which, in turn, jeopardizes the industry. Action by the Board can enhance integrity in this market.

In the wake of HOEPA and additional state regulation of higher-cost loans, the subprime industry has continued to grow. In 2005, subprime originators made 4,225,426 loans totaling $671.8 billion.[2] Through the second quarter of 2006, 80.7% of subprime loans were adjustable rate loans, predominantly 2/28s. Over two-thirds (66.3 %) had prepayment penalties – which, as we note below, can be a disastrous feature in a poorly underwritten adjustable rate mortgage. Over half (53.8%) were refinances, and almost half (48.9%) of the subprime market consisted of cash-out refinances. Finally, 61% of the loans were broker-originated, or 80.1% when correspondent/wholesale channels are included.[3]

[1] The Center for Responsible Lending is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, the nation's largest non-profit community development financial institution.

[2] *See* National Mortgage News Quarterly Data Report-

[3] All figures based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

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It is the 81% of the market consisting of ARMs that concerns us greatly. As Professor Elizabeth Warren recently noted, there is a new era of uncertainty facing homeowners:

> In the past, the home mortgage 'was a steadying influence; it neither rose nor fell over time,' says Elizabeth Warren, a Harvard Law School professor who has studied consumer bankruptcies. 'All that has changed in the last half-dozen years,' Warren says. 'The mortgage payment is now more variable than any other expense for millions of people. We're working in completely uncharted territory.'[4]

Specifically, in these comments we place considerable emphasis on the complications and dangers presented by the "2/28" or "3/27" adjustable rate mortgage ("ARM"). These hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector."[5]

In doing so, we do not mean to minimize other important issues facing consumers in this increasingly complex marketplace, but rather we seek to bring a concentrated focus on this product which is both one of the most common in the subprime market and, we fear, one of the most dangerous in today's changing economic environment. Our comments are informed by research that our organization has conducted on foreclosures in the subprime market over the period 1998 to mid-2005 demonstrating significant problems, which may become even more pronounced in different – and not unlikely – economic conditions.[6] The special dangers in the present generation of ARMs were also made apparent in a recently published Credit Suisse survey, which found that 90-day delinquencies on ARMs up over 140% in the past year, contrasting with a 27% increase in fixed-rate mortgages.[7]

In these comments, we first discuss the hybrid ARMS, sometimes called "exploding ARMS" by those who work with subprime consumers (see I-A below) and the potential hazards they present to both borrowers and lenders. Effectively addressing the dangers of these exploding ARMs would have a significant beneficial effect on home ownership, healthy competition in the marketplace, and on the soundness of the mortgage market.

Second, we note that underwriting standards have weakened. By concentrating on market growth at the expense of underwriting, many lenders are not adequately assessing a consumer's ability to successfully repay a loan.[8] While HOEPA addresses the ability to pay issue for high-cost loans, experience has shown that the problem is widespread in the market below the HOEPA threshold. As nothing is, in the long term, more hazardous to borrowers, lenders and investors alike, CRL urges the Board to work with other agencies to use its rule-making authority under 15 U.S.C. § 57a(a) and (f) to declare it to be an unfair and deceptive act or practice to (A) underwrite a adjustable rate subprime loan without using the fully indexed rate or (B) to exclude from the repayment analysis of a subprime loan the cost of hazard insurance and property tax

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[4] Elizabeth Warren quoted in Ruth Simon, "Homeowners struggle with rising rates ; Some surprised when loans reset ; Counselors hearing from the middle class" THE WALL STREET JOURNAL, (August 13,2006).

[5] 2006 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y.), Jan. 17, 20006, at 12.

[6] We hope to have the resulting report published within the next two months, and will provide a copy of the results to Board staff in the Community and Consumer Affairs division.

[7] *See* Ruth Simon, "Homeowners struggle with rising rates ; Some surprised when loans reset ; Counselors hearing from the middle class" THE WALL STREET JOURNAL, (August 13, 2006).

[8] While our experience suggests this is not a recent phenomenon, it has become more widely acknowledged. See, e.g., Jody Shenn, "05 Home Loan Delinquency Rise a Riddle," ("some of the broad loosening of underwriting that occurred last year as originators attempted to maintain volume amid rising interest rates was tough to see") (American Banker, May 23, 2006).

escrows. By working with the FTC, as well as the other financial regulatory agencies with authority under § 57a, the common rules would ensure that both depository and non-depository institutions would be subject to the same minimal safeguards assuring that due consideration must be paid to a reasoned assessment of a consumer's prospective ability to maintain a loan.[9]

Third, CRL recommends that the FRB follows the tenor of the recent interagency guidance on nontraditional mortgages by enacting specific regulations on the origination of reduced documentation loans and loans associated with special risks of payment shock.

Finally, this letter responds to selected specific questions the FRB posed regarding the home equity lending market and the inadequacy of existing regulatory and legislative provisions in protecting the interests of consumers.

I. "Exploding ARMs," deceptive marketing, lax underwriting, and the resulting strain on the mortgage market.

The mortgage market would be well served if authorized agencies stepped in with regulations that ensure that subprime originators return to common-sense underwriting standards. Inadequate attention to ability to repay over the long haul, ignoring the likely effects of payment shock, the misuse of stated income and low-documentation loans, low-balling the short-term lower payments in deceptive sales pitches, and underwriting to short-term initial rates rather than fully-indexed rates – all these are likely to contribute to yet greater foreclosures or other loss of equity.

A. "Teaser" Rates and Exploding Arms

Hybrid ARM products, described by some Federal regulators (including the FRB) as non-traditional mortgages, have become entrenched as the leading product in the subprime market. Many subprime ARMs combine features which almost guarantee a "payment shock" – a significant increase in payments when the rate resets. For this reason, advocates familiar with their negative effects call them "exploding ARMs." Exploding arms are adjustable rate mortgages (most commonly 2/28 and 3/27s) that carry an initial short-term fixed rate (in the case of 2/28s and 3/27s the initial fixed rate term is two and three years, respectively) that is followed by rate adjustments in six-month or 12-month increments for the remainder of the term of the loan. The low start rate virtually assures the payment will rise when the rate resets.

The example below illustrates the severity of payment shock that can occur on a typical 2/28 ARM. In this example, a borrower with a credit score of 580 qualifies for a 30-year loan with a fixed interest rate of 8.5%. Under that scenario, the borrower would have a monthly payment of $1,730 throughout the life of the loan. However, the lender can easily persuade the borrower to accept the adjustable-rate loan with a start rate below 8% and a lower monthly payment. As shown below, at the end of the two-year fixed period, the borrower's monthly payment jumps by $475 dollars—a large amount for most families, and certainly a significant amount for a family that already struggles with debt.

[9] We note that this is not without precedent even outside of the obvious safety and soundness implications and HOEPA. Codifications of common law unconscionability doctrine prohibit extending credit without belief that there is reasonable probability of payment in full.. *See, e.g. Iowa Code*, 537.5108(4)(a).

Subprime Loan Type	Year 1 - 2	Year 3 - 30	% Change
30-year fixed rate (8.5%)	$1,730	$1,730	0.00%
2/28 ARM			
Start rate:7.97% with 3% initial increase	$1,646	$2,121	28.80%

Assumptions: $225,000; A- credit, 580 FICO

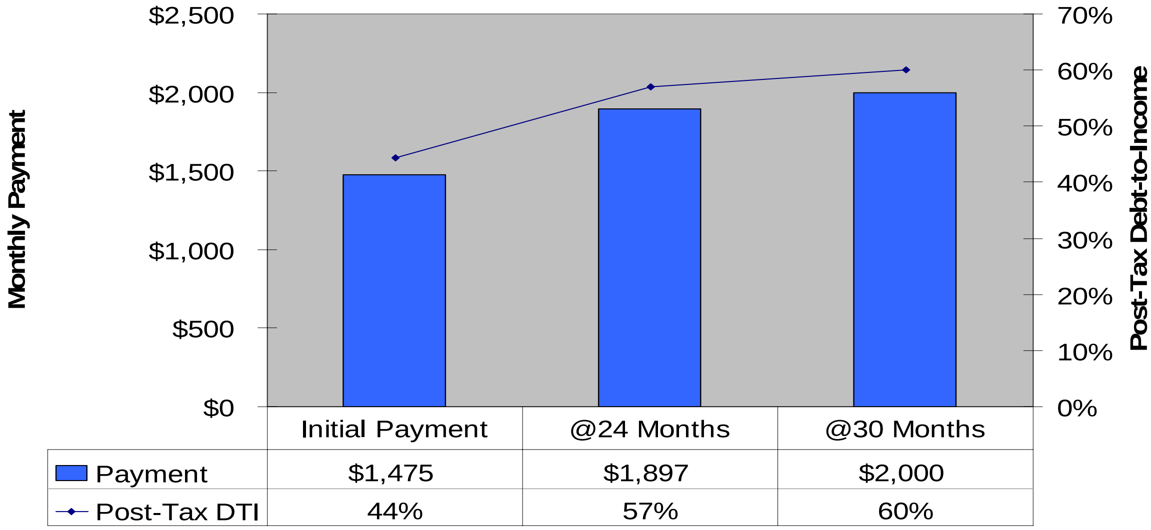
The potential for harm is compounded by other common features of this product in the market. First, it is important to note that subprime ARMs are commonly an "up-only escalator." While in the prime market, ARMs typically allow borrowers the benefit of a lowered rate in a falling rate environment, rate floors and large margins over the index interest rate in most subprime ARMs put the risk of rising rates on the borrower without offering a countervailing benefit of lowered rates in a falling rate environment. Second, the qualifying debt-to-income ratio (DTI) in the subprime market is typically an already high 50 – 55%. When this already high DTI is applied to the lower short-term payment obligation, the fully-indexed principal and interest payments may take the DTI into an unreasonably high range. Third, it is our experience that subprime loans rarely escrow tax and insurance payments, so homeowners face even tighter budgets than they may realize, and a threat to homeownership from yet another quarter – the tax office.

B. Inherent Complexity and Unsuitability of Exploding ARMs

Several questions ask about the use of education to address problems in the market, (see section IV). The complexity of exploding arms is a poor match for the subprime market. In an environment where subprime borrowers have little genuine choice and where there is an embedded culture of aggressive marketing of products to borrowers rather than efforts to place borrowers in loans suitable for their needs, these complex products, without a bedrock of sound underwriting, have created a potential house of cards for borrowers and the lending industry as a whole.

A specific example illustrates the very low risk-assessment standards that accompany 2/28 loans in the subprime market. Attached in Appendix A is a recent posting of loan pricing offered by a large subprime mortgage lender. The rate sheet shows that when determining the ability of borrowers to repay a loan (the "qualifying rate"), the lender employs a rate that is equal to the lesser of the fully indexed interest rate on the loan being applied for or one percent above the initial interest rate on the loan. For a loan with a typical 2/28 structure, the latter would always apply.

To understand how this type of underwriting affects loan risk, consider a $200,000 loan with an initial interest rate of 8.05%., a fully indexed rate of 11.75%, and a first adjustment that can go up to 3%. The lender offers this loan to a subprime borrower who already struggles with a high-level of debt, with a debt-to-income ratio of 44%. The chart below shows how the borrower's post-tax DTI rises to 57% at the two-year adjustment period, and an alarming 60% level at two and a half years.



It is difficult to say honestly that loans such as this one are underwritten with adequate regard to the borrower's ability to repay. The Office of The Comptroller of Currency (OCC) survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions."[10] In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards."[11]

Apparently as a result of the weakened underwriting itself, delinquencies are already rising even on recent vintage loans. That picture is not likely to improve as rates reset. This year Barron's announced that, over the next two years, rate resets will cause monthly payments to increase on an estimated $600 billion of subprime hybrid ARMs with two-year teaser rates.[12] In 2006, according to Fitch Ratings, payments will increase on 41% of the outstanding subprime loans.[13] Climbing interest rates and slowdowns in house appreciation threaten to compound the problems that will arise if subprime borrowers cannot afford higher periodic payments. (The most common "exit strategies" for mortgages in trouble is to find a successful refinance,[14] or turn to an equity-saving market re-sale. That is much easier in an environment with rising home values.)

C. Unfair and deceptive marketing harms homeowners and the marketplace

[10] Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005* at 6.
[11] Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005* at 5.
[12] Jonathan R. Laing, *Coming Home to Roost*, BARRON'S (New York, NY), Feb. 13, 2006, at 26.
[13] Suzanne Mistretta and Grant Bailey, *Subprime Interest-Only Mortgage Rating Criteria*, FITCH RATINGS MORTGAGE PRINCIPLES AND INTEREST (New York, N.Y.), Feb. 2006, at 1,5.
[14] A preliminary analysis by CRL indicates that about 15% of loans refinance when they are already 30 days delinquent. Unfortunately, many subprime refinances are from one bad loan to another one, resulting in more equity loss to prepayment penalties on the old loan and more fees on the new one, and utimately delay the problem without solving it.

The association of these products with unfair and deceptive marketing tactics exacerbates the problems. Reverse competition and perverse incentives among originators may exacerbate the incidence of low-balling payments through 2/28s. As the originator wants to meet origination goals with borrowers who shouldn't qualify, or the originator wants to sell at a higher rate in order to obtain his own yield-spread premium, the "bait and switch" from fixed-rate mortgages applications to 2/28 ARMs becomes more tempting. The originator focuses the borrower's attention on the lowered payments of the initial, teaser term. When and if the borrower is made aware of the fully indexed payment, the borrower may be reassured with the representation that he or she can refinance then to a fixed rate or lowered rate. Borrowers may also be assured that their good payment history during that period will help them get a lower rate. But in a rising rate environment, or when the loan was made without due regard to ability to pay both mortgage payments and tax and insurances, that promise is often hollow.

Other loan-terms may result in what some in the industry refer to as "building a fence" around the customer.[15] The loan may have a prepayment penalty, and particularly insidious is the lender with a mismatch between the teaser period and the prepayment penalty period. A borrower facing a payment shock at the end of a two-year teaser only to be confronted with a three-year prepayment penalty is stuck between the proverbial rock and hard place. If the loan was a high LTV loan, that, too, may preclude a beneficial refinancing. Here, too, a prepayment penalty on that loan would automatically increase the payoff, exacerbating the LTV hurdle in seeking to refinance to lower payments.

In addition to deceptive marketing strategies and these "lock-in" features, other unfair practices make loans more expensive than risk warrants. A number of recent studies find that, compounding the impact of pervasive opportunistic pricing in the subprime market, brokers and originators appear to be steering particular classes of borrowers into unsuitable loans that are more expensive than loans for which their relative level of risk dictates.[16]

D. Rent-seeking, opportunistic pricing and deceptive payment amounts

An additional weakness in the current market is the focus on artificially lowering monthly mortgage payment amounts to make a product (and accompanying fees) appear more affordable, and hence more attractive, to a borrower. One method of artificially suppressing the monthly payment amount is to ignore the impact of the pro-rated monthly amount of taxes and hazard insurance on the borrower's ability to repay a loan. In the prime market, escrowing taxes and home insurance is the norm, and considering those costs when looking at debt-to-income and ability to repay is the typical practice. In contrast, as interest rates rise into levels typical of the subprime sector, the portion of borrowers with escrow drops significantly.[17]

Unfortunately the volume-first culture of the subprime market rewards such risky behavior. Borrower who cannot afford the loan sold to them will have no choice but to refinance when they find they cannot manage the monthly loan payment plus the previously ignored taxes and

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[15] Other phrases used by industry insiders to reflect the broader practice of trapping a borrower in a high cost loan is "close the back door," or "take the customer out of the market."

[16] *See, e.g.*, Debbie Gruenstein Bocian, Keith Ernst, Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006).

[17] *The Chicago Home Ownership Preservation Initiative: A Learning Laboratory*, Neighborhood Housing Services of Chicago, Inc. (June 15, 2005).

insurance. The end result very well may be a refinance that generates more fees for the broker and/or originator. The subprime practices of failing to require escrow and failing to include accurate taxes and home insurance in the calculations of monthly payments and ability to repay analyses are particularly dangerous when combined with exploding ARMs. When added to the shock to payments after the reset of an exploding ARM's teaser rate, the mistreatment of taxes and insurance can send borrowers into the spiral of foreclosure.

Lenders and brokers who do not account for payments for taxes and insurance artificially lower monthly payments, leaving more leeway for the charging of yield-spread premiums and other fees, and also ensuring the flipping of the original loan when the payment amount resets. This rent-seeking behavior maximizes the profits extracted from unsuspecting subprime borrowers.

II. Necessary steps to ensure viable underwriting practices

A. The FRB should require that all adjustable subprime loans are, at a minimum, underwritten to the fully adjusted payment. Loans involving a high DTI should be underwritten to the fully debt-adjusted rates *plus* a cushion to allow for market increase.

The FRB should also use its authority under 15 U.S.C. § 57a(f) to declare it to be an unfair and deceptive act or practice to underwrite a subprime loan without using the fully-indexed rate.[18] It is particularly timely for the FRB to act on these underwriting practices in conjunction with its consideration of the Interagency Joint Guidance on Nontraditional Mortgages.[19] The joint guidance calls for originators in the prime market to underwrite nontraditional mortgages to the fully indexed rate. We fully agree that this requirement should be extended to the subprime market as the safety and soundness of the entire market is adversely impacted by the risks associated with current practices in the subprime market - payment shock, broker behavior and weak underwriting practices.

If the FRB chooses not to adopt restrictions for the subprime market it would undercut regulators' ability to properly address products in the prime market. Letting the subprime practices go unchecked creates an unlevel playing field between depository and non-depository entities. Subprime originators would have an unfair advantage as, unfettered by regulations, brokers could steer borrowers to the subprime arena where underwriting requirements are more lax, and where artificially (and inaccurately) lowered payment amounts afford more room for opportunistic profit seeking (higher yield-spread premiums, loans with both yield-spread premiums and prepayment penalties, etc.). Multi-channel originators may be faced with similar steering concerns if a double standard exists. The race to the bottom in search of high volume and easy fees could have drastic

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[18] In this environment of rising interest rates and extremely high maximum rates the best course of action may be to underwrite to the maximum rate. The primary impact will be to address safety and soundness concerns for the mortgage market. Underwriting for the maximum rate will greatly increase the transparency of the transactions and minimize the unexpected component of any payment shock. Originators would have to consider whether borrowers could afford to stay in their homes after the rate resets. Borrowers would have a more realistic understanding of what their future payments will look like. In many subprime ARMs we have seen, the lifetime maximum is much higher than is typical in the prime market. Therefore, a secondary, but equally valuable effect could be that long-view underwriting could actually lead to a decline in these maximum rates, which would be a benefit to the borrowers and stabilize the state of the market after reset.

[19] *See* Docket Number OP-1246, proposed Interagency Guidance on Nontraditional Mortgages at http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/default.htm

implications on both the quality of the loans as well as efforts to help people become, and remain, homeowners.

B. The FRB should use their authority under 15 U.S.C. § 57a(f) to mandate that subprime lenders require escrow of taxes and hazard insurance for all adjustable-rate mortgages.

The failure of some subprime lenders to escrow these amounts puts the entire market at risk by facilitating the misrepresentation of the monthly costs of homeownership and compromises analysis of a borrower's ability to repay the loan. This practice pushes originators and brokers towards products and practices driven by volume and fee goals rather than on sound underwriting principles and the results are heightened payment shock/ability to pay issues.

Fannie Mae has expressed concern that some lenders might forego establishing escrow accounts for borrowers who have troubled credit histories "with the intent of understating the true cost of financing and generating fees out of activities like lender-placed insurance."[20] Fannie Mae discourages waiving escrows for a borrower with a blemished credit record "because the borrower may find it difficult to maintain homeownership if he or she is faced with the need to make lump-sum payments for taxes and/or insurance and any other periodic payment items."[21]

FRB action on this front will encourage responsible lending practices that will help counterbalance the artificial lowering of monthly payment amounts and will persuade lenders to tighten up underwriting standards. The subprime market is dominated by non-depository lenders that have no safety and soundness obligations. But, as discussed above, their current practices put a strain on the safety and soundness of the entire mortgage market. Providing this safeguard will help enhance the stability of the market as a whole.

This action would provide valuable protection against one significant cause of foreclosure. By increasing the transparency of the transaction and tightening up underwriting, it will help protect against payment shock issues associated with payment resets of adjustable rate mortgages.

The FRB can limit this requirement to non-depository lenders, since the practice is already the norm for depository lenders. This requirement is most needed in the subprime market which has higher foreclosure rates, significant problems with affordability of the products, suitability of the products for borrowers and additional servicing issues. In addition, the FRB should use its authority to declare that it is an UDAP violation to exclude escrows of taxes and hazard insurance from the repayment analysis.

III. Eliminate unsafe practices regarding reduced documentation and stated income loans.

A. The FRB should enact specific regulations for the origination of reduced documentation loans and loans associated with special risks of payment shock.

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[20] Fannie Mae, Announcement 04-06, *Authoritative Online Selling and Servicing Guides, Purchase of Massachusetts "High Cost Home Mortgage Loans," Mortgage Loan Documents, Arbitration, Waiver of Prepayment Premium, Guaranty Fees, and Escrow Accounts* 7 (Sept. 24, 2004), available at http://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2004/04-06.pdf.
[21] Id.

As we mentioned in the section above, the failure of the FRB to adopt restrictions under HOEPA authorization would undercut the ability to properly address products in the prime market. In addition, the unlevel playing field created by differing levels of underwriting requirements would be a great cause for concern.

We note that the FRB already in theory prohibits stated-loan docs for HOEPA loans, though, as courts have recognized, enforcement is difficult because of the "pattern and practice" requirement.[22] But it is evident that problems with stated income loans are now widespread below the HOEPA threshold and should be addressed before the problems are compounded.

In the subprime market the use of stated income and low-doc loans in combination with the exploding arms often are a smokescreen for weakened underwriting practices. And these practices are playing themselves out in the increasing foreclosure and delinquency rates. Masking a borrower's income is a way of sidestepping the all-important question of a borrower's ability to repay the loan and as we have discussed above, has contributed to the growing subprime foreclosure rate. For example, a study by the University of North Carolina at Chapel Hill found that in 2003, subprime loans had almost a 15% greater risk of going into foreclosure if they were stated income/low-doc/no-doc loans.[23]

While there may be disagreement about whether the increase in inflated incomes are originator-driven, applicant-driven, or a combination of both, there is clearly a problem. A 2006 study by MARI finds that inflated incomes are very common, and that close to 60 percent of stated income amounts were inflated by greater than 50 percent.[24] Inflating of incomes to meet specific debt to income and repayment ability standards is unlikely to be solely the result of borrower statements – again, lax underwriting and volume and fee-driven originators are more likely culprits, as this facet of the states' recent Ameriquest investigation demonstrates. [25]

Immediate action is required by the FRB to protect the integrity of the mortgage market and halt the spread of mortgages with inflated incomes and property values. One such step would be to declare that the use of stated income and low documentation/no documentation processes with exploding ARMs to be an unfair and deceptive trade practice unless the borrower has an in person consultation with a credit counselor. These reduced document loans are for special circumstances and involving a counselor will reduce the chances of unscrupulous modifications to a loan file to make the loan "work."

A second step is to require third party verification of secondary income and equity claimed in stated income and low doc/no doc loans, in particular rental income and secondary business

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[22] Reg. Z, 226.34(a)(4). See *Newton v. United Companies Lending, 24 F. Supp. 2d 444 (E.D. Pa. 1998).*

[23] See Quercia, Stegman, & 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 Table 10 http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf)

[24] *See* Mortgage Assets Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association* 12 (April 2006), available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf; *See also* Collins, Brian, "Borrowers Fib About Income", NATIONAL MORTGAGE NEWS (07/24/06) Vol. 30, No. 41, P. 1 for discussion of MARI results.

[25] Note that the investigation involved a major retail lender. The incentive for brokers to engage in the practice is even greater.

ventures. Unfortunately market practices make it necessary to have a safeguard against phantom rental revenues and other phantom secondary revenue sources. A third step would be to require that a third party verify W-2 income any time a borrower who receives a W-2 from his or her employer is involved in a stated-income or low-doc loan.[26]

IV. Responses to Specific Questions

A. Topic 1: Predatory Lending: The Impact of HOEPA Rules and State and Local Predatory Lending Laws

1. **Have the revisions to the HOEPA regulations (12 CFR § 226.32 et seq.) been effective in curtailing predatory lending practices? What has been the impact of these changes on the availability of subprime credit? Have other abusive practices emerged since the 2002 revisions? If so, what are they?**

Summary: In the past, the FRB has shown critical leadership and used its authority to restrict certain mortgage lending abuses. Consumers and responsible lenders need the FRB to act again to clean up the market. As the FRB's hearings have shown, since the Final Rule was issued new abusive practices have emerged and old practices have evolved. The FRB can build upon the groundwork it laid years ago to thwart certain practices that harm homebuyers and homeowners. Key areas for reform include the loan flipping standard, and underwriting and documentation standards.

HOEPA revisions have been helpful in curtailing predatory practices.
The changes the FRB implemented in its Final Rule issued on December 20, 2001[27] (the "Final Rule") undoubtedly have impacted the consumer home loan market positively. In the wake of the FRB's declaration that lenders must count towards HOEPA's points and fees trigger premiums and other charges for credit insurance and debt cancellation products (and of action by some states to ban the financing of such premiums),[28] single premium mortgage insurance products largely disappeared from the home loan market. Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household and American General have all decided not to offer SPCI on their subprime loans.[29] While continuing vigilance is warranted, the inclusion of single premium credit insurance products into the points and fees trigger to date is a success story.

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[26] While there are rational reasons for some borrowers to use stated loan and low-doc products, we posit it highly unlikely that any borrower would willingly and knowingly pay a 75 basis point premium for the "benefit" of not having to produce their W-2.
[27] Final Rule, Truth in Lending, 66 Fed. Reg. 65,604 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226).
[28] See GEORGIA CODE ANN. § 7-6A-3(1), MASS. GEN. LAWS ch. 183, § 66, N.M. STAT. ANN. § 58-21A-4.A, N.C. GEN. STAT. § 24-10.2(b).
[29] See "Equicredit to Stop Selling Single-Premium Credit Life", *Inside B&C Lending* at p.3 (Bank of America, April 2, 2001); Erick Bergquist, "Gloom Turns to Optimism in the Subprime Business," *American Banker* at p.10 (Chase, May 15, 2001); "First Union and Wachovia Announce Community Commitment for the New Wachovia," (May 24, 2001); statements by officers of Ameriquest and Option One; Jathon Sapsford, "Citigroup Will Halt Home-Loan Product Criticized by Some as Predatory Lending," *Wall Street Journal* (June 29, 2001); Anitha Reddy, "Household Alters Loan Policy," *Washington Post* (July 12, 2001); Patrick McGeehan, "Third Insurer to Stop Selling Single-Premium Credit Life Policies", *New York Times* (American General, July 21, 2001).

Revisions to HOEPA Could Have Important Impact
In addition to the recommendations set forth earlier in this letter, CRL urges the FRB to take actions on the following issues.

Comprehensive Points and Fees Trigger

The FRB recognized the need for the points and fees trigger calculations to include the cost of financed single premium credit insurance: experience has shown that additional charges should be added. Likewise, the FRB should act to include in the trigger the maximum prepayment penalty that the borrower may be charged. Mounting evidence shows that subprime prepayment penalties do not in fact benefit borrowers,[30] disproportionately adversely impact borrowers in rural communities[31] and in minority neighborhoods,[32] and increase the risk of foreclosure.[33] The FRB also should require that lenders' points and fees calculation include the amount of any yield-spread premium paid to a mortgage broker.[34] We believe that the Board does have authority within the language of the statute to capture this form of broker fee.[35] Moreover, it makes little sense for a broker who takes 3% in fees denominated as "loan origination fees" to have all 3% count, while the broker who takes the same 3% denominated as two "loan origination points" and 1% as a YSP has only two points counted toward the trigger. Several states have expanded their points and fees trigger to capture these important costs, without harming their residents' access to fair subprime credit.

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[30] A CRL study has found that interest rates on refinance loans with the penalties were not different than the rates on loans without the penalties. For borrowers purchasing homes, interest rates actually were higher. In 2002, subprime borrowers who had a 30-year, fixed-rate mortgage paid an average of 40 basis points more if their loan included a prepayment penalty than if it did not. Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages* 1 (Jan. 2005), available at http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.

[31] Subprime prepayment penalties disproportionately harm borrowers in rural communities, who are more likely to receive a subprime prepayment penalty than are equivalent borrowers in urban communities. John Farris & Christopher A. Richardson, *The Geography of Subprime Mortgage Prepayment Penalty Patterns*, Housing Policy Debate Vol. 15, Iss. 3 (2004), available at http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Farris.pdf.

[32] Borrowers of all races in heavily minority neighborhoods are more than one-third more likely to have a prepayment penalty on their subprime mortgages compared to equivalent borrowers in predominantly white neighborhoods; Debbie Gruenstein Bocian & Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans* 1 (Jan. 2005), available at http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf.

[33] A study by University of North Carolina researchers showed that subprime refinance loans with prepayment penalties are 30% more likely to enter foreclosure than equivalent loans that do not have such penalties. Roberto G. Quercia, Michael A. Staten, & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* (Jan. 25, 2005), available at http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

[34] Research by Harvard Law School professor Howell E. Jackson showed that the average customer paid $1,850 in the form of a yield spread premium. Prof. Jackson discovered that on the broker-originated set of loans examined, the customer paid a yield spread premium in between 85% and 90% of transactions. Strikingly, Professor Jackson found that African Americans and Hispanics pay mortgage brokers more for their services—for African-Americans, an average of $474 more per loan, and for Hispanics, an average of $580 more per loan. Howell E. Jackson and Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* 9, 127 (January 8, 2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.

[35] See generally National Consumer Law Center, *Truth in Lending*, § 9.2.6.3.4 (5th Ed. and Supp.)

Loan Flipping Standard

The FRB bans on refinances of HOEPA loans that are not in the borrower's interest—for one year from loan origination. Respectfully, CRL submits that loan flipping should be banned on all loans at all times, not prohibited only for HOEPA high-cost loans and only within one year of origination. CRL continues to support the "reasonable, tangible net benefit" to the borrower test applied to refinances in several states. There is no indication that this standard has led to increased litigation or to inconsistent application—assertions many industry commentators made to discourage the FRB from using a "borrower's interest" test, and whose accuracy has not been shown.[36] CRL also maintains that the ban should apply to all home loans, not just high-cost home loans. Whether or not the FRB changes the standard or the loans to which it applies, the FRB should lift the one-year limit on the loan-flipping ban. An inappropriate loan flip is abusive whenever it occurs.

Loan Underwriting and Documentation

Specific recommendations for action on this front appear earlier in this letter.

2. **What has been the impact of state and local anti-predatory lending laws on curbing abusive lending practices? Have these laws adversely affected consumers' access to legitimate subprime lending? Have certain provisions been particularly effective, or particularly likely to negatively affect credit availability?**

Summary: Revisions to the HOEPA regulations were helpful, but it is clear they did not go far enough to adequately protect homeowners in the subprime market. Approximately 28 states have taken various regulatory actions which strengthen specific provisions of HOEPA.[37] Typical actions involve broadening the scope of loans that receive special protections from predatory lending, limiting prepayment penalties, limiting serial refinancing (loan "flipping"), including yield-spread premiums in the points and fees trigger that determines which loans receive protections, etc. As described below, the subprime mortgage market has continued to grow and prosper under these stronger regulations, while abusive loans have been significantly reduced in states with stronger laws. Today's most serious concerns in the subprime market involve abusive practices that HOEPA does not address, such as irresponsible and unethical adjustable-rate subprime mortgages.

State anti-predatory lending laws have reduced predatory lending significantly.
This year CRL released quantitative research on the effectiveness of state anti-predatory lending laws in a study called *The Best Value in the Subprime Market: State Predatory Lending Reforms*. This "Best Value" study represents the most comprehensive investigation ever conducted on how consumers have fared under state laws that strengthen HOEPA provisions. The study examined 28 state reforms by analyzing six million subprime mortgage loans made over a seven-year period (1998 – 2004). The study found that abusive lending in the subprime market was significantly reduced in states with strong laws. The study specifically looked at reforms related to prepayment penalties, balloon payments and "steering" (selling subprime loans to borrowers who could qualify for lower-interest prime mortgages). Compared to control states, states with anti-

[36] See FRB, Final Rule, Truth in Lending, 66 Fed. Reg. at 65,613. Cf. CRL, *"Flipping" Prohibitions in N.C. Elicit No Substantial Litigation* (May 7, 2004), available at http://www.responsiblelending.org/pdfs/S&P_research0504.PDF.

[37] Some state protections pre-date HOEPA, and have broader application, such as state laws limiting or prohibiting prepayment penalties on a wider range of loans.

predatory lending laws commonly reduced the proportion of loans with targeted terms by 30 percentage points.[38]

It is interesting to note that this CRL study also found that in states that implemented HOEPA reforms, borrowers' interest rates on subprime mortgages were no higher than in states without HOEPA reforms – and, in fact, borrowers often paid lower rates.[39]

<u>Under HOEPA reforms and state anti-predatory lending laws, homebuyers continue to have abundant access to credit.</u>

The spectacular growth of the subprime mortgage market nationwide has been well documented and the subject of much comment. In 1994, the market was 35 billion and less than five percent of the total market. By last year, that amount had risen to more than $670 billion, making up nearly 20% of the total mortgage market. Home loan credit has never been more widely available than it is today.

The rapid growth of the subprime mortgage market has not abated, even as more states have moved to combat predatory lending practices. In its research on state anti-predatory lending laws, CRL found that states that had implemented HOEPA reforms had similar total subprime mortgage volume to states without such reforms. Among the states evaluated, there was no statistically significant effect on overall subprime volume in the overwhelming majority of states.

The continuing availability of credit is particularly positive given that the states with HOEPA reforms showed a marked decline in abusive loans. This provides strong evidence that the market successfully substituted loans without abusive terms for loans that included such terms, with no net effect on overall volume. Thus, in states with reforms, it appears that homeowners have the same access to credit – they are just more likely to get a *responsible* subprime loan. In sum, ethical lenders have benefited along with consumers from these laws.

2. **Since the 2002 revisions to HOEPA, what efforts to educate consumers about predatory lending have been successful? What is needed to help such efforts succeed?**

(This response also applies to Topic 3, question 3.)

While we applaud all good faith efforts to increase consumer awareness and understanding, we urge the Board not to conflate education and regulation, and to carefully assess where its efforts are most profitably placed. For a myriad of reasons, more and more people grounded in the world of experience, rather than economic theory, have come to understand the limits of education as a solution to problems in this market. The complexity of the products, the constant and rapid evolution of both legitimate products and illegitimate tactics makes it unlikely that education programs can be designed to reach the target audience at the "teachable moment."[40]

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[38] Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (February 23, 2006).

[39] Li and Ernst, pp. 15 – 17.

[40] See, e.g. William R. Emmons, *Consumer Finance Myths and Other Obstacles to Financial Literacy, (Conference Presentation: Consequences of the Consumer Lending Revolution, St. Louis Univ. School of Law, December 8, 2004)* p. 23-26. *Cf.* Mark Furletti, *Credit Card Pricing Developments and their Disclosure, (Payment Cards Center, The Federal Reserve Bank of Philadelphia, January, 2003).*

Furthermore, the sophistication and, education, levels, as well as the credulousness, of consumers in the mortgage market run the full gamut. The challenges of designing educational programs appropriate for all relevant sophistication and education levels, and delivering them to the appropriate audience at a timely moment are massive and expensive. Moreover, the audience is constantly in flux, as new potential consumers come into and out of the market.

Finally, with greater variety and complexity of products and services, in most markets, the place that a consumer will turn first is to the professionals who offers themselves as knowledgeable about these – or any other complex products. Better a market – and a regulatory system -- that assures that those who set themselves up as specialists are worthy of the trust they ask, for they are where consumers look first, and should be entitled to look.[41]

The U.S. General Accounting Office (now the Government Accountability Office) reported that its reviews of literature and interviews with consumer and federal officials suggested that, while consumer education, mortgage counseling, and loan disclosure requirements are useful, their effect in reducing predatory lending may be limited. Among the factors limiting their usefulness, the GAO cited the complexity of mortgage transactions, difficulties in reaching target audiences, and counselors' lack of access to loan documents before closing.[42]

3. **Should the existing HOEPA disclosures in Regulation Z be changed to improve consumers' understanding of high-cost loan products? If so, in what way?**

Please refer to our answer to question 2 above.

Topic 2: Nontraditional Mortgage Products and Reverse Mortgages:

- **<u>Interest Only Loans and Payment Option Adjustable Rate Mortgages</u>.**

1. **Do consumers have sufficient information (from disclosures and from advertisements) about nontraditional mortgage products to understand the risks (such as payment increases and negative amortization) associated with them?**

2. **Should any disclosures required under Regulation Z be eliminated or modified because they are confusing to consumers, unduly burdensome to creditors, or are simply not relevant to nontraditional mortgage products? Do the required**

[41] "But would consumers not be better off if financial-services providers reduced fees and loan rates rather than spending on financial literacy that, by all accounts, have minimal impact? The point is, of course, that profit-maximizing financial services providers really do not want to "give back' any of their profit margin. Nor do they necessarily desire more financially savvy customers who might shop around more actively or bargain down the terms on the products and services they sell." Emmons, supra note 54, at p. 25-26.

It is perhaps more important that the Board concentrate on assuring that the market is worthy of the trust of its consumers, "For the economy trust is…'the soul of commerce and the credit it alone can generate must be regarded as a 'second species of money.' Rephrased in dryer, but more modern terminology, trust and social cohesion reduce information and transaction costs (negotiating and enforcing a contract), and also reduce perceived economic risks – the enemy of investment." Frederick L. Pryor, *Economic Evolution and Structure: The Impact of Complexity of the U.S. Economic System*. 254 (Cambridge Univ. Press 1996)

[42] U.S. General Accounting Office, GAO-04-280, *Consumer Protection: Federal and State Agencies Face Challenges Combating Predatory Lending* at 12-13 (Jan. 2004).

disclosures present information about nontraditional mortgage products in an understandable manner?

3. **Are there some Regulation Z disclosures that should be provided earlier in the mortgage shopping and application process to aid consumers' understanding of key credit terms and costs for these products?**

The Board asked four questions regarding the disclosure rules. As a general principle, we agree with the US GAO's conclusion that

> Although improving loan disclosures would undoubtedly have benefits, once again the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices. Moreover, even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Finally, as with mortgage counseling, revised disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of loans in the disclosure documents themselves.[43]

That being said, it is safe to say that for most consumers, the most understandable piece of paper in the thick stack of documents given at a closed-end mortgage settlement will be the Truth In Lending disclosure – once the consumer sees it.[44] However difficult it may be to understand, it is nevertheless the simplest and clearest summary of the obligation they are about to undertake among the documents given.

As we noted at the outset, without meaning to minimize a myriad of issues that confront consumers in the mortgage market, we are emphasizing in these comments the dangers posed by the hybrid ARMs. The exploding ARM payments, coupled with an apparently widespread failure to underwrite to those fully indexed payments, bring inherent dangers to an industry that should have <u>sustainable</u> homeownership as a core value.[45] We again emphasize that the combination of high margins and high floors on the typical subprime ARM make them different from the prime ARM product in this fundamental respect: the payments will typically go up, even if the index rate falls. So for the typical subprime exploding ARM, representations that "the periodic payment may increase *or decrease* substantially depending on changes in the rate,"[46] given in a sales pitch, in a disclosure, or in an uncorrected assumption that an ARM, by nature, can change in both directions, is in fact is misleading.

As regulators and those who work with subprime consumers know, these lowered payments are often used as part of a "bait-and-switch" tactic, to switch a FRM applicant into an exploding ARM, or simply to focus the attention on the initial payment, rather than the fully indexed payment. Indeed, given the common practice of underwriting pegged to the teaser rate not the fully indexed rate, one can hardly lay the blame for failing to think through to the next stage

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[43] U.S. General Accounting Office, GAO-04-280, *Consumer Protection: Federal and State Agencies Face Challenges Combating Predatory Lending* 14 (Jan. 2004).

[44] Unfortunately, the same cannot be said of disclosures given in connection with open-end HELCs. CRL discussed some of the problems with HELC disclosures in its Comments to the Supplemental ANPRM regarding Open-End Disclosures, December 18, 2005, at p. 7-10 and Appx.

[45] See text accompanying note above indicating that serious delinquencies have grown 141% in ARMS, compared to 27% in FRMs.

[46] See Reg. Z, § 226.19(b)(2)(viii)(B), one of the two early disclosures relating to the hypothetical $10,000 loan that the creditor may, at its option, choose to give in a mortgage secured by a principal residence.

solely at the applicant's door. Experience in the field indicates that many consumers do ask about the higher payments, and are assured that their good payment history (and/or property appreciation and/or lowered rates) will mean they can refinance before that higher rate kicks in. In practice, the exploding ARM thus has become an effective tool to aid in flipping and churning these loans.

Consequently, we have focused primarily on the adequacy of information about payment obligations in the exploding ARM context. While, as the GAO has noted, disclosures alone cannot counter the misrepresentations of the professional supposedly working for the borrower, they can be designed not to play into such market problems.

Calculation of disclosed payment schedule in exploding ARMs. Reg. Z requires that the disclosures for teaser loans reflect the effect of multiple rates, using the formula which would have been in effect as of the time of consummation in the absence of the teaser rate, or roughly so, OSC § 226.17(c)(1)-10. The calculation assumes no movement in the index rate. OSC § 226.17(c)(1)-8. If change caps preclude a catch-up payment adjustment in one step, the effect of the change cap is to be reflected. The payment schedule on a § 226.18 final disclosure, given at closing, for an exploding ARM would read, for example, as:

24 @ $906
6 @ _$1035______
329 @ $1123
1 @ $1111

While the calculation rules thus do tell the consumer the payment will rise, the question remain as to whether that information is given when it may be most useful to the consumer, and is it sufficient.

Timing of disclosures regarding payment information: It has become almost canon that consumers, particularly subprime consumers, shop on monthly payments more than other terms. Whether that is the sole criteria or simply one of the criteria, certainly few Americans can afford to ignore what the mortgage payment will do to their monthly budget. Consequently, adequate and accurate information about the probability – or certainty – of payment shock in the offing is crucial. And whatever else that means, it means that a disclosure at closing – amidst the other 40+ pieces of paper [47]-- comes too late in the process, however helpful its content may be.

Currently, only purchase money mortgages and HOEPA loans require an advance look at transaction-specific payment information or estimates. HOEPA requires payment information as part of its early-look disclosures, to be given at least three days before consummation. Reg. Z, § 226.31(c)(1), 226.32(c)(3),(4). However, given the small portion of the market subject to HOEPA rules, however helpful this early disclosure is,[48] it is available for far too few consumers.

[47] We note, too, that closings in the subprime market are often hurried events. Regulatory investigations, as well as many predatory lending cases, have shown closings scheduled at times and places which assure that there will not be an opportunity to review documents carefully. Not infrequently, closings are even conducted by "signers", who affirmatively tell the consumers that they are just there to get the signature, and cannot answer any questions about the loan documents or terms.

[48] This HOEPA rule also requires a transaction-specific "worst-case" payment disclosure for ARMs, which is valuable information required for no other ARM. See discussion below.

For purchase money mortgages, good faith estimates of all § 226.18 disclosures, including payment information, are required to be delivered or mailed within three business days of receiving the application. (Reg. Z, § 226.19(a)(1)). By contrast, non-purchase money ARMs secured by the principal dwelling have no requirement for early disclosure of transaction-specific payment information estimates. Reg. Z, § 226.19(b). They only get hypothesized and generalized information of § 226.19(b)(2)(viii) and (ix).

At a minimum, refinance applicants should get at least the same advance information that purchase money applicants get. We note that this should not be a burden on lenders, since lenders must send RESPA GFEs within three days of application anyway. There is no reason not to include good faith estimates of §226.18 information, including payment information, along with the RESPA GFEs for refinances, and, in fact, many lenders already do so.

That being said, these disclosures given three days after application is received are not as useful in practice as they should be. Coming so early in the process, for both legitimate, and, unfortunately illegitimate reasons, the RESPA and TIL GFEs often do not bear close enough resemblance to the final terms to provide the applicant a good opportunity for either comparison shopping or re-thinking the loan. On a great many occasions, advocates have seen, for example, GFEs and early disclosures for fixed rate mortgages, typically at lower rates, while the final product is an ARM, often an exploding ARM.

Sometimes the switch may result from information obtained during processing which makes it necessary to make adjustments in order to qualify the loan, but sometimes it is just to facilitate a bait-and-switch sales pitch. Correcting the disclosures at closing (§226.19(a)(2)) is simply too late to be useful for shopping or "just saying no" for most people.[49]

TIL has always required the accurate, transaction-specific disclosures "before consummation," § 226.17(a)(2), but despite its vaunted purpose to facilitate comparison shopping, in practice the timing requirement has never been interpreted in a way to fulfill that goal. It should be within the FRB's authority to make the phrase "before consummation" mean something other than "sometime during consummation," – which is what it means now. One possibility is for the Board:

> * to amend § 226.19(a)(1) to cover both purchase money and refinance loans, at least those secured by a principal residence.
>
> * to amend § 226.19(a)(2) to require re-disclosure no later than 3 days before consummation, and to require it in more circumstances than it now provides. For example, it should be required if an ARM instead of a FRM will be made, or if the payment obligations will differ from early disclosures by more than a minimal amount.

We note that creditors must already be prepared to make available transaction-specific RESPA documents at least 24-hours prior to closing upon request, 24 C.F.R. § 3500.10(a), so that creditors should already be prepared provide accurate final information prior to actual closing.

[49] In theory, the refinance customers whose mortgages are secured by their principal dwelling could use the 3-day cooling off period to examine the documents and re-think the loan, and some in fact do. But the dynamics – both practical and psychological – of unwinding a done deal are different than not concluding a deal in the first place. Particularly when budgets have been re-arranged to take into account a refinancing, and perhaps consolidation of other debts in anticipation of this loan, restoring the status quo ante may be difficult.

Content of payment disclosures on ARMs: While giving earlier disclosures of the exploding payments in a teaser rate ARM as described above would be an improvement over existing rules, HOEPA requires one additional ARM-related disclosure that would also benefit millions of non-HOEPA ARM borrowers. It requires disclosure of the "worst-case" payment scenario, pegged to the contract-specific lifetime cap required by § 226.30. See Reg. Z, § 226.32(c)(4). Advocates and attorneys general working with subprime borrowers have noted that the lifetime caps in subprime loans have tended to be relatively high, more so than in prime ARMs. Disclosure of the worst-case payment scenario is information that should be available to all ARM borrowers, not just high cost borrowers. It is our understanding that CAC members and NCLC have provided a suggested "worst case payment" disclosure to the Board, and we agree that such a disclosure would be a marked improvement.

Disclosures to be eliminated: We are unaware of studies examining whether the hypothesized disclosures or highly generalized disclosures are actually helpful to the broad spectrum of consumers with differing levels of education, sophistication, and quantitative skills. Just how helpful in extrapolating the impact on a family budget an exploding ARM with an 11.4% blended rate on a $97,000 mortgage in a rising rate environment from a hypothetical $10,000 loan using a rate that may or may not be what they will get is something that could in fact be misleadingly comforting. If it has not been done, its effectiveness should be tested on the full spectrum of borrowers, and discarded if it is not useful, or worse, leads to underestimation of the potential burden.

<u>Reverse Mortgages.</u>

1. **Are current Regulation Z disclosures adequate to inform consumers about the costs of reverse mortgages and to ensure that they understand the terms of the product?**
2. **Has counseling (under the HUD program) been effective in educating consumers about reverse mortgages and in preventing abuses from occurring?**
3. **In reverse mortgages that are not insured by HUD, is counseling offered to applicants? Do borrowers of these loans have difficulty understanding their loan terms or encounter other difficulties? Do these lenders employ alternate disclosure approaches that have proven to be effective?**

Our experience in mortgage lending issues and regulations has taught us that transaction-specific counseling has been the most effective type of counseling. Anecdotally we have heard from housing counselors that the HUD program has served as a relatively successful model and counselors would like to see the mandatory counseling extended to other reverse mortgage products.

General education, disclosures and non-transaction specific counseling have not shown to be effective methods to prevent abuses in the broader mortgage market and we are skeptical as to their value in the limited area of reverse mortgages. As we note earlier in our comments, disclosures may be one piece of the solution but they are not a stand-alone cure to the abuses prevalent in the marketplace.

We respectfully submit that the written comments submitted by AARP expound in greater detail on the topic of reverse mortgages and we defer to their expertise on this specialized issue.[50]

Topic 3: Informed Consumer Choice in the Subprime Market

1. **How do consumers who get higher-priced loans shop for those loans? How do they select a particular lender?**

It is critical to look at this question from both sides of the table (or most accurately, the phone line). Without addressing the manner in which subprime loans are marketed to borrowers and how certain borrowers are targeted for certain products any answer would miss a core reality of the subprime market.

How consumers shop for loans largely is a function of how lenders and brokers market loans--by highlighting the monthly payment. Certainly, the monthly payment is important; as discussed, however, if the monthly rate is variable, and/or if the introductory rate is greatly discounted, the original monthly payment tells a borrower little about the true costs of her loan. With refinance loans, marketing tends to highlight how monthly payments will decrease, without emphasizing the concurrent risks, e.g., of refinancing unsecured debt such as credit card debt with home-secured debt or the high risk that the interest rate on an adjustable rate mortgage will increase. Lenders and brokers who are honest about the trade-offs among various loan products are disadvantaged compared with those who gloss over or misrepresent risks and rewards. Mortgage professionals who take time to explain available options likely will close fewer loans than those who work in a "boiler room" atmosphere that promotes volume at all costs. Compensation schemes shape mortgage professionals' incentives, sometimes for the worse.

In investigating marketing practices, the FRB should continue to dig for explanations for the racial and ethnic disparities in the receipt of higher-cost loans. In an analysis of 2004 data reported pursuant to the Home Mortgage Disclosure Act, FRB researchers noted that while there might be innocuous explanation for pricing disparities, a situation that might suggest an inadequately functioning marketplace--and that could trigger fair lending concerns--would occur if minority borrowers are incurring prices on their loans that are higher than is warranted by their credit characteristics. Such a problem could arise in one or both of the following circumstances: (1) neighborhoods with high proportions of minority residents may be less well served by lenders offering prime products, a circumstance that would make obtaining lower-priced loans more difficult for well-qualified minorities, or (2) some minority borrowers may be steered to lenders who typically charge higher prices than the credit characteristics of these borrowers warrant.[51]

The FRB has access to information to which the general public does not, information that is critical to understanding the causes of racial and ethnic pricing disparities. CRL urges the FRB to investigate--and to require public disclosure of--such loan characteristics as loan-to-value ratio that contribute to loan pricing.

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[50] See AARP comments; *See also* http://www.aarp.org/money/revmort/.

[51] Robert B. Avery, Glenn B. Canner, & Robert E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (FRB Bulletin, Summer 2005). See also Keith S. Ernst and Deborah N. Goldstein, *Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data* (Sept. 15, 2005), available at http://www.responsiblelending.org/pdfs/cb001-FRB-091505.pdf.

2. What do consumers understand about the role of mortgage brokers in offering mortgage products? Has their understanding been furthered by state-required mortgage broker disclosures?

Mortgage brokers play a key role in the subprime mortgage market, originating up to 80% of all subprime home loans. Unfortunately, brokers also play a prominent role in predatory lending, and they are notorious for aggressive marketing tactics: A study by AARP found that more than half of the people they surveyed with refinanced home loans from brokers reported that the broker initiated contact with them, rather than the borrower seeking the loan.[52] Brokers will give the strong impression that they are working on behalf of the consumers they contact when in fact they usually have no legal obligation to place their clients' interests ahead of maximizing their own monetary gain. In general, brokers are legally free to sell families home loans without revealing when lower-cost alternatives are available to them. One result is that a high portion of subprime loans go to borrowers who could have qualified for lower-cost prime loans.[53]

While CRL supports stronger state regulation of brokers, we believe that disclosures alone are a very weak tool for reducing abusive lending practices. First, the home-buying process already involves so much paper and so many disclosures that it is easy to hide or gloss over additional information. We also have reviewed numerous cases in which mortgage brokers inserted disclosures in loan files after closing. In short, from a consumer's point of view, disclosures are not equivalent to helpful information, and they certainly are no substitute for being able to rely on lending professionals who are obligated to identify suitable loan products for their clients.

3. What strategies have been helpful in educating consumers about their options in the mortgage market? What efforts are needed to help educate consumers about the mortgage credit process and how to shop and compare loan terms and fees?

Information and education can help consumers to deal with mortgage professionals. No matter how much one educates consumers, however, an information imbalance will remain. First, the home loan market shifts constantly. Loan officers and mortgage brokers need to study continuously to keep track of all the products that institutions offer. Those who are less diligent only learn about and promote a few products—and have financial incentives to push those products that are most lucrative for them. It is unrealistic to expect consumers to follow the home loan market more diligently than do mortgage professionals.

Furthermore, loan officers and mortgage brokers have an advantage over even fairly sophisticated consumers. Though some lenders publish their rate sheets, others explicitly state that applicants should not see the rate sheets. Those sheets show the par rate at which the lender is willing to make the loan—and the tradeoffs and payoffs that come with loans that have different interest rates and various terms and conditions. The prevalence of teaser rates on ARMs increases the difficulty of analyzing and comparing loan products. Bait-and-switch tactics by dishonest lenders exacerbate the problem. Subprime borrowers face the greatest difficulty, since the subprime mortgage market is much less transparent than is the prime market.

Third, discrimination prevents some loan seekers from receiving important information. Several studies using "matched pairs" with comparable qualifications have found that mortgage

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[52] Kellie K. Kim-Sung and Sharon Hermanson, "Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans," AARP PPI Data Digest, No. 83 (2003).

[53] Debbie Gruenstein Bocian, Keith Ernst, Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006).

professionals treat applicants of different races and ethnicities differently. In 2002, the Urban Institute, in a report commissioned by the U.S. Department of Housing and Urban Development, declared that "paired testing reveal[ed] statistically significant patterns of unequal treatment that systematically favor[ed] whites."[54] Loan officers treated African-American and Hispanic loan seekers worse than they treated white seekers in such areas as providing basic loan information, mentioning a variety of loan products, coaching, and follow-up.[55]

The National Community Reinvestment Coalition (NCRC) testified at the Federal Reserve Board's June 6, 2006 hearing in Philadelphia regarding its six-city fair lending audit of mortgage brokers. NCRC determined, among other things, that brokers: discussed fees with 73.7% of the control group (white testers), compared with 30.6% of the protected group (African-American and Hispanic testers); mentioned more credit products to the control group than to the protected group; told 7% of the control group that better rates were available elsewhere, but never referred anyone from the protected group elsewhere for a better rate; and spent an average of 38.6 minutes with members of the control group, compared with an average of 27.4 minutes with protected group members.[56] NCRC also determined that a major mortgage brokerage firm quoted different interest rates and fees based on the race of the loan seeker and pushed subprime, rather than prime, products on African-American borrowers.[57]

Similarly, the Fair Housing Center of Greater Boston investigated loan discrimination against African-American, Latino, Asian, and Caribbean loan seekers in the Greater Boston area. In nine out of the twenty matched pair tests, the tester who represented a protected class was treated less favorably than was the white tester. The investigators reported that in seven of the twenty tests "the white loan seeker received substantially more information from the lender about different types of loans, either verbally or in writing (and often both) than the loan seeker of color, and not once did the person of color receive more information than his or her white counterpart."[58] In addition, in five out of twenty tests, the loan officer quoted a substantially lower closing cost for the white tester or offered the white tester, but not the tester of color, a discount on closing costs.[59]

Knowledge empowers, but discrimination and exploitation disempower. Consumer education is not an appropriate substitute for regulation and investigation of mortgage lenders and brokers. Regulators need to hold mortgage professionals to basic standards of professionalism, such as fair dealing, honesty, and good faith.

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[54] Office of Policy Development and Research, U.S. Dept. of Hous. and Urban Dev. , *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions* iv (April 2002).
[55] Id. The bias loan officers that showed differed in Chicago and Los Angeles and also depended on whether the borrower was Hispanic or African-American.
[56] NCRC tested in Baltimore, Maryland; Washington, District of Columbia; Los Angeles, California, Chicago, Illinois; St. Louis, Missouri; and Atlanta, Georgia. *Building Sustainable Homeownership: Responsible Lending and Informed Consumer Choice*, *Hearing Before the Federal Reserve Board*, Panel 2, The Subprime Market: The Role of Mortgage Brokers (June 9, 2006) (statement of David Berenbaum, Exec. Vice President, NCRC), available at http://www.ncrc.org/policy/analysis/policy/2006/2006-06-09_HOEPA_Broker_Testimony.pdf.
[57] Id.
[58] Fair Housing Center of Greater Boston, *The Gap Persists: A Report on Racial and Ethnic Discrimination in the Greater Boston Area Home Mortgage Lending Marke*t 14 (May 2006), available at http://www.bostonfairhousing.org/GapPersists.pdf.
[59] Id.

4. **What are some of the "best practices" that lenders, mortgage brokers, consumer advocates and community development groups have employed to help consumers understand the mortgage market and their loan choices?**

   Please refer to comments made on behalf of Self-Help by Eric Stein at the Philadelphia FRB Home Equity Hearing on Friday, June 9, 2006.

5. **What explains the differences in borrowing patterns among racial and ethnic groups? How much are the patterns attributable to differences in credit history and other underwriting factors such as loan-to-value? What other factors may explain these patterns?**

   Please refer to our answer to question 1 in Topic Three above.

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