



June 7, 2006

Filed via e-mail

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., NW
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Re: FRB Docket No. OP-1253 – Comments of the National Home Equity Mortgage Association

Introduction

The National Home Equity Mortgage Association¹ (NHEMA) appreciates the opportunity to provide written comments for the Board's hearing on June 7, 2006 on the home equity lending market and the adequacy of existing regulatory and legislative provisions (including HOEPA) for protecting the interests of consumers. Our comments for today's hearing will focus primarily on the impact of the 2002 changes to the HOEPA rules (12 CFR § 226.32 *et seq.*) and of state anti-predatory lending laws.

NHEMA's members provide most of the nonprime mortgage loans that are made to higher-risk borrowers and that are the focus of these various laws and regulations. A recent report by SMR Research² noted that in 2005, over \$1 trillion of nonprime mortgages were outstanding and originations exceeded \$600 billion and represented about 25% of the overall home mortgage market. About 40% of the 2005 originations were for home purchase, revealing how important nonprime lending has become in expanding the American dream of home ownership.

The nonprime mortgage lending industry is proud of the many positive benefits that its loans have provided to millions of Americans who only a few years ago either would not have been able to obtain a mortgage, or if they could the costs would be far higher. NHEMA believes that policy makers must take great care to ensure that legislative and regulatory changes do not result in unnecessary or unintended adverse impacts on this nonprime segment of the mortgage market. Disrupting or impeding nonprime lending would have serious negative effects on our economy. This also would be especially harmful for many new immigrants and minorities who are more likely to be economically disadvantaged and unable to qualify for a conventional mortgage, as well

¹ The National Home Equity Mortgage Association (NHEMA) is the only trade association solely representing the nonprime mortgage lending industry. NHEMA represents approximately 250 mortgage lenders accounting for 80 percent of outstanding nonprime mortgage loans. The association and its members are committed to providing open and available access to credit for all homeowners. Visit our website at <http://www.NHEMA.org>.

² "Nonprime Mortgage Loans – 2006" by SMR Research (<http://www.smrresearch.com>).



as the millions of other Americans with credit impairments, all of whom often must rely on nonprime mortgage lending to meet their credit needs.

While we think that nonprime mortgage transactions normally do not involve abusive practices, NHEMA also recognizes that some borrowers nonetheless have been subjected to improper practices by a minority of mortgage brokers or lenders. To help stop abuses, NHEMA has supported the adoption of industry best practices for nonprime lending, increased borrower financial education opportunities, sponsored fraud detection and prevention programs, called for enhanced enforcement of existing laws, and advocated new legal safeguards.

As explained in more detail subsequently, NHEMA believes that certain of the Board's 2002 HOEPA regulation revisions have been helpful. Also, while state anti-predatory lending laws have had some positive benefits, in many cases these laws have had negative aspects as well---such as limiting loan affordability and access to credit for many higher-risk borrowers---that detract from the positive aspects.

NHEMA has long taken the position that HOEPA should be amended to refine existing statutory protections and to add new safeguards, as well as applying these borrower protections to more types of loans. NHEMA believes that this can and should be done without unnecessarily limiting borrowers' credit choices with respect to mortgage loan financing. We feel that such federal legislation, which would result in the Board making further refinements to its implementing regulations, is needed to provide more effective protections that will apply to all nonprime mortgage borrowers regardless of where they live or of whether their lender is a federally-chartered depository institution or a state-chartered or licensed entity. Accordingly, we continue to urge Congress to pass uniform federal mortgage lending standards to replace the patchwork of different state anti-predatory lending laws and to provide reasonable and effective protections that will preserve borrowers' financial choices and their access to affordable mortgage credit.

The Board's 2002 Revisions to HOEPA Regulations

The Board's 2002 amendments to its HOEPA regulations lowered the points and fees trigger level from 10% for first lien loans to 8%. This reduction clearly discouraged the making of loans with fees that would exceed the new lower threshold, and we believe this has been helpful as loans generally should be able to be offered now without exceeding the 8% level for covered fees.

The amendments also included a provision designed to prevent "loan flipping" that requires that a loan refinancing within 12 months must be "in the borrower's interest." The determination of what is deemed to be "in the borrower's interest" is to be made based on the totality of the circumstances involving the loan. Lenders believe that the wording of this test is more workable than the "net benefit" test used in some state statutes discussed subsequently.



Another change made by the 2002 revisions required lenders to verify and document the borrower's ability to repay the loan. We believe that this requirement as drafted is reasonable and offers better protection for borrowers if they obtain a high-cost loan.

Relatively few major nonprime lenders, however, now intentionally make HOEPA loans due to an increased perception of legal and reputational risks and the unwillingness of secondary market investors to buy such loans. The special protections against specific lending practices in the Board's regulations, like those in state laws discussed subsequently, therefore generally do not apply to most mortgage loans since these requirements typically apply only to the high-cost loans that are not made.

One change that clearly did impact nonprime loans that are made was the 2002 revision that required that single premium credit insurance costs be counted as a fee for purposes of HOEPA's "points and fees" trigger calculation. This change in the HOEPA regulations effectively ended the sale of such insurance in connection with all nonprime home mortgage loans. NHEMA believes this has been an effective and important borrower protection.

The Board's regulations still do not apply to several important types of loans that now are covered by many state laws. In particular, HOEPA's requirements do not apply to loans made to purchase a home, or to open-end loans (e.g., a home equity line of credit). A number of state statutes have expanded protections to include purchase and open-end loans. NHEMA favors extending protections to such loans. It would appear, however, that the Board has very broad regulatory authority and may be able to extend protections to these other types of loans by regulation³.

State Anti-Predatory Lending Laws

Roughly 30 states have adopted their own anti-predatory lending laws⁴. These state laws typically utilize the basic HOEPA regulatory model which involves targeting additional restrictions or disclosure requirements on loans that are deemed to be especially high-cost based on their APR or the amount of certain points and fees charged on these loans. Mortgages are deemed to be "high-cost" when the loan's APR exceeds comparable Treasury bill rates by a set percentage, or the total of certain points and fees exceeds a specified percentage of the total loan amount.

On the positive side, these state laws often have strengthened certain provisions that experience has suggested have been too weak or not covered adequately by current federal law. However, given that these laws' provisions rarely apply to the loans that lenders in fact make, perhaps the greatest positive benefit has been that these state laws

³ 15 USC § 1639(I).

⁴ NHEMA's comments herein will not separately address local anti-predatory lending laws other than to note that such local rules have generally been much more problematic than state anti-predatory lending statutes, and we believe that it would be totally disruptive to the nonprime mortgage market if such local laws were allowed to proliferate.



collectively have greatly heightened awareness of what are broadly considered to be unfair or improper lending practices⁵. This has caused most major lenders, who make the great majority of nonprime loans, to adopt and follow progressive best practices which apply voluntarily to all of their loans and which often reflect or exceed many of the key requirements that would apply by law if these loans had been high-cost⁶.

State laws also have had numerous negative impacts, and these laws provide borrowers far fewer legal protections against abusive practices than many parties recognize. In this regard, policy makers need to recognize that many states do not have laws supplementing HOEPA's limited protections and of the states that do, none have the same law, some do little more than mirror the federal law without expanding protections, and others contain overly restrictive provisions that tend to limit credit access and affordability as will be discussed more subsequently. Furthermore, even in states that have their own anti-predatory lending laws, thousands of borrowers there can not rely on these laws' protections because their loans are made by a federally-chartered depository which is exempt from having to comply with these state laws.

The current uneven patchwork of state laws not surprisingly has created tremendous compliance burdens and costs for lenders. These costs naturally increase borrowers' loan costs. However, we believe that borrowers also have to pay significantly more in many cases, and some can not get the loan they want, because of how some of the state laws are worded as we will now explain.

State Anti-Predatory Lending Laws' High-Cost Loan Triggers - As mentioned earlier, the various state laws generally use the HOEPA framework of applying special protections to loans that are viewed as being especially "high-cost" and the determination of what mortgages are so classified is made on the basis of whether the

⁵ It should be noted that there still is no precise definition of what practices are considered "predatory" or abusive. Most informed parties today will say, for example, that a loan should not be made unless it provides a benefit to the borrower. At that point, however, agreement ends and different parties take different positions---as do different state laws---as to what is considered an adequate benefit. Some say it should be an "identifiable" benefit, others a "tangible net" benefit, and still others contend that the standard should be "in the borrower's interest." Another example of differing meanings or standards as to what is considered abusive is how prepayment penalties are treated. Some states ban them entirely, at least with respect to certain loans, while others allow them, and still others apply a range of different restrictions that determine whether a prepayment penalty is legitimate or "predatory."

⁶ Of course, there have been other important reasons in addition to state laws why nonprime lenders have refined their practices. As the nonprime industry has grown and matured, competition has been intense, leading to consolidation of more and more of the lending into a smaller number of very large lenders who essentially offer loans nationwide. These lenders have been very sensitive to legal and reputational risks and this has made them improve their practices and police broker and loan officer actions more carefully. Technological advances also have not only made lenders more efficient, but have provided for less subjective decision making and facilitated monitoring capabilities of management. Another important factor in improving industry practices in a number of cases has been the adoption of separate state broker licensing laws that have significantly helped curtail abuses by brokers (who now originate roughly 60% of all nonprime loans).



APR rate is above the rate of a comparable Treasury note by a set amount, or if the total of certain specified points and fees exceed a set percentage of the total loan amount. Only one of these two tests, which are commonly referred to as “triggers,” has tended to present problems from a lender’s perspective.

In most cases, state laws have set their APR trigger at 8% on a first lien or 10% on a subordinate lien like federal law. This percentage is high enough so that the trigger threshold will be exceeded on only a relatively few loans. However, many states have also made significant changes in the so-called “points and fees” trigger. Not only have states increasingly tended to reduce the first lien trigger percentage from the 8% level used in HOEPA to 5%, but more significantly a number of states also have included indirect broker compensation (YSP), or the maximum potential prepayment penalty, or both as costs that must be counted when calculating the points and fees percentage.

The mathematical effect of this in real terms is to dramatically lower this trigger when compared to HOEPA’s points and fees trigger. Many people have said that the state laws that do so are **very “tough”** and apply additional safeguards to many more loans. However, the practical marketplace effect of these laws is different than many parties have recognized. In a very real sense, this trigger percentage figure and the items that must be counted when calculating this percentage have less to do with which loans benefit from special safeguards than they do with how nonprime loan **pricing** is structured and this in turn has fundamental effects on **loan affordability** for many nonprime borrowers⁷.

Risk-Based Pricing in Nonprime Lending - Before discussing how changes in the trigger calculation can impact the availability of nonprime loans, a few points should be noted regarding loan pricing. Many factors go into how a loan is priced. Market competition can impact pricing significantly and rates are likely to be lower when competition is most intense. Obviously, the loan pricing is also affected by the lender’s cost of funds and operating costs. However, at the individual loan level, nonprime lenders price their loans on the basis of risk, and it is well documented that the industry does a relatively good job matching pricing to risk.

⁷ Loan affordability also has been reduced for many borrowers who would like to lower their monthly payment by paying discount points. In the past, although discount points were counted in the HOEPA trigger calculation, there normally was enough room to include one or two discount points without exceeding the trigger. However, when the trigger percentage is cut to 5% and more large items are included, discount points typically can not be used in most such cases. Some state laws have an exception for up to two bona fide discount points, but these laws generally limit the exception so that it actually will not apply to most nonprime loans so it is of no help to borrowers who would like to lower their monthly payments by using discount points. A similar “crowding out” situation has occurred with respect to fees paid to lenders’ affiliates. Under the much more restrictive trigger in such state laws, lenders now find that they often have to obtain services from third parties, even when the actual cost is higher than if the service was provided by their affiliate, because the third party fees are not counted while the affiliate fees are. NHEMA believes that reasonable exceptions should be made for both discount points and affiliate fees.



Borrowers are divided into various risk grades based on a variety of factors such as: credit score; mortgage or rental payment history; history of paying consumer obligations; income documentation; loan-to value ratio; debt-to income ratio; and history of bankruptcy, if any. Once an applicant is categorized into a risk grade, his or her interest rate still depends on a number of other factors including, for example: loan program; loan size; credit score band; property type; the state in which the property is located; points paid; and whether there is a prepayment penalty.

Interested parties need to understand that an integral part of risk-based pricing is the ability of borrowers, lenders and brokers to work together to come up with a mix of interest rate, up-front points and fees, discount points and yield spread premiums that best suit each individual consumer's needs and circumstances. Being able to tailor this mix so that the borrower is able to obtain the loan and make payments on an affordable basis is critically important for borrowers.

Limiting Choice and Loan Affordability - Instead of applying numerous specific requirements (*e.g., repayment ability tests; limits on the financing of points and fees; mandatory pre-loan counseling; no mandatory arbitration; no short-term balloon payments; etc.*) to many more loans, what has actually happened is that state laws with the more restrictive points and fees trigger tend to deny many borrowers adequate flexibility and choice in how they structure their mortgage, leaving them with less affordable credit options.

- Most of the “special protections” do not apply to loans that actually are made to borrowers because these requirements only apply to high-cost loans. Lenders generally will not make high-cost loans because secondary market investors will not buy such loans and lenders are unwilling to take the legal and reputational risks of selling high-cost mortgages.
- Lenders change how loans are priced to avoid crossing the high-cost thresholds. In most cases, they can still offer the borrower a loan. However, instead of recovering their costs by charging points and fees at closing, lenders will recoup more of their costs by charging borrowers a higher rate, but one which is still below the APR trigger level.
- Also, quite significantly, some states require that the maximum potential prepayment penalty for paying off a loan earlier than agreed be counted as a fee for purposes of the points and fees trigger calculation. In such cases, this normally prevents lenders from offering borrowers the option of a significantly lower rate if they agree to pay a penalty to offset the loss that occurs if prepayment is made⁸.
- Thus, the borrower ends up with a loan (1) that is not subject to most of the prohibitions or limitations on potentially abusive practices that apply to high-cost loans, and (2) that is more costly in terms of his or her monthly payment because the flexible financing options that can make mortgages more affordable are no

⁸ Prepayment penalties are generally paid to secondary market investors, not the lender, and help compensate the investor for the loss of expected income that occurs when the loan is paid off earlier than the term on which the loan was priced.



longer available in states that have such an inclusive and thus restrictive points and fees trigger.

It is difficult to know how many consumers are unable to obtain a loan or the loan amount that they want due to this type of trigger restrictions, but clearly many are⁹.

- ✓ Most borrowers are still able to obtain the loan amount they want but they are faced with a higher monthly payment----often \$125-\$200 more per month.
- ✓ Many other borrowers, however, find that the higher monthly payment is either more than they feel they can afford, or is more than is allowed under applicable debt-to-income repayment ability requirements. In those cases, the borrower either does not get a loan, or shifts to a smaller loan with lower payments. A smaller loan, of course, for many means that they can not buy the home they want, and they are forced to buy a smaller home, often in a less desirable neighborhood.

Many consumer advocacy groups say that this is a desirable result because limiting borrowers' financing flexibility can prevent them from using their equity or from obtaining a loan which may prove unaffordable for them. On the other hand, many borrowers may find such "protections" are severe or insurmountable roadblocks to meeting their personal credit needs or home ownership desires. In any case, the lack of flexible financing options will undoubtedly adversely impact even more people as mortgage rates continue to rise.

In addition to the perverse impacts of many state laws' points and fees trigger on loan affordability and borrower choice, NHEMA is concerned that some lending practices are being unnecessarily restricted. There are certain loan terms, for example, that can be either abusive or quite legitimate and very beneficial to borrowers. State legislators in a number of cases are using an overly broad "just prohibit it" regulatory approach instead of more carefully targeted rifle shot regulation that prevents abuse while preserving the beneficial aspects for borrowers.

Prepayment Penalty Limitations - The prime example of this state law overkill approach is how a number of states are now dealing with prepayment penalties. Without question, a prepayment penalty can be abusive if the borrower is not made fully aware that the loan will include a penalty provision, if the length of the penalty is too long or if the amount of the penalty is unreasonably high. On the other hand, a prepayment penalty

⁹ Although some consumer advocacy groups like the Center for Responsible Lending (CRL) have issued reports employing questionable methodology and faulty interpretations claiming that restrictive state laws in North Carolina and elsewhere have had little or no adverse impact on credit availability, other more credible analyses by academic and regulatory officials have shown that many consumers' credit availability and loan affordability are adversely impacted by such laws. Recent examples of the latter type study are a new paper by Georgetown University's Credit Research Center entitled, "*The Effects of State Predatory Lending Laws on the Availability of Subprime Mortgage Credit*" (March 2006) and two papers by staff of the Federal Reserve Bank of St. Louis entitled, "*The Impact of Local Predatory Lending Laws on the Flow of Subprime Credit*" (February 2006) and "*Predatory Lending Laws and the Cost of Credit*" (April 2006).



can be very beneficial to borrowers saving them thousands of dollars through a lower loan rate.

Instead of banning prepay penalties outright, or in effect doing so indirectly by requiring that the potential penalty amount be counted in the trigger, NHEMA believes that policy makers should impose reasonable restrictions on such penalties and preserve the penalty as an option that can give reduce the borrower's rate significantly (e.g., 1% less). NHEMA feels this can be done by requiring that borrowers be given the option of selecting a loan with and without a prepay penalty, by limiting the term of the penalty to 3 years or the first rate adjustment date in the case of an adjustable rate loan (ARM), and by limiting the amount of the penalty to 3% during the first year, 2% during the second year, and 1% if there is a third year. We suggest that the Board also consider addressing this important issue when it revises its regulations.

Yield Spread Premiums - Some state laws have included yield spread premiums (YSP) paid by lenders to brokers in the points and fees trigger even though this cost is an element of and factored into the interest rate and therefore covered by the separate APR trigger. This has several impacts including: (1) capping brokers' maximum compensation; (2) encouraging lenders to shift lender fees into the interest rate in order to stay under the typical 5% threshold; and (3) limiting credit availability with regard to smaller loans as brokers find it uneconomical to originate such loans (e.g., a broker will have to do about the same amount of work on a \$50,000 loan as on a \$150,000 loan, but the *de facto* 5% fee cap may result in less compensation than the broker needs so he or she is unwilling to spend time originating the smaller loan.)

As the Board is well aware, YSPs are generally legitimate and are widely used in both the prime and nonprime mortgage markets. Nonetheless, consumer advocates have pushed regulators to limit YSP, often incorrectly claiming that it is *per se* an illegal kickback. These groups also claim that a broker is improperly "steering" a borrower "to a higher rate than they qualify for" when the broker is paid YSP. It is very misleading to make this claim because "**qualify for**" does not mean "**can obtain**" a loan at the qualifying *wholesale* rate which is stated before factoring in the broker's significant, legitimate loan origination costs. The lender does not offer this wholesale rate to the same borrower who applies directly to the lender for a loan through the lender's retail loan office. Instead, the same borrower normally is quoted a higher rate by the lender that takes into account the lender's full loan origination costs---e.g., the work done by the lender's loan officer on the loan that otherwise would be done by the broker. In fact, if a loan is priced fairly, the borrower almost always will get the loan at a lower cost through a broker (even including up-front broker's points and YSP) than they can by going to a lender's retail loan office. Most brokers simply have lower operating costs than retail lenders.

Brokers must be allowed to receive a reasonable level of compensation for their work, and their origination costs and any profit can only be recovered through: (1) up-front fees paid by the borrower; and/or (2) YSP paid by the lender who must increase



the rate to cover the cost of the payment to the broker. Brokers should have some discretion as to how they price loans, including having reasonable flexibility in how their compensation is structured. The amount of work brokers do may vary significantly on different loans. Borrowers also may prefer to keep their up-front closing costs down and have some portion or all of the broker's compensation paid as YSP by the lender. However, NHEMA does think that the Board should work with HUD and other regulators to help develop a better, earlier disclosure of what a broker's compensation will be and how it will be structured.

Borrower Benefit Tests - Another area of concern in more restrictive state laws involves borrower benefit tests. A number of states have adopted an undefined "tangible net benefit test," and some (e.g., NC) have applied this test to all home loans. Although NHEMA believes that a loan should not be made unless the borrower receives a reasonable benefit, we wish to note that in many cases this is a very subjective and personal matter, making compliance requirements quite uncertain in many cases. Therefore, lenders have been concerned when undefined and therefore unclear "tangible net benefit" requirements are imposed. They understandably do not want to be subjected to litigation arising out of claims that a loan did not provide an adequate "tangible net benefit" (whatever that means). NHEMA thinks that the term "net" is especially problematic, particularly since it can be interpreted as meaning a benefit based on some economic, mathematical calculation when many borrowers are seeking a benefit that is not necessarily based on mathematical results. Therefore, we believe that any benefit test should not include the word "net" and also should be qualified as is done in the NC law by terms such as "knowing or intentional" and by limitations on the awarding of attorney's fees.

Repayment Ability – State laws now typically include a requirement that a lender should not make a loan without making a determination that the borrower appears to be able to repay the loan based on his or her income and debts and not taking into account their home equity. These statutes usually have a presumption that the borrower can repay the loan if a 50% debt-to-income test is met. Generally, the state laws only require a reasonable level of documentation of a borrower's income. Recently, advocates are pushing legislators to adopt more restrictive requirements that would entail only counting income that can be documented fully from third party sources. NHEMA is of the opinion that the existing general repayment ability documentation requirements are adequate and thinks that neither the Board nor states should adopt restrictive new mandates that would require such third party documentation in all cases. A significant segment of the nonprime market consists of more limited documentation loans, and these are especially helpful for many smaller businesses and immigrants who often are unable to provide more detailed third party income verification. Lenders have learned to employ alternative underwriting techniques that have been proven adequate to sufficiently control the somewhat higher risk of more limited documentation.

Steering & Suitability – As discussed earlier in the context of YSP, concerns have been raised about lenders and brokers allegedly steering borrowers to more costly loans



than borrowers may actually qualify for and be able to obtain. Many parties have claimed that nonprime lenders regularly make loans to borrowers who could have obtained a much cheaper prime rate loan. NHEMA does not believe that this is in fact the case. However, we recognize that sometimes this situation may occur. Accordingly, we are encouraging our members to develop internal systems that will allow them to offer borrowers a prime rate loan or to at least alert them that another lender may be able to offer such a loan, if it appears likely from available information that the borrower could qualify for a lower cost prime loan.

With the exception of California, states have not generally included anti-steering provisions in their state anti-predatory lending statutes. Consumer advocates now are urging the passage of specific steering requirements. This trend seems to now be evolving to have the steering issue addressed through the concept of imposing a “loan suitability” requirement that would mandate that brokers and lenders ensure to some as yet unclear degree that the particular loan offered is generally suitable for the borrower.

NHEMA’s members are currently reviewing these issues, and we have taken no formal position yet how loan suitability might be defined or on whether legislation or regulation is needed or appropriate. We have, however, heard initial concerns from a number of members that a loan suitability mandate might be quite problematic. In any case, we would urge the Board to fully and carefully analyze all aspects of the steering and suitability issues before adopting any new requirements relating to them.

Assignee Liability - Experience under the current state law schemes also has shown that applying assignee liability to the broader nonprime mortgage market can be disastrous. As the Board will recall, when state legislators imposed assignee liability on a broad segment of nonprime loans in Georgia, the market literally shut down and legislators were forced to repeal the assignee liability requirements. Nevertheless, we find that many advocacy groups still argue in favor of applying HOEPA-type assignee liability to all mortgage loans, or to at least all nonprime mortgages. NHEMA does not support such an extension and urges the Board to reject endorsing or imposing such liability on other assignees.

Uniform Federal Mortgage Lending Standards Are Needed

NHEMA believes that it would be far better to have uniform national statutory standards imposed at the federal level instead of the ever-growing hodgepodge of “half-baked” and “over-baked” state requirements. Lending is increasingly dominated by large nationwide lending organizations and funding for most loans now comes from the global capital markets.

Uniform federal standards would greatly reduce compliance costs, allowing lenders to pass on savings to borrowers by offering lower rates. National standards would also provide all borrowers, regardless of where they live or whether they borrow from a federally-chartered or a state-chartered or state-licensed lender, with equal and



effective protections against abusive practices. NHEMA believe that such uniform standards can be crafted so as to provide effective safeguards while preserving borrower choice and flexible financing options which make loans more affordable for many borrowers. We hope that the Board will urge Congress to promptly pass such national standards.

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NHEMA appreciates the opportunity to present these comments. Please direct any questions that the Board or its staff may have to Jeffrey Zeltzer, NHEMA's President (202-347-1210) or to me (202-347-6875).

Sincerely,

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