August 15, 2006 **Via email and U.S. Mail**

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Regs.comments@federalreserve.gov

Docket no: OP-1253

Dear Ms. Johnson:

We[1] write in response to the Federal Reserve Board's (FRB) request for comments on issues relating to the FRB's recent hearings on the home equity lending market and the adequacy of existing regulatory and legislative provisions in protecting the interests of consumers.

Collectively, we are nonprofit legal service organizations and advocacy organizations that represent, both formally and informally: consumers, counseling agencies, community development corporations, advocacy organizations, housing providers, local government, private firms, research establishments, neighborhood community development initiatives and policy think tanks. We submit these comments in response to the devastating impacts imposed by abusive lending practices on families, seniors, people of color, immigrants, low- and moderate-income households, and the communities in which they live.

In short, we believe that current protections are inadequate to protect consumers in California and elsewhere from abusive lending practices in the subprime, nontraditional and reverse mortgage markets. The Board can and must take action to blunt the impact of these practices which, at best, rob unsuspecting consumers of millions of dollars in valuable home equity and, at worst, propel homeowners into a downward spiral towards default and foreclosure.

We urge the FRB to take the following actions:

1. **Require home loan counseling;**
2. **Require translation of home loan documents;**
3. **Strengthen HOEPA regulations and extend assignee liability;**
4. **Expand HMDA reporting requirements;**
5. **Develop and implement a suitability standard that will protect consumers;**
6. **Prohibit lenders and brokers from steering borrowers to harmful loans;**
7. **Restrict prepayment penalties that trap borrowers in unsuitable loans;**

[1] The authors of this letter are Maeve Elise Brown and Heidi Li, Co-Directors, Housing and Economic Rights Advocates; Kevin Stein, Associate Director, California Reinvestment Coalition; and James Zahradka, Senior Attorney, Public Interest Law Firm.

8. **Expand Community Reinvestment Act requirements;**
9. **Expand regulatory authority over bank holding companies;**
10. **Protect homeowners from equity-stripping foreclosure "rescue" scams; and**
11. **Reduce secondary market investment in exotic and predatory loans.**

<u>Introduction</u>

There are serious challenges facing consumers in California's home mortgage market. Housing costs and household debt burdens have been increasing, making consumers more vulnerable to unscrupulous actors who promise homeownership or the ability to access home equity. A tightening in the market has led to increased and intense competition within the industry to keep churning out loans, even if many consumers cannot afford homeownership and others have already recently refinanced. More brokers and lenders are more aggressively selling both expensive subprime and "creative" loan products.

But these loan products—with their lax underwriting standards, deceptively low teaser rates, large hidden costs, and packed-in prepayment penalty provisions and other abusive loan terms—mean borrowers are increasingly stuck with loans they cannot afford and do not deserve, even as interest rates have been climbing and housing prices have been leveling. The secondary market has a voracious appetite for nontraditional and higher priced subprime loans, yet has little incentive to police itself so as to ensure it is not financing predatory and abusive lending. A cottage industry of super predators has developed to feed off the vulnerability and remaining equity of homeowners who can't keep up with their newfangled loans. This changing marketplace is fast outpacing existing regulations. All the ingredients for a financial disaster are in place, unless the FRB and other key regulatory and legislative participants can step in to protect American households that are merely trying to keep up.

Interest-only, stated-income, piggy-back loans, and option ARMS are among the riskiest mortgage products on the market. As such, they should be available to only the savviest of borrowers who is fully informed of the true cost and volatility of these products and is consciously choosing one of the products as part of a reasoned investment strategy.

Alas, these products are, instead, being marketed and issued to borrowers who do not understand their true cost or dangers. In California, we are seeing these loans marketed to low- and moderate-income borrowers, including non-English-speaking immigrants, who do not understand the nature of the loan, the consequences or cost of its structure and the long-term implications of those variables. Further, stated-income borrowers are coming to us with loans that are larger than they can afford because the mortgage broker falsified the borrower's income information.

The only way out for these borrowers is to sell the home; but the prepayment penalty attached to some of these loans and mortgage brokers' fees strip away whatever equity the borrower may have accrued. As home prices in many areas in California begin to flatline or decline, the opportunity for borrowers to sell or refinance their way out of these inappropriate and deleterious loans is shrinking. The possibility and probability of even greater losses for borrowers—and losses that affect owners of the mortgage note—is growing. Losses that are now affecting borrowers directly and immediately will inevitably begin to affect the secondary market. The FR should act now.

1. **Protect borrowers from getting into loans that could strip equity or even cost them their homes by requiring home loan counseling.**

Problem

Subprime lending mortgage products began flooding the single-family home financing market during the 1980s and 1990s. While these products made homeownership possible for more families—especially for moderate-income and minority consumers, as well as those who presented a higher credit risk—it did not always result in the consumer obtaining a truly affordable loan.[2] This phenomenon also led to a noticeable increase in mortgage delinquency and foreclosures, particularly when high-cost, unaffordable subprime home loans were coupled with predatory lending or another nefarious scheme.[3] For this reason, Congress passed (at FRB's recommendation) the Home Ownership and Equity Protection Act in 1994, which provided stronger legal protections for consumers who are put into certain high-cost loans, often those who are most vulnerable and likely to be harmed by these loan products.

HOEPA has been undeniably effective. While higher-cost subprime loans still exist, we have seen a significant decline in the last half decade of mortgage loans which violate HOEPA.[4] For this reason alone, both the FRB and Congress should be heartily applauded for enacting and (in 2002) improving HOEPA, because it helped curtail predatory high-cost subprime mortgage lending without drying up the legitimate subprime lending market.[5]

The mortgage lending landscape has changed in the intervening decade, confronting us with updated versions of by now familiar predatory mortgage lending abuses. Since 2002, we have seen lenders and mortgage brokers aggressively stepping up their marketing and origination of non-traditional or exotic mortgage loan products—interest-only, option ARM and stated-income loans—to low-to-moderate income, minority and other consumers. In 2005, 63% of new mortgages were interest-only and adjustable-rate

---

[2] *See* Remarks by FRB Governor Edward M. Gramlich regarding predatory lending at the Housing Bureau for Seniors Conference, Ann Arbor, Michigan, January 18, 2002, *available at* http://www.federalreserve.gov/BOARDDOCS/Speeches/2002/20020118/default.htm.
[3] *Id.*
[4] *Id.*
[5] Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending, February 23, 2006. The report found that in states with laws that provide greater protections than those that exist at the federal level, borrowers have abundant access to responsible subprime credit, pay about the same or less for subprime mortgages as borrowers in states without such laws, and get loans with fewer abusive terms.

mortgages,[6] and approximately one-third of the $924 billion in residential mortgages originated in the third quarter of 2005 were interest-only or option ARM loans.[7] This has led to more borrowers paying off less and less of the principal of their loans—in fact, in California, negative amortization loans accounted for 27.5% of non-agency securitizations in 2005.[8]

Regulation of these non-traditional loans—particularly the suitability of these products for particular borrowers—has lagged far behind the pace of lenders' and brokers' aggressive marketing and selling. This has resulted in too many uninformed and unsuspecting consumers incorrectly believing that the dream of homeownership is more within their financial reach than it truly is.[9] This is a recipe for disaster.[10] With interest rates on hundreds of billions of dollars in loans scheduled to reset in the next few years, we know that many of these new homeowners will not be able to make their mortgage payments.

Because they have stretched themselves beyond their financial means to afford their homes in the first place, these borrowers will have a difficult time qualifying for refinance loans. Those who can refinance will face very costly upwardly adjusting interest rate loans and steep prepayment penalties which, in California (where most loans have very high principal amounts), can cost a homeowner thousands of dollars in stripped equity. We anticipate that the result in California will be devastating, with huge numbers of families facing the loss of their hard earned assets as well as their homes.

To put things into even starker perspective, the Public Policy Institute (PPI) in its August, 2005 report "California's Newest Homeowners—Affording the Unaffordable," found that "[o]ver half (52%) of state residents who purchased a home within the last two years spend more than 30 percent of their total income on housing – a percentage that exceeds the top threshold recommended by the U.S. Department of Housing and Urban Development. Even more startling, 20 percent of these recent homebuyers spend more than half their income on housing."[11]

PPI further found as part of this recent study that:

> Higher debt-to-income ratios are possible because more and more lenders are forgoing the fiscal practice of limiting housing costs to

---

[6] Michael Powell, "A Bane amid the Housing Boom: Rising Foreclosures," *Washington Post*, May 30, 2005.
[7] Brian Collins, "Tough Guidance Coming for IOs," *Origination News*, January 2006.
[9] "Infographic: Tracking Neg-Am Loans," *American Banker*, December 22, 2005.
[9] Vikas Bajaj and Ron Nixon, "Variable Rate Loans Help Put Off Mortgage Pain," *New York Times,* July 23, 2006.
[10] Audrey Cornish, "Foreclosure Rates Rise Across the United States," *NPR – Your Money Program: Morning Edition Show*, May 30, 2006, *available at* http://www.npr.org/templates/story/story.php?storyId=5438623.
[11] Hans P. Johnson and Amanda Bailey, "California's Newest Homeowners Pushing the Envelope – Affording the Unaffordable," *California Counts: Population Trends and Profiles*, Vol. 7, No. 1, August 2005, pp. 11-13, Public Policy Institute of California, *available at* http://www.ppic.org/content/pubs/cacounts/CC_805HJCC.pdf.

> no more than 30 percent of income. Instead, they are qualifying buyers for loans that consume 40, and even 50, percent of their income. Additionally, increasing numbers of homebuyers are opting for variable and interest-only loans – loans that allow buyers to minimize their initial monthly payments but make them vulnerable to increases in payments if and when interest rates rise.[12]

Loan Performance, an industry research firm, this year identified that close to 50% of all single-family mortgage loans originated to borrowers in the San Francisco Bay Area are ARMs.[13]

It is no accident that the increase in lenders' origination of non-traditional home loan products has coincided with a rise in foreclosure rates, particularly in California. In its most recent report, RealtyTrac noted that the number of properties that entered some stage of foreclosure in May 2006 was 28 percent higher than a year earlier.[14] In addition, the number of defaults on mortgage payments in California rose to a three-year high in the second quarter of 2006, representing a 67% increase from a year ago.[15] Alarmingly, as the housing market slump deepened, foreclosure activity in California soared an annual 104.4 percent in the second quarter of 2006. Over 27,000 California property owners entered some stage of the foreclosure process during April through June 2006, the second most in the nation.[16]

Most borrowers who have taken out one of the high-risk types of loans listed above do not fully understand the terms of the loans, including the true cost of the loan at the time of issuance or as it adjusts upward. Our experience is reflective of the findings of several recent studies. The FRB found in a 2006 study that 35% of ARM borrowers did not know the value of the reset interest rate cap and more than 44% did not know how to calculate the lifetime interest rate cap.[17] A 2004 Consumer Federation of America (CFA) study found that lower-income and minority consumers are most likely to prefer ARMs yet misunderstand the interest rate risks of these mortgage loans.[18] More than three-fifths of

---

[12] *Id.* at p. 13.
[13] *Id.*
[14] Realtytrac, "Foreclosures Up 28 Percent from Last Year…," June 26, 2006 press release, *available at* http://www.realtytrac.com/news/press/pressRelease.asp?PressReleaseID=113.
[15] Nick Godt, "Mortgage defaults up 67% in California - Notices filed on late loans highest in more than three years," *MarketWatch*, August 3, 2006, *available at* http://www.marketwatch.com/news/story/story.aspx?guid=%7B1075F84E-0DCE-4484-B8D2-024F9E64D029%7D&print=true&dist=printBottom; *see also* "Mortgage defaults in California saw sharp increase during 2nd quarter," San Jose Mercury News, August 2, 2006, *available at* http://www.mercurynews.com/mld/mercurynews/business/15182120.htm.
[16] Gregory J. Wilcox, "Foreclosure activity takes off - Annual 104.4% spike seen in Q2 amid worsening housing slump," *L.A. Daily News*, July 7, 2006, *available at* http://dailynews.com/business/ci_4099727.
[17] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006, at p. 19.
[18] Consumer Federation of America, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004, *available at* http://www.consumerfed.org/pdfs/072604_ARM_Survey_Release.pdf.

young adults, African Americans, Latinos, those with incomes below $25,000, and those without a high school diploma did not know how to estimate what would happen to monthly mortgage payments if interest rates rose two percentage points. Those who were willing to estimate the increased monthly costs underestimated the increase by between 40-50 percent.[19]

But the consequences are not expressed fully by statistics alone. Increasing mortgage broker and financial services' underwriting and processing of interest-only loans and negatively amortizing ARMs, usually on a no-document or income-stated basis, is proving to be a deadly combination for unsuspecting and uneducated consumers, as demonstrated by the poignant homeowner testimony offered during San Francisco FRB hearing[20] and the examples below.[21] These families are striving for the American dream of homeownership but are being misled by unscrupulous mortgage brokers, realtors and other financial industry predators about whether they can truly afford to buy a home in our overheated market.

Many of these borrowers were unaware of the interest-only and/or negatively amortizing ARM nature of their loans and did not know that one or more of their loans had a costly pre-payment penalty provision. And most of them were shocked to learn what their monthly payments were going to be. In short, many of these borrowers only came to understand just how expensive and unaffordable their loans were after they received post-purchase housing and legal counseling.

Ms. D: Broker abusing no-document loan

Ms. D purchased a San Francisco home in early 2006 for $745,000, and put only $5,000 down towards the purchase price. To cover the rest, she received two no-document loans with a total monthly payment of $4,100, not including property taxes or homeowner's insurance. In order for Ms. D to be approved for these two loans, the broker falsified the loan application by inflating her $6,000 monthly income to over $16,500, almost three times its actual amount.

In two years, the interest rate on her first loan will adjust upwards, resulting in an increase in her total monthly payments to over $6,300—payments exceeding her gross monthly income. And if Ms. D seeks to refinance this first loan within the first two years, she will be required to pay six months' interest as a pre-payment penalty, which could amount to $20,000 or more.

---

[19] *Id.*

[20] For a transcript of the hearing, see http://www.federalreserve.gov/events/publichearings/hoepa/2006/20060616/transcript.pdf.

[21] Note that these consumers received services from Housing and Economic Rights Advocates (HERA), other legal services and/or HUD-certified housing counseling agencies during the past year and only after they had signed for their loans. Of the examples provided, most received assistance within 2 to 6 months after they'd signed their loan papers and begun receiving their initial monthly mortgage servicing statements.

Ms. D's mortgage broker never told her the nature of these loans, nor what the interest rate and other terms would be; the broker simply said that she would only need "good credit" to be approved.

Mr. & Mrs. L: pushed into buying an unaffordable house

Mr. and Mrs. L—a mechanic and homemaker, respectively, and parents to a young daughter—were pushed by their loan officer, the mortgage broker he referred them to, and a real estate broker to sell their home in Oakland to purchase a bigger home in Tracy, California—a home that they could not afford.

While they profited from the sale of their home, they put almost all of those proceeds towards the down payment and, thereafter, monthly mortgage payments for the Tracy home. Their net monthly income of less than $2,400 was not nearly enough for them to afford the $590,000 home that they had purchased. They went from paying $1,700 a month on the Oakland home (inclusive of homeowner's insurance and property tax payments) to paying almost $3,800 a month on the new Tracy home—more than twice their prior payment—not including homeowner's insurance and taxes.

Unknown to them at the time, the broker they were referred to processed their new purchase loan as an income-stated, interest-only loan with a steep interest rate increase after a low initial teaser rate. This loan is a $531,000 2-year fixed/ARM loan with starting interest rate of 5%. However, after the initial two years, the loan will adjust up to a minimum 10.25% interest rate which can then go as high as 14.250%. Their current monthly payment will adjust to $4,800 and could go as high as $6,415.

Mr. & Mrs. Z: unknowingly trapped into neg-am loan

Mr. and Mrs. Z are homeowners in Livermore who were approached by a broker whom they met at their church who said he could assist them to refinance their loan and lower their $2,400 monthly mortgage payment. They said to the broker they wanted to lower their monthly payments to around $1,800, to which he replied "no problem, all you need is good credit." At the time, both their FICO scores were above 700.

Mr. and Mrs. Z went through with the refinance based on the broker's representations. However, unknown to them, the broker moved them from a 5.5% fixed, prime interest rate $446,000 loan (which covered their homeowner's insurance and property tax payments) into a $470,000 ARM.

Once the couple received their new loan's first monthly servicing statement, they were shocked. Only then did they discover that they had now an option ARM, with four options for monthly payments; the lowest of these was $1,359, and the highest was $3,219. After struggling to pay approximately $3,000 per month, they sought assistance to review their loan documents. After getting that assistance, Mr. and Mrs. Z realized that if they chose the lowest payment option, they would have a negatively amortizing loan; that if they opted for the $2,144 monthly payment, they would only be paying off interest.

Further, they have since discovered that their payment does not cover their homeowner's insurance and property taxes, and that their current loan has a 3-year prepayment penalty provision. Instead of getting a better, lower monthly payment mortgage loan, this couple has been put into a much worse, negatively amortizing, interest-only 30-year loan.

All of this troubling information squarely points to a critical need for mandatory borrower counseling. This need is particularly acute for those most financially at risk who are in the process of obtaining non-traditional home loans (e.g., no-document/income-stated and/or interest-only and negatively amortizing ARMs).

The home loan process is complex and few homeowners fully understand all of their loan documents; even former FRB Governor Olson stated during the San Francisco hearings that he—with years of industry experience—felt at a distinct disadvantage as a consumer when he closed his personal mortgages. To make matters worse, the consumers who are least familiar with financial transactions and most isolated from the financial mainstream are often the very borrowers targeted for today's higher-priced subprime, interest-only, option ARM, and reverse mortgage products, which are much more complex and have significantly greater negative impact on consumers than conventional products.

Recommendations

- The FRB should require counseling for all borrowers who have a debt-to-income ratio of 35% and above, and a FICO score of 580 and up, who are planning to take out non-traditional home loans.
- Additionally, the FRB should require counseling for **all** high-cost home loans as defined by HOEPA (subject to our recommendations for expanding the law, set forth below), and **all** reverse mortgages.
- In both of the above cases, the counseling should:
    - be HUD-certified;
    - include actual document review by the counselor; and
    - be conducted no later than two days prior to closing.

Several of the homeowners testifying at the San Francisco hearing indicated that they probably would not have found themselves in their current difficult circumstances if they had had access to HUD-certified home loan counseling. Mandatory counseling would further the FRB's goals of promoting consumer understanding of their transaction, and fighting predatory practices. In fact, at least fifty percent of the homeowners with predatory non-traditional loans who we have served during the last year have said that if they had received impartial housing counseling services prior to being put into these loans, they would not have taken them out.

Instead, too many are both lured into thinking they are being given affordable loans and then rushed through a home loan approval process that was largely unexplained to them. Only when these borrowers receive their first mortgage servicing statement do they realize what has happened. For many, this time of recognition may already be too late, as costly and prohibitive pre-payment penalties and an increasing interest and/or principal debt load make it very difficult, if not impossible, to refinance. Increasingly, we are seeing homebuyers desperately trying to sell homes they have purchased only 3 to 6 months prior; these sales are often at a total loss, as the borrowers realize no home value appreciation during this brief span. Further, the (now-former) homeowners end up with significantly impaired credit as they find themselves struggling (and, sometimes, failing) to make their loan payments up until the time of sale.

Precedent exists for mandating home loan counseling; it is currently required for many reverse mortgage transactions, and several states require it for certain complex home loan transactions. And the salutary effect of this counseling has been significant. Leading national legal and consumer advocates have recognized that "[p]re-purchase education and counseling has been credited with expanding homeownership in underserved communities, in part, by producing informed borrowers knowledgeable about the lending process and better prepared to accept the responsibilities of homeownership. Pre-purchase education and counseling has also been found to lower the risk of default."[22]

- The FRB should work with Congress and other regulatory agencies to meaningfully increase funding for HUD-certified home loan counseling agencies.

It is critically important to strengthen existing HUD-certified, non-profit housing counseling agencies' capacity to effectively counsel homeowners in distress. The most important way in which this can be done is to ensure that adequate federal funding is provided to these organizations.[23] In fact, while the need for these impartial consumer services has markedly increased with the continued rise of predatory abuses, the amount of funding for these agencies has actually declined in recent years.[24]

Imposing a requirement for certain borrowers to attend counseling, as we suggest, must be tied to greater funding of counseling agencies. Without such a requirement, the burden is entirely on consumers to understand their complex loan documents. Industry, regulatory agencies and consumer advocates agree that counseling and education are critical, but the capacity of counseling agencies to serve all who would benefit from such education is limited. Consumers and community residents are, and will be, rightly frustrated by continued calls for them to seek counseling when such services may not exist in their communities.

At present, funding for counseling agencies is inadequate. Additional monies would build the capacity of the housing counseling infrastructure and provide more consumers with unbiased and qualified advice, enabling them to make educated decisions. This will inevitably result in a smoother, more efficient marketplace where buyers and sellers of loans knowingly enter into loan transactions. An educated consumer is less likely to be deceived, dissatisfied, financially harmed, or interested in litigation.

---

[22] Odette Williams, "Successful Homeownership and Renting through Housing Counseling," Testimony before the Subcommittee on Housing and Community Opportunity, March 18, 2004, p. 2.
[23] *Id.* at pp. 5-6.
[24] *Id.* at p. 8.

In short, if borrowers are to be prevented from getting into loans which are designed to fail and suffering foreclosure, the FRB must recommend to Congress that it require housing counseling for certain borrowers, particularly those who are improperly put into nontraditional loans and are most at risk to lose their homes and tens of thousands of dollars of hard-earned equity. Additionally, sister banking regulatory agencies of the FRB should further encourage banks and thrifts to support and fund housing counseling agencies.

2. Protect consumers from unscrupulous lenders and brokers who seek to take advantage of borrowers who are not fluent in English by requiring translation of home loan documents.

Problem

The FRB should protect consumers from unscrupulous lenders and brokers who seek to take advantage of borrowers who are not fluent in English. The San Francisco hearings highlighted the pervasive problem of brokers and loan officers selling loans in languages other than English. These negotiations are cemented at the closing table with a huge stack of English-only documents that borrowers do not understand, often include different terms than what borrowers were promised, and sometimes come with pressure by brokers and loan officers for borrowers to just sign and stop asking questions. Advocates and consumers testified directly to this issue at the San Francisco hearings.

A common practice is for lenders or brokers to promise very attractive loan features. The borrowers trust their broker—who is usually a member of their ethnic community—to take them through this complex process. Borrowers are rushed or otherwise pressured by the lender or broker into simply signing documents without reviewing them. If the borrower can somehow identify discrepancies, the lender or broker coerces the borrowers into signing with promises to "fix" mistakes, or even threatens legal action, as the below example shows.

Ms. V: San Jose brokers target and prey on Limited English Proficient homeowners

In a shocking case from San Jose, a Spanish-speaking couple of Latino origin systematically preyed on members of their own community by engaging in a series of unfair practices aimed specifically at people who did not speak English fluently. The couple—one a licensed broker and the other a salesperson (Ms. V)—lured homeowners into their offices with promises of lowering monthly payments, allowing them to tap tens of thousands of dollars of equity, and other attractive features, all ostensibly at no cost to the borrower. All of these negotiations were in Spanish; in fact, Ms. V became irate with her staff if they referred English-speaking borrowers to her.

When these borrowers appeared at closing, they were confronted with large stacks of documents written in English with no Spanish translation. If they asked Ms. V any questions, she became very impatient and pushed them to simply sign where she indicated.

Some borrowers noticed major inconsistencies with what they had been promised despite the lack of translated documents. Ms. V would assure them that the terms were a mistake that she would "fix" later, or that she could secure a refinance for them shortly so the terms in question were nothing to worry about.

The terms of the loans in the binding English-language documents that these borrowers ended up with were far less attractive than what Ms. V had verbally promised them in Spanish. The loans featured huge fees to Ms. V, adjustable rates, balloon payments, and pre-payment penalties, and borrowers often received a fraction of the cash they were promised from the transaction.

Recommendations

- The FRB should make it an unlawful and deceptive practice to fail to provide translated copies of loan documents to a consumer where the negotiation of the home loan transaction was in a language other than English.

- The FRB should develop guidance for lenders that builds upon California Civil Code §1632 to require that key loan documents (including, but not limited to, the promissory note, HUD-1, TILA, and GFE) are available in languages spoken in different markets, and that these documents be available through all retail and wholesale channels.

California Civil Code section 1632 is a very useful model for the Federal Reserve when it considers this issue. 1632 requires the party negotiating a mortgage to provide a translated version of the loan documents in the non-English language that loan was negotiated in. This translation is required for five most-spoken non-English languages in California; however, it seems clear that we are not the only state with these problems, so the FRB should make these protections nationwide. Further, consumers in **all** high-cost loans should at least be provided documents in a language they understand, whether those loans are brokered or not; lenders have argued that 1632 only applies to brokered loans.

In short, the FRB should ensure that borrowers in all refinances—but especially high-cost HOEPA loans—are fully aware of the terms of the loan they are getting into. Otherwise, there is a basic failure of contract (i.e., both parties are not fully informed of the terms of the agreement) in a transaction that puts at risk what is almost certainly the largest asset a low- or middle-income family owns. In addition, we would recommend that those same requirements be implemented with regard to the non-traditional loan products discussed immediately above in item 2.

3. Strengthen HOEPA regulations to address the current sub-prime and predatory lending landscape.

HOEPA represents the primary federal attempt to address predatory lending abuses in the high-cost home loan market. Despite its limitations, it has been effective in reducing the number of risky loans issued to borrowers; in California in 2004, less than 1% of all loans fell within HOEPA's parameters (2,029/2,453,492[25]). Unfortunately, many higher-cost loans that are susceptible to abuse are not subject to HOEPA's protections.[26] The Federal Reserve has estimated that HOEPA loans accounted for only 0.0003 percent of all of the originations of home-secured refinance or home improvement loans reported for 2004.[27] The limitations in the HOEPA regulations are a reflection of how today's market and today's abuses have outpaced the current regulatory scheme.

Specifically, when HOEPA was enacted, abuses were more likely to predominate in the refinance market. Today, we see an increasing number of abuses in the home purchase market. Additionally, the thresholds under HOEPA are unreasonably high and therefore do not provide coverage to more than a few loans, especially in California with our high housing prices. Further, subprime borrowers are much more likely to be stuck with yield spread premiums that reward brokers for charging them more, and prepayment penalties which trap them in bad and predatory loans.

HOEPA is important in light of its unique position as a federal anti-predatory lending law. A main reason why predatory lending persists is that secondary market actors enjoy high returns on subprime loans, and have little interest in performing the necessary due diligence to ensure they are not financing predatory loans. HOEPA, with is assignee liability provision, can go far to protect vulnerable consumers if regulations can be enhanced to expand its reach. The FRB has raised the issue of the secondary market in its proposed guidance on nontraditional loan products.[28] We believe that secondary market actors must be included in any effort to restrict predatory lending, and a more relevant HOEPA framework could accomplish that. We also note that the Federal Trade Commission is reportedly investigating the secondary market practices of Bear Stearns' EMC unit, suggesting that this has become an increasingly important and visible issue.[29]

Recommendations

- The FRB should expand HOEPA so that it covers more loans, in the following ways:
    - Extend coverage of HOEPA to home purchase loans;
    - Lower the points and fees threshold to 5% of the total loan amount;
    - Lower the rate threshold to 6% above comparable Treasuries; and

---

[25] Analysis is based on loans originated on single-family properties (1-4 units) in the state, using PCI's CRA Wiz software, 2006.

[26] For this section of our letter only, when we refer to "higher cost," we mean all loans that meet the HOEPA triggers but are not covered by HOEPA because they are not refinance loans.

[27] Robert B. Avery and Glenn B. Canner, "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin*, Summer 2005, p. 372.

[28] *See Interagency Guidance on Nontraditional Mortgage Products* (December 2005), Office of the Comptroller of the Currency (OCC), FRB, Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), pp. 8, 10, 24-25.

29 *See, e.g.*, Gregory Cresci, "Bear Stearns Gets FTC Demand for Data on Mortgages," *Bloomberg News Service*, December 30, 2005, *available at* http://www.bloomberg.com/apps/news?pid=10000103&refer=us&sid=amLFixecfHw0.

- Expand the definition of points and fees to include Yield Spread Premiums and prepayment penalty provisions.

Below we discuss these proposals in more detail.

Extend coverage of HOEPA to home purchase loans

One very basic way in which HOEPA is not meeting the current challenge posed by predatory lending is its application only to refinance or home equity loans, not home purchase loans. While there is certainly a good deal of abuse in the refinance and home equity market, we have seen an increasing amount of high-cost and abusive lending occurring in the home purchase market.

It is clear that very expensive home purchase loans are being originated in California. Analysis of 2004 HMDA data for lending on single-family homes in California reveals that while 35% of all home loans originated were home purchase loans (856,099/ 2,453,492), a full 46% of all rate-spread loans (i.e., those first lien loans with APRs over 3 points above the comparable Treasury rate, and those second lien loans with APRs over 5 points above the comparable Treasury rate) were home purchase loans (128,085/ 277,971). Even more striking, a very large 69% of loans with rate spreads more than 5 points over the comparable Treasury were home purchase loans (82,600/119,854).[30] Higher priced home loans are increasingly found in the home purchase market, and these loans, when improperly priced, are just as threatening to homeowner wealth as refinance loans. As such, home purchase loan borrowers deserve the same level of protection.

In addition to high-cost loans, consumers and advocates have also seen far too many predatory purchase loans issued. For example, in San Jose advocates were forced to file a federal lawsuit after lenders and brokers "engaged in a practice of predatory and racially discriminatory lending" aimed at a significant number of Hispanic homebuyers in the South Bay.[31] The brokers "charged the plaintiffs numerous undisclosed, duplicate or improper fees and closing costs," "misrepresented actual loan terms and engaged in unfair business practices; . . . failed to translate the necessary writings from English to Spanish; . . . failed to explain, until the time of closing escrow, that their loans had much higher repayment terms than was previously represented; and . . . made little or no effort to ascertain or verify plaintiffs' ability to repay their loans."[32] The consequences of these misdeeds were dire: "defendants' issuance of predatory loans were ultimately designed to fail and inevitably triggered foreclosure proceedings causing all but one of the plaintiffs to lose their homes."[33] These allegations mirror problems that have been seen in the home equity and refinance market and underline the need to extend HOEPA's protections to consumers of home purchase loans.

---

[30] Analysis by CRC using PCI's CRA Wiz software, 2006.
[31] *Muñoz, et al., v. International Home Capital Corp., et al.*, 2004 U.S. Dist. LEXIS 26362 *6 (recounting plaintiffs' allegations).
[32] *Id.* at *6 & fn.2.
[33] *Id.* at *6.

In short, we concur with the recommendation that the National Association of Realtors' Judy Ziegler made during the San Francisco hearings that HOEPA be extended to cover home purchase loans.

Lower points and fees trigger from 8 percent of total loan amount to 5 percent

Due to huge increases in home values in many parts of California (particularly in the Bay Area), loans with very high fees—many times the alternate trigger ($528)—are not covered by HOEPA's important protections. For example, a $500,000 loan (not an unusual amount in the Bay Area) would require fees of $40,000—**75 times** the dollar amount trigger (which is basically irrelevant in California)—to qualify as a HOEPA loan. Even if the trigger were lowered to 5 percent, the lender and broker could charge up to $25,000 in fees on a $500,000 loan before HOEPA would kick in.

Here are two examples of extremely high-fee refinance loans that clients of the Law Foundation of Silicon Valley's legal services programs—Fair Housing Law Project (FHLP) and Public Interest Law Firm (PILF)—were pressured by Ms. V (discussed above) into taking which did not receive HOEPA protections:

Mrs. G

- Principal: $470,000
- Fees: $25,000
- Since the fees "only" amounted to 5 percent of the principal, HOEPA was not triggered despite the huge dollar amount of the fees that she was charged. Note that 97 percent of these fees went to the broker.

Mr. A

- Principal: $432,000
- Fees: $24,000
- In Mr. A's case, the fees "only" amounted to 5.5 percent of the principal, so HOEPA was not triggered for this loan either, despite the very large fees that he was charged.

It's particularly ironic that both of these borrowers paid these huge fees for the privilege of receiving very bad loan products, since the broker did not select them because they met the borrowers' needs, but rather because they provided her with the most fees and stripped the most equity from the borrowers. Based on our experience, the unscrupulous brokers seem to be aiming for 5 percent in fees even on these huge loans, so the trigger should be in that range as well. Again, we join NAR's Judy Ziegler's recommendation (made during the San Francisco hearings) that the trigger should be lowered to 5 percent.

This amount is in line with what several states have been adopting to protect their consumers against predatory lending (e.g., Georgia, Illinois, Massachusetts, New Mexico, New York, and North Carolina); in fact, New Jersey has set its thresholds below 5 percent.[34]

Lower the rate threshold to 6% above comparable Treasuries

HOEPA fails to capture many loans that are high-cost in another respect; their exorbitant interest rates, as analysis of 2004 HMDA data in California shows. Lenders issued a large volume of loans with high interest rates (277,971 rate-spread loans comprised of first lien loans with APRs over 3 points above the rate for a comparable Treasury or second lien loans with APRs over 5 points above the rate for a comparable Treasury; and 119,854 first and second lien loans made with APRs over 5 points above the comparable Treasury). The numbers for 2005 will be far worse as most lenders reported significantly more rate-spread lending in 2005 due to the flattening yield curve.[35] Long Beach Mortgage, for example reported over 90% of its loans in California in 2005 as higher-cost rate-spread loans, compared to only 27% of its California loans being reportable rate-spread loans in 2004.[36]

Our suggested rate threshold of 6% above Treasury is not an unreasonable one; in fact, at least one state (Illinois) has a HOEPA-like law that uses this trigger.[37]

Add yield-spread premiums ("YSPs") and pre-payment penalties ("PPPs") to the points and fees calculation

The current failure of the regulatory scheme to explicitly include YSPs and PPPs in its points and fees calculation is a huge loophole, allowing many risky, high-fee loans to slip through HOEPA's fingers.

Not including YSPs in the calculation is particularly unfair to borrowers, because the *raison d'etre* of these fees is for the lender to reward the broker for putting the borrower in a more expensive loan (i.e., one with a higher interest rate). Not including PPPs is also unfair, because some unscrupulous brokers and lenders persuade borrowers to take out high-cost loans with a promise that borrower will be able to quickly refinance. At the same time, these actors conceal the existence of a PPP in the loan, which will actually make refinancing very expensive for the unsuspecting borrower.

---

[34] *See* Georgia Fair Lending Act – O.C.G.A. Title 7, Chapter 6A-2(17)(B)(i); Illinois High Risk Home Loan Act, Public Act 93-0561, Section 10; Massachusetts Predatory Home Loan Practices Act, General Laws, Chapter 183C, Section 2; New Mexico Home Loan Protection Act, NMSA 58-21A-3N(1); State of New York, Chapter 626, Laws of 2002, section (g)(2); North Carolina Prohibit Predatory Lending Act, G.S. section 24-1-1E(a)(6)(b); and New Jersey Home Ownership Security Act, N.J.S.A. 46:10B-22 *et seq.* Note that state laws vary with regard to whether the points and fees thresholds are further qualified by loan limit restrictions, bona fide discount points, and/or the inclusion of certain fees in the points and fees definition.

[35] *See, e.g.,* "Frequently Asked Questions about the New HMDA Data," April 3, 2006, p. 9-10, FRB, Department of Housing and Urban Development, FDIC, NCUA, OCC, OTS. Many lenders acknowledged the large increase in reported rate spread loans in cover letters accompanying their release of 2005 HMDA data.

[36] Analysis by CRC using PCI's CRA Wiz software, 2006.

[37] Illinois High Risk Home Loan Act, Public Act 93-0561, Section 10.

Sometimes YSPs and PPPs come together to make for a particularly pernicious mix. FHLP and PILF currently represent a dozen plaintiffs in a civil action in federal court that also includes a state-court criminal prosecution; the mortgage salesperson at the center of the case is Ms. V, discussed above. A former employee of Ms. V recently testified in the criminal trial that the YSP that the lender paid to Ms. V—she termed it a "rebate" —was actually based on the amount of the PPP. This practice is even worse than the usual practice of tying YSPs to interest rates, as it rewards the broker for making it hard for the borrower to refinance out of the predatory loan.

Indeed, a high PPP—which is, again, all too often concealed from borrowers by unscrupulous brokers—can make refinancing impossible for the borrower, so the borrower is stuck in a loan that he or she can't afford. While Indymac Bank's Rick Lieber described some legitimate purposes of PPPs at the San Francisco hearing (for example, allowing the lender to recoup its costs for originating the loan if the borrower refinances early in the loan's term), we have more often seen them used in an abusive fashion. The homeowners who've sought our help have been charged for all of the costs associated with their loans—and are charged huge fees—in addition to being saddled with a PPP. As the California Reinvestment Coalition's Kevin Stein testified at the San Francisco hearing, and as discussed in the section of this letter discussing PPPs more generally, consumers are simply not bargaining for PPPs in any sense of the word.

For example, one of Ms. V's victims, Mr. A (discussed above in the points and fees section), was saddled with a PPP on his loan (6 months' interest on the amount of the loan above 20% of the original principal) that could amount to almost $12,000; Mrs. G's loan (another of Ms. V's victims discussed above) included two PPPs that totaled over $11,000.

The case involving Mr. A, Mrs. G, and the mortgage salesperson Ms. V discussed above also points out the lack of effectiveness of criminal laws to protect homeowners, which industry representatives often point to as the proper way to deal with "bad" brokers. In fact, we heard the argument that regulators should focus on enforcement of existing laws from George Hanzimanolis of the National Association of Mortgage Brokers at the San Francisco hearing.

But in this case, even after they were indicted by the grand jury of 47 felony counts, Ms. V and her cohorts continue to do business. At a recent bail hearing, the District Attorney was unable to convince the judge to find the defendants in violation of their bail condition that they not "write loans"—even though they were clearly directing their employees to do just that—merely because the defendant brokers had had limited direct contact with prospective borrowers. This, despite highly compelling testimony from the whistleblower former employee about the defendants' clearly predatory practices.

The criminal court judge candidly admitted his lack of familiarity with real estate law, stating he hadn't cracked a real estate book since he studied for the bar. It also seemed that he didn't understand how much real damage these brokers were causing to people's lives by ruining their credit, stripping equity from them, and in some cases making them lose their homes. And the federal court has stayed FHLP and PILF's civil case pending the outcome of the state criminal action, so they can't be stopped via that action either.

District Attorneys are simply overwhelmed, as demonstrated by this case and another predatory lending case handled by FHLP (in which a senior was victimized by a title scam of the type that HERA's Heidi Li mentioned at the hearing and that is discussed elsewhere in this letter). They are overwhelmed by the volume of evidence, the complexity of issues, and the tactics of aggressive defense counsel. While NAMB's Michael Faust testified that District Attorneys are "carrying the water" on combating predatory lending, the reality is that they they're staggering under the weight of it. The bottom line is that enforcement of existing laws isn't enough to protect consumers from predatory brokers, even when both the District Attorney is prosecuting them and consumer advocates are suing them.

The FRB can't mandate that the County of Santa Clara or any other jurisdiction spend more resources on prosecuting lending fraud, but it can make the prophylactic measures stronger to prevent fraud from being as harmful in the first instance. If HOEPA—with its assignee liability provisions—were extended to cover more loans, it could serve as a powerful tool to dry up financing from the secondary market for the type of predatory loans that Ms. V and her co-conspirators were pushing on homeowners, ultimately reducing lenders' origination of such loans.

4. Expand HMDA reporting requirements to capture important information about discriminatory lending.

The Problem

Borrowers of color, low- and moderate-income borrowers, and the neighborhoods in which they live are much more likely to receive higher-cost home loans. In looking at 2004 Home Mortgage Disclosure Act data, minority neighborhoods in California were nearly four times as likely to receive higher-cost home purchase loans as non-minority neighborhoods, and we estimate that people of color in the state are paying millions more per month as a result.[38] This dynamic means many homeowners are being robbed of additional equity they could have used to support their families, send a child to college, or plan for retirement.

Though HMDA data are designed to help identify discriminatory lending patterns, HMDA data are limited. Currently, HMDA data do not include key underwriting criteria that could better help regulators, the industry, and the public determine if unfair and discriminatory lending is occurring. Additionally, there is no information available through HMDA as to whether a homeowner is a senior, one of the primary groups targeted for home equity scams and predatory lending. Further, while the banking regulators are expressing concern about the impact of nontraditional mortgage products on underserved communities, the HMDA data do not distinguish nontraditional loans.

---

[38] *See* Kevin Stein, *Who Really Gets Higher Cost Home Loans*, California Reinvestment Coalition, December 2005.

Accordingly, a stated-income or negatively amortizing loan made to a low-income Latino household in a minority neighborhood will be viewed as a prime loan that not only will not be flagged as a potentially problematic loan, but could actually qualify for Community Reinvestment Act credit for a bank.

Reporting requirements must be expanded to give meaning to HMDA and to promote fair lending. If not, the public will continue to lose confidence in the fairness of our mortgage lending system as the industry continues to dig in its heels by criticizing HMDA data while at the same time vehemently opposing its expansion. When the Attorney General of the state of New York sought the very data that lenders say are needed to establish whether discrimination is occurring, he was met by lawsuits from the nation's largest lenders and, sadly, from their regulator, the Office of the Comptroller of the Currency.

Further, we believe that the current HMDA loan pricing data are only capturing about 50 percent of the subprime loan market, and virtually none of the nontraditional mortgage market. Many loans are priced just under the thresholds. Brokers and lenders are aggressively marketing interest-only, option ARM (Adjustable Rate Mortgage) and other exotic loan products that have artificially low introductory interest rates that inevitably rise and often put the borrower in significant financial distress.

Experts expect to see an increase in the number of foreclosures in California as interest rates rise and homeowners face mounting challenges in meeting their monthly payment obligations. In fact, foreclosure activity in California is already jumping,[39] without any warning from the HMDA data.

Just as the increase in subprime lending necessitated changes in the HMDA data in years past, so too the explosion of nontraditional loan products now requires the FRB to upgrade its regulations to keep pace with the changing marketplace.

Recommendation

- The FRB should expand Home Mortgage Disclosure Act reporting requirements, so more data are available to better detect areas of discrimination and foreclosure risk, specifically by including the following data fields:
  - Credit score;
  - Loan-to-value ratio;
  - Debt-to-income ratio;
  - Points and fees;
  - Age of borrower; and
  - Whether the loan is a nontraditional loan (e.g., option ARM, interest-only, stated-income, etc.).

---

[39] "Defaults may skyrocket in West," *Central Valley Business Times*, June 26, 2006. In this article, Alexis McGee, president of Foreclosures.com, is quoted as saying, "Interest-only and so called option adjustable rate mortgages with very low initial rates and high negative amortization are financial time bombs. When these loans reset to full amortization and market rates, the payment shock to homeowners is severe."

One of the stated purposes of HMDA data is to assist in identifying possible discriminatory lending patterns. Unfortunately, the current HMDA data reporting requirements are not allowing regulators or consumer advocates to achieve this result. By addressing HMDA's limitations, the FRB can help shed light on problematic lending patterns, which inevitably leads to better lending practices.

5. Develop a suitability standard for loans that will protect consumers from getting into loans that benefit lenders and brokers more than borrowers.

Problem

Complex and harmful loan products are being sold to unsuspecting consumers. Yesterday, we were alarmed by high-cost subprime loans that did not reflect borrowers' credit profiles. Today, we are concerned about nontraditional loan products. Tomorrow, there will likely be new practices and products that have the potential to unfairly threaten consumer wealth and assets.

As one example, industry representatives assert that stated-income loans are appropriate for certain consumers, perhaps those who cannot easily document their income. But even if that were true, we know that this product creates massive opportunities for abuse by some unscrupulous brokers and lenders. The stated-income feature allows brokers to state and inflate borrowers' incomes in a manner designed to increase broker fees and to make a deal work, even if the borrower's actual income is woefully inadequate to support the mortgage payments.

Some lenders and brokers inappropriately target subprime and unsophisticated borrowers for these risky products, offering alluring deals of option ARMs, low introductory rates, no money down and low or no documentation requirements. In 2005, 73.4% of subprime securitizations were adjustable-rate mortgages, 23.5% were interest-only loans, and 37.2% were stated-income loans.[40] In offering these features in subprime mortgages, lenders are setting the stage for vulnerable consumers to sustain payment shocks which they may not be capable of bearing. In many subprime loans, several of these dangerous loan features overlap, heightening the risk for borrowers. Nearly two-thirds of the subprime securitized loans in 2005 carried a prepayment penalty, making it more difficult for borrowers to escape these hazardous loans before rates reset and increase.

Some lenders have acknowledged the associated risk of providing nontraditional mortgages to subprime borrowers. In one *Inside B&C Lending* article, many lenders discussed their concern with providing products to subprime borrowers with limited income documentation, interest-only ARMs with quickly approaching reset periods, and second-lien mortgages. As one lender put it, "negative amortization with a subprime product is a scary proposition."[41]

---

[40] "What Else is New? ARMs Dominate Subprime MBS Mix," *Inside B&C Lending*, January 20, 2006.
[41] "Doubts Persist About Alt Products in Subprime Space," *Inside B&C Lending,* February 3, 2006.

A review of Prospectus Supplements for pools of securitized mortgage loans confirms that these problematic and unsuitable loans are being sold on the secondary market, disincentivizing lenders from being on their guard in originating these products. In one pool of 2,481 loans originated by American Mortgage Network, Inc. and securitized by Wachovia Securities, 100% of the loans were adjustable rate, 88% were interest-only, and 68% were subject to minimal stated-income or stated-income/stated-asset documentation, while 16% of borrowers had subprime credit scores.[42]

The New York Times recently reported on the frighteningly high percentage of negatively amortizing loans in certain California metropolitan areas (through March 2006): Los Angeles 43%; Oakland 50%; Merced and Stockton 51%; San Luis Obispo and Vallejo 52%; and San Francisco 55%.[43] How will these California consumers respond when they face rate resets, balloons, and newly amortizing payments in the months and years ahead? How many of these consumers actually understand that this is coming?

Recommendations

- The FRB should develop meaningful suitability standards that protect borrowers from being pushed into loans that are not suitable for them. The FRB should seek Congressional authorization to accomplish this goal if that is deemed necessary.

- The FRB should develop improved underwriting standards and due diligence requirements for lenders who fund interest-only, stated-income, piggy-back loans and option ARMs to ensure that such loans are not issued to borrowers for whom they are not beneficial. The improved underwriting standards should include such safeguards as: (1) not providing these types of loan products to borrowers with FICO scores below a certain level; (2) requiring a minimum level of downpayment by borrowers who are seeking purchase loans; (3) prohibiting prepayment penalties on these high-risk loans so that borrowers in distress can reasonably refinance; (4) capping interest rates on the second loan in a piggy-back and/or requiring that it be a fixed rate loan; and (5) requiring housing counseling before the closing of the loan (as discussed elsewhere in this letter).

- None of the exotic products listed above should be underwritten as income-stated loans.

- In the meantime, the FRB should require home loan counseling for all HOEPA (after HOEPA's reach is extended, as discussed above), subprime, and nontraditional loan products as a transition to a suitability standard.

We understand that there has been lively discussion about creating a suitability standard for home loans akin to what currently exists in the securities realm. We support the

---

[42] Wachovia Mortgage Loan Trust, Series 2006-AMN1, Prospectus Supplement, May 23, 2006.
[43] Vikas Bajaj and Ron Nixon, "Variable Loans Help to Put Off Mortgage Pain," *New York Times*, July 23, 2006.

development of such a standard that would force loan sellers to ensure that a given deal is appropriate for a given borrower, given the totality of that borrower's circumstances and profile. Where unsuitable loans are sold, as is rampant today, borrowers must have meaningful redress.

Citigroup recently was reported to be newly offering interest-only loans to subprime borrowers. At the same time, Citi announced it would be developing a "best fit" tool which includes a suitability test.[44] How such tests are developed will go a long way towards determining whether loans will be sold that are suitable for consumers, or whether they will merely be suitable for brokers and lenders. The FRB should fully engage in this debate and ensure consumers' interests are protected in the development of suitability standards.

6. Prohibit lenders and brokers from steering borrowers to harmful loan products.

Problem

As discussed above, HMDA data consistently reveal lending disparities based on race, ethnicity, and income of borrowers and neighborhoods, disparities that mean that people of color in California are paying millions of dollars more per month for their home loans than their white counterparts. This is problematic, as studies suggest that up to half of all borrowers with subprime loans could qualify for a lower cost prime loan.[45]

The Federal Reserve has noted that much of the lending disparity by race and ethnicity can be explained by the fact that people of color are more likely to use a higher-cost subprime lender.[46] The FRB has noted that the greater use of higher-cost lenders by people of color may reflect that lower-cost prime lenders are not serving these communities well, or that these borrowers are being improperly steered into higher-cost loan products.[47] For those companies that have both prime and subprime channels, it is imperative that they offer all borrowers the best loan product for which they qualify, regardless of how they look, where they live, or what language they speak.

---

[44] Jody Shenn, "New Citimortgage Primed for Nonprime," *American Banker*, July 31, 2006.

[45] A poll of the 50 most active subprime lenders found that 50% of their clients could qualify for a conventional loan, according to Inside Mortgage Finance, a trade publication. (Paul D. Davies, *Beg, Borrow, Besieged,* Philadelphia Daily News, February 5, 2001.) A Freddie Mac publication cited the same poll, attributing it to Inside B&C Lending, and estimated based on its own findings that between 10% and 35% of subprime borrowers could qualify for prime loans (Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families, September 1996).

[46] "Most of the reduction in the difference in the incidence of higher-priced lending across groups comes from adding the control for lender to the control for borrower-related factors." Robert B. Avery and Glenn B. Canner, "New Information Higher-Cost Loans Under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin*, Summer 2005, p. 379.

[47] *Id.* at p. 381 ("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 … or (2) some minority borrowers may be steered to lenders who typically charge higher prices than the credit characteristics of these borrowers warrant").

Most of the large lenders that have both prime and subprime channels acknowledge that some of their prime-qualified borrowers are being sold loans through the subprime channel. Higher cost lending by financial corporations that also offer lower cost loans represents roughly a quarter (25%) of the hundreds of billions of dollars of subprime loans originated.[48]

None of the lenders have sufficient safeguards in place to ensure that all customers get the lowest priced loan product that they deserve, regardless of which channel they come through. Some institutions have reluctantly agreed to offer the best-priced loan to new loan applicants or existing customers, but none have been successful in originating lower cost loans to these borrowers.

- By late 2003, Citigroup had identified 25,430 existing customers of higher cost subprime lender Citifinancial that Citigroup believed could qualify for a lower cost prime loan, but only 110 of these obtained a lower cost loan (less than half of one percent). Of the 1,868 higher cost subprime loan applicants that Citigroup believed should be "referred up" to a lower cost prime loan, only 311 had received a prime loan. Citi's other higher cost subprime lender, Citicorp Trust Bank, FSB, which is Citigroup's main lender to African Americans and Latinos in California, was not part of this initiative. Citigroup has since given up on this approach, and is seeking to streamline operations and lower pricing at all subprime channels.

- Washington Mutual has been attempting to offer qualified subprime applicants a best-priced product, though it reports very few Best Price Offers have been accepted.[49]

- Countrywide has maintained that it underwrites all home loan applicants for a prime loan first, though the revelation of an internal memo encouraging loan officers to steer customers to more expensive loan products calls Countrywide's commitment into question.[50]

- H&R Block, with its new federal thrift charter, had refused until recently to develop a program to guarantee that qualified home loan applicants to its higher cost subprime lender, Option One Mortgage, have access to a lower cost prime loan product. As of a few months ago, Block had no specific plans for implementing this program.

---

[48] General Accounting Office, "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," GAO-04-280, January 2004, p. 52. The report notes that of the total subprime loan originations made by the top 25 subprime lenders in the first 6 months of 2003, 24 percent were originated by nonbank subsidiaries of holding companies. In addition, of the 178 lenders on HUD's 2001 subprime lender list, 20 percent were nonbank subsidiaries of holding companies that also own banks.
[49] Letter from Susan James, Senior Vice President, Community Performance Resources, Washington Mutual, to Kevin Stein, California Reinvestment Coalition, October 25, 2005.
[50] Annette Haddad, "Countrywide Fires Manager, Citing Ethics," *L.A. Times*, November 20, 2004; Jody Shenn, "Countrywide Firing Raises Subprime Steering Issue," *American Banker*, November 30, 2004.

- Wells Fargo has suggested it will offer existing, qualified Wells Fargo Financial customers a lower cost product, but its plans appear to fall short of guaranteeing all customers the best-priced products for which they qualify.

Each of these institutions must make best-priced products available to new and current subprime loan applicants and borrowers. This entails a commitment from top management, as well as an effective implementation plan which creates employee and broker incentives to make sure the borrower gets the best loan for which she qualifies.

Yet steering concerns are not limited to depository institutions. Ameriquest, one of the largest subprime lenders, recently came to terms with 49 state Attorneys General amid charges that it sold loans to borrowers that were more expensive than their credit profiles warranted (among other allegations). Such practices are egregious, especially so if they have a disproportionate impact on certain borrowers and certain neighborhoods.

Additionally, studies have called into question the industry's insistence that the market reflects risk-based pricing. The National Community Reinvestment Coalition has shown that lending disparities by race and age of neighborhood persist even after accounting for neighborhood credit scoring data.[51] The Center for Responsible Lending, with access to enhanced loan level data, released a report that found that for most subprime home loans, African American and Latino borrowers are at greater risk of receiving higher rate loans than white borrowers, even after controlling for legitimate risk factors. These disparities are large and statistically significant.[52]

The home loan process has many phases, each of which presents an opportunity to steer borrowers to the wrong product. The National Community Reinvestment Coalition completed a national 2-year investigation using paired mystery shopping to determine whether loan applicants of similar credit profiles are offered similar rates. Amongst other findings, seven percent of white applicants were "referred up" to a lower cost loan – but not one African American or Latino shopper with superior credit profiles was told the same.[53]

Anecdotally, we believe that borrowers of color, immigrants and limited-English-proficient borrowers are being steered to nontraditional loan products that enable brokers to close loans, but can be perilous for unsuspecting borrowers. At the Federal Reserve home equity lending hearings in San Francisco, consumers and their advocates testified that brokers sold stated-income and option ARM loans to borrowers who did not understand their loan terms and who could not afford to make the payments.

Recommendation

---

[51] *The Broken Credit System*, The National Community Reinvestment Coalition, 2003.
[52] Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages," Center for Responsible Lending, May 31, 2006.
[53] Kenneth Harney, "It's illegal, but mortgage firms aren't colorblind," *San Francisco Chronicle*, June 18, 2006.

- The FRB should develop anti-steering guidance and provide that the steering of borrowers to higher-priced products is an unfair and deceptive trade practice.

- Federal regulators, including the FRB, must examine lending practices and enforce anti-predatory, fair housing/fair lending, and consumer protection laws and regulations more vigorously. This analysis should be heightened for companies that operate different lending channels which are susceptible to abuse and have had a discriminatory effect on people of color.

- The FRB should ban YSPs and discretionary pricing. Home loan sales where brokers or loan officers have discretion to charge different prices to different consumers are an invitation to discriminate. Former Federal Reserve Governor Mark Olson noted last year that institutions must examine if loan originators have discretion in pricing and receive incentives "to extract fees from vulnerable or less well-informed borrowers."[54] Lenders should eliminate this practice and regulators should vigorously pursue those lenders who do not. Yield Spread Premiums provide financial incentives for loan brokers to charge borrowers a higher rate than they deserve. YSPs are inherently abusive fees that only heighten the problem of borrowers of color paying more for their loans, and, as such, should be eliminated.

7. Restrict prepayment penalties that trap borrowers in unsuitable loans.

Problem

Prepayment penalties trap borrowers into higher priced and unsuitable loan products. To the extent borrowers are misled about their loan terms, they are doubly victimized by prepayment penalties which effectively prevent them from refinancing out of bad loans. Especially onerous are loans where the rates will rise or reset before the expiration of the prepayment penalty period. Borrowers are left with the harrowing choice of paying higher rates with their existing loan, or refinancing to a better loan and losing valuable equity in their home, typically thousands of dollars in California.

A series of studies has shown that prepayment penalty provisions provide no borrower benefit;[55] are more prevalent in rural communities;[56] are more prevalent in minority neighborhoods;[57] and are more likely to lead to foreclosure.[58]

---

[54] Ethan Zindler, "Olson: Pay Packages May Spur Predatory Lending," *American Banker*, November 8, 2005.

[55] Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits From Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending, January 2005.

[56] Keith S. Ernst, *Rural Borrowers More Likely To Be Penalized For Refinancing Subprime Loans*, Center for Responsible Lending, September 2004.

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

A study by the Center for Community Capitalism at the University of North Carolina found that certain subprime loan terms increased the likelihood that the borrower would go into foreclosure. Specifically, loans with prepayment penalties with terms of three years or longer were 20% more likely to enter foreclosure than loans without these terms; subprime loans with large balloon payments due at the end of the loan term were 46% more likely to enter foreclosure than loans without balloons; and loans with adjustable interest rates were 49% more likely to enter foreclosure than fixed-rate loans.[59]

In CRC's Stolen Wealth[60] study of over 100 subprime borrowers and their loan documents, several loans contained prepayment penalty provisions that extended beyond the initial interest rate of the loan. In other words, many borrowers had loans that would adjust by the second year, but would have a prepayment penalty that lasted from three to five years. This meant that if interest rates rise as expected and borrowers' monthly obligations increase, they will be unable to refinance out of their unaffordable loan. This dynamic was never explained to, and never understood by, the borrowers. Research of subprime loans sold on the secondary market suggests that this unconscionable practice is widespread.

In fact, at the recent Federal Reserve hearings on home equity lending in San Francisco, the entire morning panel—including Bruce Fuller of World Savings Bank—agreed that this dynamic is problematic for the consumer. Yet our understanding is that nearly all of World's mortgage loans reset on an annual basis, and most of their loans come with a 3-year prepayment penalty period.

Recommendation

- The FRB should include prepayment penalties in the points and fees calculation under HOEPA (see HOEPA section for more regarding this recommendation) (assuming that the FRB is not willing to outright ban prepayment penalties on HOEPA loans, as we recommend below).

- The FRB should prohibit prepayment penalty provisions from extending beyond the initial interest rate period of any loan.

- The FRB should prohibit prepayment penalty provisions for HOEPA and non-traditional loans.

---

[58] Michael A. Stegman, Roberto Quercia, Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill, January 25, 2005.
[59] *Id.*
[60] Kevin Stein and Margaret Libby, Stolen *Wealth, Inequities in California's Home Subprime Mortgage Market*, California Reinvestment Committee, 2001, available at www.calreinvest.org.

- In the alternative, FRB should prohibit prepayment penalty provisions from extending beyond one year after closing of any loan and/or require that they expire 90 days before the interest rate change for these loans.

8. Expand CRA to require banks to better serve the communities in which they do business.

Problem

Narrow and outdated regulatory definitions have reduced the scope of the Community Reinvestment Act. As more nonbanks seek to attain bank and thrift charters, the impact of this dilution of the CRA will lead to further disinvestment from local communities.

When the FRB released the 2004 HMDA data with new pricing information, it provided analysis to explain the data. Amongst other findings, the FRB staff noted lending disparities that showed that minority racial and ethnic groups were more likely to receive higher priced home loans, but that these disparities were reduced within a bank's Community Reinvestment Act (CRA) assessment area. In other words, where banks had CRA responsibilities subject to regulatory oversight, their lending appeared to be more equally and fairly distributed.[61] This was promising data that reinforced the need to preserve the effectiveness and reach of the Community Reinvestment Act.

Yet at the same time, the bank regulators have allowed certain companies such as H&R Block Bank, Countrywide Bank, and Charles Schwab Bank to confine their CRA responsibilities to a small fraction of the communities where they lend money and take deposits. In each case, the new banking institution is seeking to attract depositors and cross sell banking products to customers of its retail, non-bank affiliates (H&R Block Tax Preparation offices, Countrywide Home Loans branches, and Charles Schwab brokerage offices, respectively). These institutions are most likely taking more deposits and conducting more banking business in California than any other state. Yet, none of these institutions have identified California communities as part of their CRA assessment area.

This is a total circumvention of the CRA, all done with the blessing of the regulators who hold onto an old definition of a "branch" as a deposit-taking outlet. The banks recognize this legal fiction and simply maneuver around it by technically not "taking deposits" in California while still conducting millions of dollars of banking business here. For example, Countrywide Bank used to have California Bank employees help customers open bank accounts, and place deposits in an envelope to be deposited in a "lock box" in the hallway, so that it could be picked up and delivered to Countrywide Bank's Alexandria headquarters per instructions supplied by Countrywide Bank. The Office of

[61] Robert B. Avery, and Glenn B. Canner, "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin*, Summer 2005, p. 382 ("However, whether the loan was originated by an institution in its CRA assessment area does matter. Differences across groups for lending within an assessment area are about one-third of those for lending outside the assessment area. Moreover, for all racial and ethnic groups, lending within an assessment area exhibits a much lower incidence of higher priced lending").

the Comptroller of the Currency apparently responded to these concerns by issuing an interpretive letter[62] that merely resulted in Countrywide Bank simply contracting with another vendor to deliver deposits. H&R Block, in seeking to establish a federally chartered thrift, sought a legal opinion from the Office of Thrift Supervision that its retail tax preparation offices would not be deemed branches that would trigger CRA responsibility.[63]

Recommendation

- The FRB should expand CRA requirements to promote fair lending. Specifically, the banking regulators should revise outdated definitions of what constitutes a "branch" subject to CRA responsibility, by looking at where banking companies lend and where their depositors live.

9. Expand regulatory authority over holding companies to prevent banks from evading fair and responsible lending standards.

Problem

Banks and mortgage companies are making subprime loans to prime customers. A Government Accounting Office report, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* ("GAO report") noted that nearly a quarter of subprime loans are originated by non-bank mortgage lending subsidiaries of bank or financial holding companies, and that the environment in which these lenders operate is relatively unregulated. Recent efforts by the Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) to preempt state anti-predatory and consumer protection law vis-à-vis federally chartered financial institutions and their subsidiaries will no doubt harm consumer interests and the preservation of home equity in California. In its consideration of this issue, the GAO recommended that Congress give the FRB broader authority to monitor, examine, and

---

[62] Office of the Comptroller of the Currency, Interpretive Letter #980, 12 USC 36, January 2004. ("Your inquiry was prompted by the OCC's request seeking additional information about the operation of drop boxes on the premises of the Bank's financial centers into which deposit account applicants would place their applications, along with their initial deposits, for pick up and delivery to the bank's main office in [State]. The concern at the time was that the operation of these drop boxes could cause the financial centers to be considered to be branches of the Bank. Since then, you have advised us that the drop boxes are being replaced with UPS drop boxes." This change in vendor by the Bank, presumably Countrywide Bank, was deemed sufficient by the OCC to avoid recharacterization of the financial centers as "branches" that would have triggered CRA responsibility for Countrywide in California and elsewhere.

[63] Pursuant to a Freedom of Information Act request made during H&R Block's application to become a federally chartered thrift, CRC obtained a February 4, 2004, letter from the Office of Thrift Supervision to H&R Block's counsel which referenced a memo previously sent by H&R Block to the OTS seeking clarification on whether the solicitation of Express IRA accounts by H&R Block tax offices would provide a basis for those offices to be regarded as "branch" offices of the proposed Bank. We believe a reason for Block to be interested in this determination is that if H&R Block tax offices were deemed Bank branches, H&R Block Bank would have to reinvest in communities around each of these tax offices.

begin enforcement actions against these lenders for non-compliance with consumer protection laws.[64]

Recommendation

- Bank regulators need to do more to ensure that large banking companies are engaged in fair and responsible lending practices. We support the GAO's call for Congress to give the Board of Governors of the Federal Reserve System more authority to monitor, examine, and begin enforcement actions against the non-bank lending affiliates of banks. It was only during the course of a CRA protest of a bank merger that the Federal Reserve agreed to conduct a fair lending examination of Citifinancial; that exam resulted in a $70 million fine. Fair lending examinations of this kind must be conducted more frequently in order to assuage the public's legitimate concern about discriminatory lending.

10. Protect homeowners from equity-stripping foreclosure "rescue" scams.

Problem

Borrowers who are in default on their mortgages are at special risk for foreclosure "rescue" scams. Realtors, mortgage brokers and others will actively seek out and approach borrowers in default. Default notices must be recorded with the county recorder's office; thus, it is easy to obtain a list of homeowners who are not keeping up with their mortgage payments.

Foreclosure rescue scammers make false promises that they will help homeowners out of foreclosure. These individuals typically:

> (1) Charge the homeowner an up-front fee to locate and obtain refinancing but never deliver on the promise;
> (2) Misrepresent to the homeowner that a refinancing option has been found; the homeowner signs "refinance" documents but later learns that the documents were in fact to sell the home; and
> (3) Represent to the homeowner that the only way to "save the home" is to sell it to an investor with an option to repurchase it at some later time; the repurchase price is generally too high for the homeowner to ever repurchase, and the homeowner ends up being charged rent in the meantime to stay in the home.[65]

---

[64] General Accounting Office, "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," GAO-04-280, January 2004, p. 55. The GAO report states, "Congress should consider making appropriate statutory changes to grant the Board of Governors of the Federal Reserve System the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory practices. Also, Congress should consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries."

[65] For more information on foreclosure rescue scams, *see* "Dreams Foreclosed," National Consumer Law Center (2005), *available at* http://www.consumerlaw.org/news/ForeclosureReportFinal.pdf.

Under each of the foregoing scenarios, the homeowner is encouraged not to contact the lender directly to try to arrange for a work-out, but to, instead, rely on the "rescuer." The scammer in the second scenario walks away with whatever equity was left in the home, either via onerous fees imposed for bogus "foreclosure bail-out services" or by taking possession outright of the home and its remaining equity without any realistic opportunity for the homeowner to repurchase the home.[66]

Recommendations

- The FRB should institute special notice requirements for lenders for loans on a home that is in default.

Although some states have special laws intended to protect consumers from the types of unscrupulous practices outlined above, these laws generally rely on the wrongdoer to give a warning notice or additional disclosures to the homeowner. In addition, some of these laws create exceptions for mortgage brokers, realtors and some of the other actors in the market who are implementing such scams. As a result, homeowners are not adequately protected from this type of abuse and walk, unknowingly, into the scam.

We recommend that the Federal Reserve require its member financial institutions to provide notice to homeowners in default. That notice would explain in simple clear terms the dangers of foreclosure rescue scams and the availability of HUD-certified housing counseling in the area to explore the homeowner's foreclosure avoidance options. HUD's toll-free number should be included for borrowers to find the agency closest to them.

- The FRB should require due diligence by lenders for loans on a home recently or currently in default.

When the property against which the mortgage loan is issued is in default or was in default within 90 days prior to the loan application under consideration, the lender should be required to exercise increased due diligence to determine the legitimacy of the proposed transaction. This would consist of a notice sent directly to the current owner of the home, at the address of the property in question, warning of foreclosure rescue scams and encouraging the homeowner to get HUD-certified housing counseling assistance to ensure that the transaction is in the homeowner's best interest.

Notably, in lease/option to buy-back scams, the investor purchasing the property from the distressed homeowner often claims falsely to the lender that he/she will be living at the property in question. In fact, it is the distressed homeowner who, having been turned into a renter of her/his own home, will be living at the property for some period of time.[67] It would be beneficial to the lender to find out the true status of the property and its occupancy. The notice we propose that the lender send to the homeowner could also ask

---

[66] For a specific California example of this "foreclosure rescue scam" problem, see C. W. Nevious' column, "Predators Feeding on Homeowners," S.F. Chronicle, June 24, 2006.
[67] *Id.*

the homeowner to make contact with the lender directly to verify the circumstances surrounding the proposed transaction.

11. Reduce secondary market investment in exotic and predatory loans.

Predatory lenders are able to make high-cost and unsuitable non-traditional loans to vulnerable borrowers because they do not hold on to these loans for any length of time. Rather, they are able sell these loans to banks and Wall Street firms that do not care if the loans are predatory, so long as the return is acceptable. Most high-cost and non-traditional mortgages are financed through securitization, where predatory lenders can sell their loans to large financial companies that will in turn pool the loans together into one large package of loans and sell that package of loans to investors on Wall Street. While financial firms make large profits at various points in this complex process, these same firms fail to take steps to ensure they are not buying, pooling, or selling loan packages containing predatory loans.

In 2005, over $500 billion in subprime loans were securitized, 23% of which was interest-only loans, and 28.9% of which was stated-income/no-documentation loans.[68] This trend continues in 2006, with nearly $260 billion in subprime loans securitized in the first half of the year, and 20% and 34.9% of that constituting interest-only and stated-income/no-documentation loans, respectively.[69] We believe that between 25% and 50% of these subprime loans are originated in California.

The regulatory agencies have noted that beyond consumer demand, "secondary market appetite has grown rapidly for mortgage products that allow borrowers to defer payment of principal and, sometimes, interest."[70] The agencies suggest that financial institutions develop written policies that specify acceptable securitization practices relating to exotic loan products, yet offer no guidance as to what those policies should look like.[71]

Standard & Poor's (S&P) has acknowledged this increased risk to investors in Mortgage-Backed Securities (MBS) in the revision of its criteria for option ARMs, effective August 1, 2005, for borrowers with FICO scores at or below 695.[72] Due to the increased risk of default in such products, S&P stated that additional credit enhancement would be required. Fitch Ratings has also warned that the "numbers of borrowers exposed to payment shocks in the coming two years is unacceptably high."[73]

We believe that much of the demand for exotic and higher-cost home loan products comes not from borrowers, but from investors. For example, a major subprime lender

---

[68] *Inside B&C Lending*, "ARMs Power the Subprime MBS Market in Early 2006," chart, July 21, 2005, p. 5.
[69] *Id.*
[70] Interagency Guidance on Nontraditional Mortgage Products, Federal Register, Vol. 70, No. 249, p. 77250, December 29, 2005.
[71] *Id.* at p. 77253.
[72] Kenneth R. Harney, *Wall Street and Financial Regulators Take Aim at Wildly Popular "Option ARMs,"* Realty Times, August 8, 2005.
[73] *Id.*

reported responding to secondary market concerns by further emphasizing adjustable-rate over fixed-rate loans. "We're not opposed to making changes in the program where it makes sense," one executive said. That's been accomplished in part by incentivizing sales people not to do fixed rate loans. "Ultimately, the market is driven not by what is best for borrowers, but by what products investors can invest in and what delivers a decent rate for the borrower and allows the company to still make some money."[74] The agencies must provide greater guidance to secondary market participants, so that the secondary market does not create the market for loans that are not in the consumer's interest. The Federal Deposit Insurance Corporation, to its credit, began this discussion a few years ago in the form of draft guidance on how to avoid purchasing or investing in predatory loans, but this effort was thwarted, apparently in response to strong industry criticism.

Disclosure of key loan data are critical to investor, regulator, industry, and public understanding of the performance of certain home loan products. A Task Force on Mortgage Backed Securities Disclosure[75] found that, "the significant degree of evolution in disclosure standards in the offer and sale of MBS—whether of GSEs, Ginnie Mae or private label MBS—in the past has been nearly entirely market driven."[76] Sadly, no relevant standards have been driven in any way by the impact loan products and lending practices have on victimized consumers and communities, except to the extent that foreclosures and home sales impact revenue streams of investors.

Recommendations

- The FRB should develop improved due diligence standards for the secondary market to ensure that the market does not buy, securitize or sell unsuitable exotic or predatory loans. These standards and any resulting regulations should impose liability on lenders who fail to comport with such standards and due diligence requirements on interest-only, stated-income, piggy-back loans and option ARMs.

- The FRB should develop regulatory guidance making secondary market investment in loan pools containing the aforementioned types of high-risk loans contingent upon proof of borrowers' having received counseling from a HUD-certified housing counseling agency. The FRB should seek Congressional authorization to accomplish this if that is deemed necessary.

- The FRB should work with the Securities and Exchange Commission (SEC) to provide more loan-level data for investors and the public, including information relating to points and fees paid by the borrower and borrower debt-to-income ratios, amongst other items. The Task Force on Mortgage Backed Securities

---

[74] *Inside B&C Lending*, "Diversification, Branding, Key to Ameriquest Strategy," remarks of Ketan Parekh, Vice President for Capital Markets, Volume 9, Issue 22, p. 6.
[75] Staff of the Department of the Treasury, the Office of Federal Housing Enterprise Oversight, and the Securities and Exchange Commission formed a joint task force in August 2002 to conduct a study of disclosures in offerings of mortgage-backed securities. *Enhancing Disclosures in the Mortgage Backed Securities Markets*, U.S. Securities and Exchange Commission, Executive Summary (January 2003).
[76] "Enhancing Disclosures in the Mortgage Backed Securities Markets," U.S. Securities and Exchange Commission, p. 3 (January 2003).

Disclosure expressed in its findings that these data should be given consideration as subjects of enhanced disclosure.[77]

The Illinois Legislature has recently imposed the requirement of HUD-certified housing counseling for borrowers in 10 of its Chicago-area zip codes that have a high foreclosure rate.[78] This requirement covers borrowers with a credit score below 620, as well as borrowers with scores between 621 and 650 if they are seeking higher-risk loan products, such as interest-only loans or option ARMs. Violations of the law constitute a violation of Illinois' Consumer Fraud and Deceptive Practices Act.

Disclosures of MBS are generally provided in the aggregate. Loan-level data—correlating all relevant loan terms and features by individual loan—will best enable investors to determine the relative risks of MBS issues, and educate the public about the subprime and nontraditional home loan markets. Specifically, the amount of points and fees a borrower pays should be disclosed. "The number of points paid, if any, to the lender at the time of loan origination may also be related to the likely prepayment behavior."[79] Additionally, "the ratios of borrowers' required payments on their mortgage debt (or on all of their debt) to their income might provide additional information about the expected default and prepayment behavior."[80]

Financial firms must use strong predatory lending screens in order to ensure that they are not financing predatory loans. If banks and other financial firms refuse to buy costly and predatory loans, this will put pressure on predatory lenders to improve their practices.

Conclusion

We write with a sense of urgency. Homeowners in California and elsewhere are suffering at the hands of unscrupulous industry actors. Current regulations are insufficient to protect consumers who are stripped of their home equity and often lose homes they have worked hard to buy. We urgently request that the FRB follow up on the hearings with decisive action that will better protect consumers, as we have set forth herein.

Thank you for your consideration of these views.

[77] *Id.* at p. 35.
[78] See HB4050, Illinois General Assembly.
[79] "Enhancing Disclosures," S.E.C., *supra*, at p. 26.
[80] *Id.* at p. 30.

Very Truly Yours,

James Zahradka, Senior Attorney
Public Interest Law Firm
111 W. St. John Street, Suite 315
San Jose, CA 95113
(408) 280-2423
Fax: (408) 293-0106
jamesz@lawfoundation.org

Kevin Stein, Associate Director
California Reinvestment Coalition
474 Valencia Street, Suite 110
San Francisco, CA 94103
(415) 864-3980
Fax: (415) 864-3981
kstein@calreinvest.org

Maeve Elise Brown
Heidi Li
Co-Directors
Housing and Economic Rights Advocates
P.O. Box 29435
Oakland, CA 94606
(510) 271-8443
Fax: (510) 868-4521
melisebrown@heraca.org
heidili@heraca.org