HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20219
Attn: Docket No. OP-1288

Re: Request for Comments on Docket No. OP-1288

Ladies and Gentlemen:

Recommendations:

The Housing Policy Council recommends that the Board of Governors of the Federal Reserve System:

1. Adopt a strictly drawn set of regulations on certain hybrid ARM loans, offered by any lender, covering prepayment penalties, escrows for taxes and insurance payments, stated income loans, and underwriting to a fully indexed rate over a fully amortizing schedule;

2. Adopt a disclosure document which is clear, in simple English, and if used by lenders will serve as a safe harbor for disclosures required for certain hybrid ARMs under 12 CFR 226.19, and the Statement on Subprime Mortgage Lending ("Statement") and the Guidance on Non-Traditional Mortgage Product Risks ("Guidance") recently adopted jointly by the Board and other federal depository institution regulatory agencies;

3. Adopt a regulation requiring brokers to disclose to borrowers whom they represent and who pays them;

4. Harmonize the Guidance and Statement with the recommended regulations to avoid conflicts between different laws;

5. Make exceptions for loans currently in place for which the terms of workouts or refinancing would conflict with the regulations; and

6. Ensure that lenders can make loans nationally under these regulations notwithstanding that state laws might impose greater burdens, be in conflict or might supplement these regulations.

Background

The Housing Policy Council ("HPC") of the Financial Services Roundtable is pleased to submit this statement to the Board in response to the request for comments by the Board on how the Board might use its rulemaking authority to "curb abusive lending practices in the home mortgage market, including the subprime sector, in a way that preserves incentives for responsible lenders to provide credit to borrowers."

HPC believes that increased access to mortgage credit for more Americans has been a positive development and has helped increase homeownership in our nation. The debate is now focused on the question of whether there is excessive access to mortgage credit as opposed to insufficient access to mortgage credit. HPC believes that continuation of the benefits of greater access to mortgage credit by qualified subprime borrowers should remain a significant part of the considerations of the Board as it attempts to strengthen standards for responsible lending.

The Housing Policy Council has earlier provided comments to the Board and the other bank depository institution regulatory agencies on the Statement and the Guidance. In both comment letters, we made two points that we want to emphasize once again:

> First, the Board must make every effort to strike a balance between regulating to stop certain practices which it considers abusive and regulating so rigidly as to diminish the supply of credit to qualified customers with less than perfect credit.
>
> Second, the Board should recognize the need for continuing regulatory flexibility on existing subprime hybrid ARMs to permit servicers and borrowers to refinance or modify such loans, thereby enabling a very large number of borrowers to avoid defaulting on their loans as their interest rates reset to higher levels.

I. Authority of the Board of Governors

HPC believes that HOEPA provides authority for the Board of Governors to adopt the carefully crafted regulations we recommend and to extend coverage of that regulation to all lenders, not just federally regulated lenders.

It is our conclusion that the Board has the authority under HOEPA not only to change for HOEPA designated loans the interest rate and points and fees triggers, as well as what is included in the points and fees, but it has the authority to prohibit acts and practices related to any mortgage loan, high cost or not, if it determines that the activity is unfair or deceptive or, in the case of a refinancing, is abusive or otherwise not in the best interests of the borrower.

II. The Board Should Take Action Which Will Be Effective While Still Avoiding Unintended Consequences

Under TILA, the Board has the authority to require that lenders provide certain disclosures to enhance borrowers' knowledge of the loans into which they are entering. HOEPA gives the

Board the authority to extend regulation of mortgage lending to state regulated lenders either through enhanced disclosure, guidance or regulations.

Adoption of guidance provides ample basis for enforcement of violations by federally regulated lenders, since federal agencies have ample examining staff and treat a failure to follow a guidance as a serious breach of the duty owed by the lender; from the perspective of the lender, such a violation is not appreciably different vis-à-vis its relationship with its supervisory agency from violation of a regulation.

It is not clear that the same vigilance can be exercised by all state agencies vis-a-vis all state regulated entities, and while many of the best state regulated entities have voluntarily committed to complying with the Guidance and probably will do the same on the Statement, HPC members have no assurance that all have or that new entrants will adhere voluntarily to such guidance if faced with a competitive opportunity generated by products that would be prohibited or restricted by the Guidance or Statement. In many cases, states may not have sufficient regulatory staff to police the Guidance and Statement, or may be lacking sufficient statutory authority to do so. In addition, the inconsistency of interpretation and enforcement among the various states will perpetuate the unequal playing field between state and federal lenders, as well as between lenders in different states.

We recognize that adoption of regulations may make it easier for a state to enforce violations since the violation of a regulation will be a violation of HOEPA and the state attorneys general are given express authority to enforce violations of HOEPA. We also recognize that assignee liability may be generated by creditor violations if regulations are not carefully drafted, and if that occurs in cases in which assignees cannot predict the extent of the liability, such as in present HOEPA loans, there will be virtually no secondary market for such loans.

Nevertheless, the competitive inequity that exists absent the adoption of regulations which cover all lenders causes HPC to recommend that the Board adopt regulations rather than extending the Guidance and Statement to all lenders. Any regulations, however, need to have black line standards, and need to contain safe harbor and cure provisions.[1]

Unfortunately, flexibility is limited in appropriately drafted regulations. As the Chairman of the Board of the Federal Reserve has wisely said, any regulation should be "strictly drawn." Strictly drawn regulations do not provide much flexibility for lenders and regulators to adjust the legal parameters as the market changes, and therefore it is imperative that the Board take into account how hard it will be to reverse any regulation it chooses to adopt, and how important it is to draft any regulations strictly, sharply, and limited to what is absolutely necessary.

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[1] We applaud Congress for making it clear that class action suits under TILA and HOEPA have a cap on them of $500,000 or 1% of the net worth of the violator. Some latent ambiguity surrounds that statute, however, and we would like to see the Board clarify that ambiguity with an official interpretation during this rulemaking process

III. <u>Regulation with respect to specific discussion items</u>

The Board has said that it specifically wishes to receive comments on prepayment penalties, escrow accounts for taxes and insurance on subprime loans, stated income loans, and consideration of a borrower's ability to repay a loan.

HPC has reviewed that request and has prepared the recommendations that follow as part of an integrated package. For example, HPC has recommended a specific category of loans to which any Board regulations would apply, and has based its recommendations on specific questions raised by the Board on the assumption that the loans covered by the Board regulations would be limited to a category of loans such as these.

If the Board chooses not to limit its coverage to the loans of the type we have described as covered loans, the balance between eliminating bad practices and eliminating credit to worthy borrowers may be lost.

Covered Loans – Certain Subprime Hybrid ARMs

The loans which have been integral to the present problems are subprime loans which contain the problems articulated in the Guidance and Statement. The regulations should address those loans.

HPC recommends that the Board limit the loans covered under the regulations to loans that both (1) meet or exceed a specified estimated APR threshold at application, and (2) are adjustable rate mortgages in which (a) a reset of a fixed introductory interest rate to an adjustable rate takes place during the second or third year of the loan, and (b) the initial reset of the rate of the loan in effect during the fixed interest rate period to the starting rate under the adjustable part of the loan is an increase of more than 200 basis points. Those loans are referred to in this letter as "covered loans."

While the definition of subprime loans found in the 2001 Expanded Guidance for Subprime Lending Programs is useful for its purposes, it presents too much ambiguity to use as a definition in a regulation prohibiting certain practices for a particular category of loans. Certainty is needed in a regulation that attempts to balance prohibitory rules and the need to retain access to credit, and the 2001 guidance does not provide that kind of certainty.

We considered recommending that the APR rate criterion to define the loans covered by the regulation be loans which are reportable under HMDA, but concluded that this might provide misleading guidance. HMDA reportable loans cover loans that are not subprime, and can move in and out of being reportable, not because of any change in lending policy or borrowers, but simply because of the movement of the long and short yield curves relative to each other. In addition, any benchmark which utilizes Treasury rates as a marker is subject to considerable volatility in certain markets, and would be a misleading direction to lenders if the desire is to focus on subprime loans.

We defer to the broader experience of the Board to determine the appropriate rate definition that best limits the regulations to subprime loans and still present easy to follow compliance guidelines. We believe, however, that the date for determining when such loans will be covered under the regulations must be available well in advance of closing, since lenders will have to know whether or not the loans are covered under the regulations sufficiently early to take that fact into consideration.

With respect to the appropriate rate definition the Board should choose, we have looked at the H-15 report of the Board, and believe that the Freddie Mac generated information, the contract interest rates on commitments for fixed rate first mortgages, with a margin of 200 basis points, would track Treasury plus 300 basis points historically, but would not have as much volatility, and therefore would recommend that the Board consider that benchmark as it reflects on an appropriate rate definition.

On the payment shock aspect of the definition, we believe that the Board should focus on an increase of 200 basis points between the fixed rate and the reset rate as an appropriate level of concern, and that increases in excess of 200 basis points should warrant inclusion within the category of covered loans to which these regulations would apply.

None of the other segments of the market have created significant problems that should be addressed by the Board at this time, and since regulations have tenacity and rigidity greater than guidance, we would urge that any regulations the Board chooses to adopt be limited to these covered loans.

Prepayment Fees for Covered Loans

HPC recommends that the Board adopt a regulation that prohibits all lenders from including in any covered loan prepayment fees that terminate later than 60 days before the initial reset date of the covered loan. Such a regulation should also require the lender to provide the borrower the right to choose whether or not to have a prepayment fee in the covered loan and the price of the loan with the prepayment fee and without the prepayment fee.

We make this recommendation notwithstanding our belief that that the benefits prepayment fees provide to borrowers have been overlooked, as has the cost to borrowers if prepayment fees are not available except under restricted terms. Also overlooked has been the fact that companies such as the member companies of HPC follow practices which clearly explain the options to the borrower and permit the borrower to choose whether or not to include prepayment fees in the loan in exchange for an improved rate of interest. All lenders do not follow such practices, however, and to ensure that borrowers receive the benefits of the practices followed by HPC member companies, we would urge that they be promulgated by the Board.

Escrows for Covered Loans

HPC recommends that the Board adopt a regulation that requires lenders to establish escrow accounts for all first lien covered loans, subject only to the right of borrowers to choose not to have such an account.

Many borrowers focus only on the payment of principal and interest as they consider whether or not they can afford a mortgage loan. They often overlook the fact that they are also obligated to pay real estate taxes and insurance on the property. Notification by the lender of that obligation would be helpful to those borrowers, but for covered loans, HPC would recommend that escrow accounts be mandatory, subject only to the right of borrowers to decide that they do not want to have such an account and that they will meet their tax and insurance obligations in a different way. For such borrowers, we would recommend that they sign a written statement recognizing their obligation and requesting that an escrow account not be established.

The Board should allow a reasonable sufficient time to establish a system for escrows, and should delay the effective date of any regulation mandating escrows for at least 18 months, with a provision for extensions based on extenuating circumstances.

Stated Income Loans

HPC recommends that the Board adopt a regulation that requires lenders to verify and document the borrower's income for all covered loans. Stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification or repayment capacity. Exceptions should be limited to those the Board concludes are appropriate. We would recommend that among such exceptions should be exceptions for borrowers who are self-employed or who receive compensation on a commission basis. Because there are many programs in use by various lenders in which different documentation levels are required or optional, the Board should carefully define stated income and what types of verification, documentation, and mitigating factors are acceptable.

Underwriting to a fully indexed rate on a fully amortizing schedule

HPC recommends that the Board adopt a regulation which requires lenders to qualify a borrower for a covered loan by analyzing the borrower's ability to repay the loan, including an evaluation of the borrower's ability to repay the loan by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The fully indexed rate equals the index rate prevailing at origination of the loan (to be defined by the Board, perhaps using Reg Z comment 17(c) (1)-(10i) plus the margin to be added to it after the expiration of any introductory interest rate. The fully amortizing payment schedule should be based on the term of the loan.

As part of that regulation, lenders who use debt to income ("DTI") ratios in evaluating repayment capacity should be required to include payment of principal, interest, taxes and insurance as a percentage of gross monthly income in creating that ratio. We do not recommend that the Board adopt any specific DTI ratio, however, since borrowers with DTIs in excess of 50% could have large and easily accessible reserves available, notwithstanding a relatively small income relative to debt; could be engaged in acquiring a debt consolidation loan which reduces an extremely high DTI they have and reduces monthly payments by significant amounts, although extending the life of the loan and retaining a DTI in excess of 50%; or have other mitigating factors in their financial situation which make accepting a 50% or greater DTI ratio appropriate. Use of an arbitrary ratio will reduce the opportunity for sound borrowers to access credit.

IV. Disclosure

In a number of questions in the request for comments, the Board has asked whether enhanced disclosures would be useful or desirable. HPC strongly believes that consumers should be provided clear, concise disclosures so that they can understand the terms, costs and risks of various mortgage products, and can make an educated choice about which product meets their needs. HPC supports enhanced consumer education and urges the Board should to address disclosure issues, but believes they should be addressed more globally, and pursuant to the Board's authority under section 105(a) of TILA (15 U.S. C. 1604).

HPC recommends that the Board by regulation adopt a model form or forms articulating the disclosure principles found in the Guidance and Statement, and that those lenders who use such forms or any form modeled after such forms and approved by the appropriate agency be deemed to be in compliance with the disclosure provisions of the regulation.

Currently section 226.19(2) of Reg Z requires that a loan program disclosure must be provided for certain variable rate transactions at time of application or before the consumer pays a non-refundable fee. That disclosure is articulated in a lengthy series of paragraphs but does not contain a model form which would serve as a safe harbor for lenders if used.

While we believe that the Board is correct in considering in another context changes in that and other parts of Reg Z, we would urge it to use this opportunity to enhance disclosure for ARMS which are covered loans, and to provide a model form under 12 CFR 226.19 which would supersede all other disclosure requirements for covered loans under this section, applicable state law, the Statement, and the Guidance, and which if used by lenders would be deemed to have produced the disclosure required under the regulation. For the benefit both of consumers and lenders, we would urge that the model forms be in clear and simple English.

We appreciate that creating such model forms is not uncomplicated, and we would urge the Board to test the forms with groups of consumers before publishing them for comment. Any new disclosures required under the regulation would be required only when the forms became effective.

While our recommendation is limited to disclosures for covered loans, we would also urge the Board to consider replacing all of the disclosures in section 226.19 with new disclosures modeled after the ones the Board produces under this regulation.

V. Broker representations

The Board did not ask whether or not regulations should be adopted to restrict or guide some acts or practices of mortgage brokers. We believe, however, that the Board has the authority to limit lenders business with brokers, and therefore makes the following recommendations.

The Board should adopt a regulation that prohibits a lender from paying any compensation to a broker, including compensation paid by the lender on behalf of a borrower, if the broker fails to provide written evidence to the lender that it notified the borrower in writing (at a time to be determined by the Board) and has retained evidence of such writing, of the nature of its relationship to the borrower, including how and by whom it will be compensated for its services, and whether it is representing the borrower or the lender.

We urge the Board to draft a model form implementing this regulation which, if obtained by the lender, will be deemed to represent compliance with the regulation.

VI. Modification of Statement and Guidance to account for new regulations

Should the Board chose to promulgate regulations as we have recommended, we would request the Board to harmonize the regulations with the Statement and the Guidance and to clarify that compliance with the regulations constitutes compliance with the Statement and Guidance on those subject matters mutually addressed.

Because these suggested regulations would be issued under the HOEPA authority of just one agency, the Board, and the Statement and Guidance were issued under the safety and soundness authority of all the federal depository institution agencies, it may be that the Board will conclude that a modification of the Statement and Guidance is necessary in order to have the regulation issued by the Board supersede the relevant parts of the Statement and Guidance. If that is the case, we urge the Board to raise the issue with the other depository institution regulatory agencies and make best efforts to secure any modifications that are needed.

VII. Exception for current borrowers and current loans

Because of the current circumstances faced by some borrowers, HPC believes that there should be a bright line differentiation in any regulation between borrowers already holding a covered loan and those who might wish to acquire one but who do not now hold one. Lenders dealing with existing borrowers covered by the Guidance and the Statement, as well as those covered by the regulations HPC is recommending, should be permitted more flexibility in refinancing and modifying covered loans than is in the Guidance, Statement or suggested regulations. Absent that flexibility, many borrowers who otherwise would be able to remain in their homes with modified or refinanced loans may be unable to make the payments under the existing loans and will lose their homes.

VIII. Uniformity and Damages

We urge the Board to utilize its authority to ensure that all lenders are subject to these regulations. In the interests of providing consumers, wherever they might live, equal benefits from these regulations, we would urge that the regulations state that all lenders may make covered loans under these regulations, and are not required to comply with any other law that prevents, significantly interferes with, or creates additional limitations on originating such loans.

The basis of the authority for the Board to promulgate these regulations is found in 15 U.S.C. 1639(l) where acts which are unfair or deceptive or abusive are the acts which the Board may prohibit by regulation. As the Board has said in earlier guidance, whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances. Similarly, 15 U.S.C. 1640 permits creditors to show they are not liable for enhanced damages if the damages in the specific case are not material. Consistent with those directions, the regulations should state that liability must be determined by analyzing the facts in each specific case, and that enhanced damages only be available if the analysis of those facts shows the damage to be material. If the regulations create a risk of liability to the lenders disproportionate to the damage to consumers, it will have a chilling effect on lending.

The regulations should specifically state that liability for enhanced damages must be determined by analyzing the facts and circumstances in each specific case. Where the violation concerns a practice that the Board has determined to be unfair, the regulation should require an analysis of (1) whether the consumer has in fact suffered an injury of type and due to the circumstances that the Board sought to address through the regulation, (2) whether the consumer could reasonably have avoided the injury, and (3) whether the borrower received countervailing benefits that outweighed the injury. Where the violation concerns a practice that the Board has determined to be deceptive, the regulation should require an analysis of (1) whether the representation, omission or practice misled the consumer, (2) whether the consumer's interpretation of the representation, omission or practice was reasonable, and (3) whether the misleading representation, omission, or practice affected the consumer's decisions regarding the loan.

Specifying in the regulation when a violation is material should not lessen compliance. The burden of proof to show that the violation was not material will rest with the creditor. Even if the creditor is successful in carrying that burden, the creditor will still be subject to damages under 15 U.S.C. 1640(a) (1)-(2) for the violation. However, by limiting enhanced damages to those individual situations where they are appropriate, the Board will greatly limit the potential chilling effect of the regulation on the availability of credit.

Thank you for considering the views of the Housing Policy Council. We look forward to working with the Federal Reserve Board to craft improved standards to protect consumers and to assure the continued availability of mortgage credit to deserving borrowers.

With best wishes,

John H. Dalton

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The Financial Services Roundtable