CONSUMER MORTGAGE COALITION

August 14, 2007

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave, NW
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Re: Docket No. OP-1288

Ms. Johnson:

The Consumer Mortgage Coalition (the "CMC"), a trade association of national residential mortgage lenders, servicers, and service-providers, appreciates the opportunity to submit comments in connection with the Board of Governors of the Federal Reserve System's ("Board") hearing on the Home Equity and Ownership Protection Act ("HOEPA") and on the adequacy of existing regulatory and legislative provisions in protecting the interests of consumers.

This comment is divided into five sections. First, it provides an executive summary of the issues discussed herein. Second, it describes, on a macro level, some of the principal reasons underlying the subprime market failures. Third, it addresses the Board's use of its regulatory authority to prohibit unfair and deceptive practices and outlines principles that should guide such use. Fourth, it responds to the Board's specific questions. Fifth, it identifies some of the changes and constraints needed to avoid this type of market dysfunction from re-occurring. And, it emphasizes the need to reform the disclosures consumers receive and rely on when shopping for a mortgage loan. Due to the length of this comment letter, a table of contents and executive summary follow.

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I. Executive Summary

The secondary mortgage market is one of the most significant developments in the history of modern finance. The flow of capital resulting from the secondary market has been a key factor in the record rates of homeownership our country has seen in recent years. However, the very characteristic of the secondary market that results in a flow of capital to lenders—the transfer of risk—enabled some less-capitalized entities to engage in mortgage lending and related transactions with an insufficient level of due diligence because they had very little, if any capital at risk. The result of these fundamental problems in the mortgage market was that the subprime mortgage market became dysfunctional. This letter discusses the reasons underlying the recent problems in the subprime mortgage market that have led to calls for regulatory action and, in particular, Board action. The reasons for the problems in the secondary market inform the comments below, and should inform any action taken by the Board to address these problems.

When considering how to use its authority under Section 129(l) of the Home Ownership and Equity Protection Act ("HOEPA"), the CMC urges the Board to recognize that the current difficulties in the subprime mortgage market result from industrial organization issues and are not the result of inaction or inattention by regulators or the result of specific types of products. Imprudent underwriting by some, primarily inadequately capitalized institutions put in the wrong hands products that can otherwise be beneficial in the right hands. Because the problems arise from organizational issues, meaningful and lasting solutions must address these issues. To ensure prudent underwriting, lenders and brokers must be required to meet minimum capitalization requirements. As discussed in more detail below, appropriate capital requirements act as a discipline which will lead to greater responsibility.

Nevertheless, to the extent the Board decides to use its Section 129(l) authority to adopt some or all of its proposals or other measures, the CMC urges the Board to acknowledge that lenders could face substantial and likely disproportionate liability exposure under Section 129(l). To avoid such inappropriate liability, the CMC urges the Board to adopt bright-line rules, if it implements any rules at all, so that responsible lenders can take reasonable steps to avoid unreasonable liability. The CMC also asks that the Board consider that risks of substantial liability could lead lenders to tighten underwriting standards beyond what is warranted, with the result that credit will be unavailable to many consumers who need and deserve it. A further contraction in the availability of credit will exacerbate, not alleviate, the current difficulties. The CMC urges the Board to act with caution.

The Board's authority under Section 129(l) is limited to addressing acts or practices that are "unfair" and/or "deceptive," and the legislative history of HOEPA indicates that those terms have the same meaning in HOEPA as they do in other law addressing unfair and deceptive acts and practices. In 2004, the Board, together with the FDIC, issued guidance regarding which acts and practices may be considered "unfair" and/or "deceptive." This letter reviews that guidance and suggests that the Board's authority under Section 129(l) is limited to addressing acts and practices that would be considered "unfair" and/or "deceptive under the Board's 2004 guidance. In this letter, the CMC also urges the Board to exercise its authority under Section 105(a) of the Truth in Lending Act ("TILA") to implement any new disclosure requirements. The CMC also urges the Board to consider the potential liability exposure its actions may create for lenders, including responsible lenders, and to act cautiously to avoid creating disproportionate or even draconian liability for lenders.

In exercising its authority under Sections 129(l) and 105(a), the CMC urges the Board to adopt a number of guiding principles to inform its actions. For example, any action the Board takes should not decrease the affordability or availability of mortgage credit to consumers, and should not exacerbate any increase in foreclosures by making it more difficult for consumers with current loans to refinance. The CMC urges the Board to keep the larger picture in mind when addressing particular problems relating to the subprime mortgage market.

This letter also comments on specific questions posed by the Board. In summary, the CMC provides the following comments in response to the Board's questions, for reasons discussed in greater detail below:

Prepayment Penalties

- Any rule limiting prepayment fee options in ARM loans should be limited only to the initial fixed rate period or three years, whichever is less.
- Enhanced disclosure of prepayment penalties would help address concerns about abuses.
- A prohibition or restriction on prepayment penalties limited to the initial fixed rate period should not have a significant impact on the availability or cost of mortgage credit.

Escrow for Taxes and Insurance on Subprime Loans

- It is not necessary that escrows for taxes and insurance be required for subprime loans.
- If taxes and insurance are not escrowed, this fact should be disclosed to consumers.
- Requiring disclosure of (1) the costs of taxes and insurance, and (2) whether or not taxes and insurance will be escrowed would not negatively impact the availability or cost of mortgage credit to subprime borrowers.

Stated Income or "Low Doc" Loans

- Stated income loans serve important purposes and provide important benefits to certain populations and should not be prohibited.
- Creating specific requirements limiting stated income loans, particularly if tied to one factor such as loan-to-value ratio, would be inappropriate.
- If stated income loans are restricted or prohibited, certain borrowers, such as many borrowers from immigrant communities, may pay more for, or may be unable to obtain, mortgage credit.

- A disclosure that a stated income loan is being offered and an estimate of the price impact of the stated income option relative to a fully-document option would be appropriate, provided the timing of the disclosure is efficient and at a logical point in the transaction.

Borrower's Ability to Repay

- Notwithstanding the requirements in the Statement on Subprime Lending regarding underwriting standards for certain types of loans, the CMC continues to believe that lenders should not be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments.
- Debt-to-income ratio is only one factor in determining whether a borrower can repay a loan, and any presumption of ability or inability to repay should be based on a variety of factors and lenders should have flexibility in analyzing such factors.
- More effective disclosures would enable borrowers to make better decisions regarding whether they can repay particular loans.
- Requiring that lenders underwrite to a fully indexed rate would prove disastrous to consumers, both in terms of the availability and affordability of credit.

Additionally, this letter provides additional recommendations regarding how the Board may use its authority under Section 129(l) and Section 105(a). These recommendations are divided into two categories: recommendations that can be implemented relatively quickly by the Board, and recommendations that involve more comprehensive action and are more long-term solutions designed to prevent the current problems from recurring. These recommendations are as follows:

Recommendations the Board Can Address Now

- Do not lower the HOEPA thresholds.
- Require appraisers to report instances of pressure to adjust appraisal values and create an operational structure to receive and process such reports.
- Make the broker fees transparent by requiring brokers to disclose how they are compensated for the transaction and the source of that compensation (i.e., borrower-paid, lender-paid, and yield spread premiums) and the amount of such compensation.

Recommendations the Board Can Address in the Long Term

- Reduce the separation between origination and investment by (1) creating capital requirements for entities participating in the origination process; and (2) impose constraints on collateralized debt obligation managers and ratings agencies to make the secondary market more transparent.
- Rationalize mortgage disclosures so that borrowers receive one coherent and digestible disclosure that provides the information borrowers need to make informed decisions.

- Engage in additional examination of the role the rating agencies play in the secondary market, including the problems that have arisen in the subprime market, and how this role can be improved.

The CMC appreciates the opportunity to submit these comments, and commends the Board for its ongoing efforts to benefit consumers.

II. The Mortgage Market – What Went Wrong

In the simplest terms, much of the problem in the subprime mortgage market was that many of those responsible for making loans had too little financial interest in the performance of those loans and many of those with financial interest in the loans had too little involvement in the how the loans were made. Those well capitalized firms, such as the major banks and other lenders who chose to remain in the market, found their ability to enforce underwriting and other standards were limited by competitive pressures.

The capital markets are a wonderful vehicle for transferring risk and providing capital to lending activities. But when the transfer of risk leads to a lack of diligence, markets become dysfunctional.

For much of the last century, it was the savings and loan associations, or "thrifts," that provided the bulk of the mortgage loans. In the traditional lending model, the thrift raised money from deposits from its customers and then lent that money to other customers to finance home purchases. If the borrower was unable to make its mortgage payments, the thrift would suffer the consequences directly. With the advent of deposit insurance, the depositors were protected and the only risk was to the capital of the institution. With limited risk management capability and limited ability to raise deposits outside of their home markets, thrifts were subject to a boom and bust cycle that meant that capital flows for mortgage lending were uneven.

The secondary market for mortgages was developed to separate the process of creating loans from the capital required to fund the loans. In the secondary market, the risk of borrower default would be transferred to an investor. Investors for the most part however, were unwilling to take on the risk of borrowers whose credit characteristics were unknown to them. To facilitate the availability of capital, Ginnie Mae, Fannie Mae and Freddie Mac were established. Without getting into the full history or details, the main impact of these agencies was to take on the credit risk of borrowers and allow other financial market participants to provide the funding for the mortgages.

These agencies, as well as the mortgage insurance companies, bore the primary risk of default. To protect themselves they established underwriting criteria for the types of loans they would own or guarantee. While they did not originate loans (and are prohibited from doing so), they are actively involved in monitoring the process of loan origination.

To further insure the performance of purchased loans, the mortgage market has developed the practice of requiring representations and warranties on purchased loans. These representations and warranties are designed to insure that the loans sold meet the guidelines of the purchasers. This is necessary because mortgage market participants have long recognized that there is substantial risk in acquiring loans originated by someone else. Representations and warranties are only valuable, however, if the providers of those promises have sufficient capital to back up their obligations to repurchase loans subsequently determined to be inconsistent with the representations and warranties.

The current secondary market for non-agency mortgages, including subprime mortgages, has many participants and a great separation of the origination process from the investment process. Each participant has a specialized role. Specialization serves the market well, as it allows each function to be performed efficiently. Specialization, however, also means that risk creation and risk taking are separated.

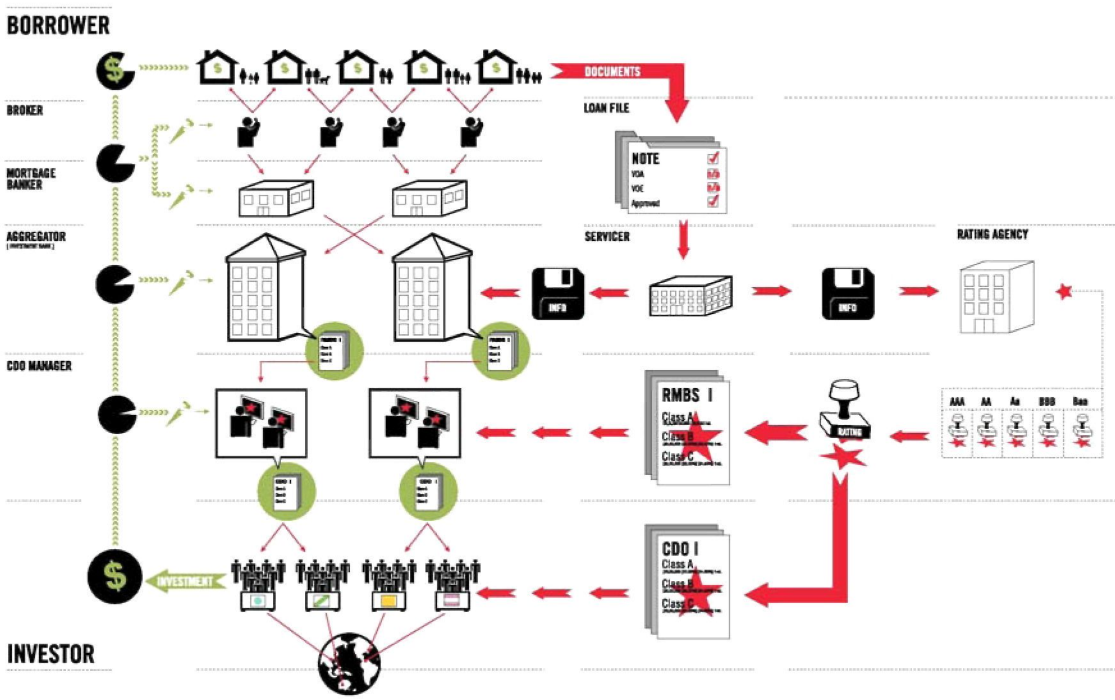
In simplified form, the process can be described as involving:

- Borrowers—who want a loan for home purchase or refinance;
- Brokers—who work with the borrowers and lenders to arrange a loan;
- Mortgage bankers—who fund and then sell the loans;
- Aggregators—(often a broker-dealer) who buys and then packages the loans into a securitization that are sold to investors;
- CDO (Collateralized debt obligation) managers—who buy portfolios of mortgage-backed securities for a trust that issues debt backed by those securities; and
- Investors—who buy the CDO debt.

Three additional participants are also involved:

- Servicers—that keep the loan documents and collect the payments from the borrower;
- Rating agencies—that place a rating on the mortgage securities and on the CDO debt; and
- Investment banks—that act as underwriters and placement agents for the mortgage securities and the CDO debt.

This can be illustrated as follows:



This description is obviously a simplification of a more complex process. For example, CDOs were not the only purchasers of risk in the subprime market. They were, however, a dominant player, with some estimating that they bought about 70% of the lower rated classes of subprime mortgage securitizations. What is clear even from this simplified process is that the investor in the CDO bond has attenuated contact with the borrower. While this process allows access to capital from global investors, it is not sufficiently close to insure a sound mortgage origination process, *without some built-in discipline or constraints*.

The problem with the current secondary market, especially for subprime loans, was that the lack of capital on the line resulted in too few entities shutting the door on uneconomic loans. Rather than conducting their analysis, the ultimate CDO investors, to a large extent, relied on the first loss investor, the rating agencies, and the CDO managers. And, in some cases, that reliance was misplaced.

In the secondary market, mortgage transactions are generally structured so that the lender or initial purchaser would take the first slice of credit risk and thus insure that loans were originated properly. In the subprime market, however, it was possible to originate loans and sell them at such a high price that even if the mortgage banker or aggregator retained a first loss piece (or residual) the transaction could be profitable even if the loans did not perform well. Furthermore, the terms of the residuals were set so that the owner of the residual might receive a substantial portion of their cash flows before the full extent of losses were known.

Rating agencies set criteria to establish credit enhancement levels that ultimately lead to ratings on bonds. The rating agencies generally rely on historical statistical analysis to set ratings. The rating agencies also generally rely on numeric descriptions of loans like loan-to-value ratios and debt-to-income ratios to make their determinations. While rating agencies do review the origination practices of the major mortgage banks, rating agencies generally do not review loans files or "re-underwrite" loans. Rating agencies also do not share in the economic costs of loan defaults. The rating agencies methodology allowed for the inclusion of loans of dubious quality into subprime mortgage pools, including low documentation loans for borrowers with poor payment histories without the offsetting requirement of high down payments.

The rating agencies also established criteria for collateralized debt obligations that allowed CDO managers to produce very highly leveraged portfolios of subprime mortgage securities. The basic mechanism for this was a model that predicted that the performance of subprime mortgage pools were not likely to be highly correlated. That is, defaults in one pool were not likely to occur at the same time as defaults in another pool. This assumption was at best optimistic and most likely just wrong.

In the CDO market the rating agencies have a unique position. In most of their other ratings business, a company or a transaction already exists or is likely to occur and the rating agency reviews that company or transaction and establishes ratings. In the CDO market, the criteria of the rating agency determine whether or not the transaction will occur. A CDO is like a financial institution. It buys assets and issues debt. If the rating agency establishes criteria that allow the institution to borrow money at a low enough rate or at high enough leverage, then the CDO can purchase assets more competitively than other financial institutions. If the CDO has a higher cost of debt or lower leverage, than it will be at a disadvantage to other buyers and will not be brought into existence. If the CDO is created, the rating agency is compensated for its ratings. If the CDO is not created, there is no compensation. This compensation structure creates incentives that make it very difficult to remain wholly objective.

CDO investors also relied upon the CDO manager to guide them in the dangerous waters of mortgage investing. Here again investors were not well served by the compensation scheme. In many cases CDO managers receive fees that are independent of the performance of the deals they manage. While CDO managers sometimes keep an equity interest in the transactions they manage, often the deals are structured in such a way that the equity of the deal can return the initial equity investment even if some of the bonds have losses. Moreover, many of the CDOs were managed by start-up firms with little or no capital at risk.

CDO investors were not blind to the additional risks posed by CDO investing. CDOs generally provided higher yields than similarly rated bonds, and investors know that with higher returns comes higher incremental risk. It is not unusual, however, for investors not to realize the magnitude of additional risk they bear for a modest incremental return.

Ultimately, it is investors who will bear the losses and investors must bear the bulk of the burden in evaluating their investments. Nevertheless, despite the warning signs as to the problems and risk of investing in subprime mortgages, investors continued to invest in this sector as the risks grew and reward decreased.

The mortgage market seems to be particularly susceptible to this problem. Over the last few decades, investors have been enticed into mortgage investments that offer some extra yield in exchange for substantially greater risk. This has occurred with mortgages funded with short term debt, mortgages funded with long term, non-callable debt, interest-only bonds, inverse floaters, capped floaters, and now with the subprime mortgages and CDOs. Each time, investors were willing to invest in bonds that would produce higher income if markets remained stable, but could produce substantial losses if market conditions changed. And, each time, there were investors who were willing to make the investments without performing their own diligent analysis of risk and reward.

In almost all case the same level of income could have been obtained at a lower risk level, but only if the investment were structured with the risk presented in a more transparent manner. For example, rather than buying mortgages funded with non-callable debt, an investor could just sell options. In many cases, however, an investor might be prohibited from utilizing that strategy or the more transparent strategy would be prohibited by management, regulators or other interested parties. Once investors are blind to the level of risk in an investment by choosing a form that obfuscates risk, market forces will work to increase the risk of those investments beyond the expectations of the investors.

Thus, the primary problem facing the subprime market is a failure of industrial organization. The key risk takers in the market, the CDO investor, were too far from the origination process. Moreover, they did not even realize that they were the key risk takers. At the origination end, without the discipline of a skeptical buyer, abuses grew. The buyer was not sufficiently concerned with the process of loan origination and the broker was not subject to sufficient constraints. Stories abound on the amount of fraud that has occurred. The mortgage investor was like an absentee landlord. Without supervision and oversight, there is no constraint on a volume-driven originator.

An unintended consequence of the readily available credit provided largely by the less well-capitalized mortgage market participants was that many borrowers were able to buy homes that they otherwise could not afford. This served to increase home prices. Once home prices stopped rising, the inadequacy of the loan underwriting standards of some has become clear to all market participants.

Now, the current tightening of credit standards is exacerbating the adverse consequences of the subprime mortgage boom. First, many borrowers who have been current on their loan payments are facing a steep increase in payments as they approach reset. With tighter credit standards it is more difficult for them to refinance, increasing the risk of default. Second, with the decline in home prices, the opportunity for a borrower to sell their home is reduced, thereby increasing the possibility of higher foreclosures. These developments are affecting even those who maintained disciplined lending practices.

III. The Board's Use of Section 129(l) of TILA

The CMC applauds the Board's consideration of using its authority under Section 129(l) of HOEPA to limit unfair and deceptive practices in mortgage lending. The Board's authority under Section 129(l) is limited to addressing acts or practices that are "unfair" and/or "deceptive," and the CMC believes that the Board can exercise this authority to address acts and practices that truly are unfair or deceptive. The CMC urges the Board to follow its 2004 guidance on unfair and deceptive trade practices in determining whether an act or practice is "unfair" or "deceptive" and, therefore, subject to the limited authorization of Section 129(l).

The CMC also recommends that the Board consider using its broad authority under Section 105(a) of the Truth in Lending Act ("TILA") to require any new disclosures or modify existing disclosure requirements. Whereas Section 129(l) does not authorize new disclosure requirements, Section 105(a) provides broad authority to create such requirements.

Moreover, the CMC urges the Board to recognize that any new requirements create potential liability for lenders who may fail to comply in some respect. As discussed in greater detail below, that potential liability can be draconian in some instances. The CMC urges the Board to clarify in each instance of a new requirement the source of the Board's authority in promulgating the rule, and to clarify that inherently individualized inquiries cannot be resolved on a class-wide basis. The CMC believes that while liability may be appropriate for failures to comply with Board regulations, any liability must be proportionate to the compliance failure. Disproportionate liability will lead many lenders—including many responsible lenders—to withdraw from the market, likely resulting in a reduction in the availability and affordability of credit and thereby harming consumers.

Additionally, if the Board decides to exercise its authority under section 129(l) to limit the use of stated-income loans, require underwriting to a fully-indexed rate, and/or to create a standard for presuming a borrower's ability to repay a loan, the CMC urges the Board to clarify that such rules preempt inconsistent state laws. Section 111 of TILA provides that state laws that are "inconsistent" with TILA's provisions are preempted.[1] A state law is inconsistent with federal law if the state law requires a creditor to take actions that contradict the requirements of federal law, and is contradictory if it gives a term a different meaning than under federal law.[2] Thus, if a state defines terms such as "fully-indexed rate" or "repayment ability" differently than the Board defines them, such state laws are preempted by the Board's regulations under TILA.[3] The CMC urges the Board

[1] 15 U.S.C. 1610.

[2] *See, e.g.*, 12 C.F.R. § 226.28(a).

[3] States already have adopted widely divergent standards for these terms. For example, states have incorporated very different standards for determining repayment ability. *See, e.g.*, Colo. Rev. Stat. § 5-3.5-103(1)(b) (looking to income, obligations and employment); 38 Ill. Code R. 345.20 (presumption if DTI does not exceed 50% and requiring verification through various documentation); Nev. Rev. Stat. §

to clarify that state laws that define fully-indexed, repayment ability, and other terms used in the Board's regulations differently than the Board defines them, such state laws are preempted.[4]

The CMC also notes that the Board, along with the other federal banking agencies, recently released the final Statement on Subprime Mortgage Lending ("Subprime Lending Statement"). This Statement provides guidance to lenders subject to the federal banking agencies' authority regarding subprime lending practices. The statement is not applicable, however, to other entities and therefore creates an uneven playing field for mortgage lenders, despite the recent issuance by the Conference of Bank Supervisors, the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators of a statement mirroring the Subprime Lending Statement and urging the states to adopt such statement. While the CMC continues to have reservations about some requirements of the Subprime Lending Statement (e.g., the requirement regarding the fully-indexed rate), the CMC believes it is best for any such requirements to be applied uniformly throughout the industry rather than only to those lenders subject to the authority of one of the federal banking agencies. The CMC suggests that the Board exercise its authority under Sections 105(a) and 129(l) to apply the requirements of the Subprime Lending Statement uniformly throughout the industry.

Finally, in addition to responding to the specific questions posed by the Board, the CMC recommends additional ways in which the Board can exercise its authority under Section 129(l) or 105(a) to curb practices that are potentially harmful to consumers. The CMC looks forward to working with the Board to shape approaches to curb abusive lending practices.

The CMC suggests that any action taken by the Board regarding subprime credit must be based on a clear picture of the subprime credit market. In particular, the CMC recommends that any action by the Board reflect (1) the important benefits subprime mortgage credit confers on consumers, and (2) an accurate assessment of the subprime credit market and how the market has responded to the loose underwriting by some lenders. To that end, we refer you to the CMC's extended discussion of this in its recent comment letter regarding the then-proposed inter-agency Statement on Subprime Lending. In particular we urge the Board to give due consideration to the following:

- Subprime mortgage products can provide substantial benefits to consumers resulting in expanded home ownership opportunities.

598D.100(1)(b) (looking to assets); Ohio Admin. Code 109:4-3-19(A) (looking to a wide variety of factors).

4 The CMC acknowledges that state laws that are more "protective" and not inconsistent are not preempted by TILA. Nevertheless, state laws that define terms such as "fully-indexed rate" and "repayment ability" in such a way as to allow fewer borrowers to qualify for a loan are not more protective of borrowers' interests. Restricting the availability of credit harms, rather than helps, consumers. More stringent state laws that restrict consumer access to mortgage credit are not more protective, just more restrictive. State laws that are inconsistent with Board regulations and are not more protective are preempted under section 111 of TILA.

- The market has already taken significant steps to react to the default environment.
- Implementation of the Nontraditional Mortgage Product Guidance and the Subprime Statement is well underway among federally chartered lenders.

A. Guiding Principles and Recommendations

Before addressing specific issues identified in the Board's hearing notice, the CMC respectfully recommends that any action taken by the Board be based on the following principles:

1. Loan performance as well as market discipline has caused lenders to tighten underwriting standards and that many imprudent lenders have closed their doors. In other words practices consumer advocates are asking the Board to address have already been addressed to a great extent by the market.[5]

2. Actions that decrease the availability or affordability of credit will result in more foreclosures, not less—leading to a "Herbert Hoover effect" on the economy. If mortgage credit is less available and less affordable, many of borrowers seeking to refinance before a payment adjustment date may be unable to refinance.

3. Consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Actions that limit choice or stymie new product development reduce the ability of the market to serve consumers. Consumers will benefit if the Board allows for a range of solutions to the issues presented rather than mandating one particular approach.

4. Consumers must be able to make informed decisions regarding the products that are most appropriate for their particular circumstances. As recommended above, simplified, understandable disclosures of key loan information would enable consumers to better understand their credit obligations and to more effectively comparison shop for loans, thereby enhancing competition which would benefit consumers. Any new disclosure requirements must be streamlined, standardized and uniformly applied to all lenders, such as through Regulation Z. Anything less will result in increased consumer confusion, less effective comparison shopping, and competitive disadvantages between lenders.

5. The best way to address pricing and other concerns in the subprime market is to encourage more competition and more entry into the market, not less. Only competition will effectively reduce prices and increase consumer choice. To this

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[5] *See, e.g.*, William Poole, President, Federal Reserve Bank of St. Louis, *Reputation and the Non-Prime Mortgage Market*, Address to the St. Louis Association of Real Estate Professionals, (July 20, 2007) ("Until we receive clear evidence that basically sound financial decisions and arrangements were disrupted by erratic and irrational market forces, I believe we should conclude that this year's markets punished mostly bad actors and/or poor lending practices.") *available at* http://www.stlouisfed.org/news/speeches/2007/07_20_07.html.

end, any substantive restrictions on products or practices must be applicable to all lenders equally.

6. As discussed above, many of the current problems in the subprime mortgage market are the result of industrial organization. Effective and lasting solutions must address these industrial organization issues.

7. In a competitive market, the least constrained participant will drive the market. Therefore, limitations need to be applied consistently to allow the broadest range of competition while assuring appropriate practices.

8. To the extent additional limitations or restrictions are imposed on subprime lending products or on underwriting or disclosure practices, these limitations and restrictions should be applied only to that segment of the market—the subprime market—giving rise to the concerns. There is no need for further restrictions on the prime mortgage market.

9. The Board, in partnership with the other federal banking agencies, industry, and advocacy groups, can play an important role in educating consumers—and helping consumers understand that they must educate themselves—regarding the nature and impact of home-secured credit. Ultimately, the key to minimizing negative impact of subprime credit is helping consumers understand the products available to them. Rationalizing mortgage disclosures is essential to aid consumers in understanding the mortgage products available to them.

Additionally, the CMC urges the Board to adopt the following recommendation in any actions it takes:

1. The Board can ensure consistent behavior by all mortgage originators by adopting regulations applicable to all lenders (and as appropriate, brokers) implementing the requirements of the Subprime Lending Statement. Currently, the Statement applies only to lenders subject to the authority of the federal banking agencies. This places entities subject to the federal banking agencies' authority at a competitive disadvantage vis-a-vis other lenders and fails to fully address the problem. Although the recent issuance by the Conference of Bank Supervisors ("CSBS"), the American Association of Residential Mortgage Regulators ("AARMR"), and the National Association of Consumer Credit Administrators of a statement mirroring the Subprime Lending Statement and urging the states to adopt such statement is commendable, the fact is that many states, even if they adopt the parallel guidance, do not have the enforcement mechanism to assure compliance with the Statement.[6]

2. Broker fees should be made transparent to borrowers. To this end, brokers should provide clear, meaningful information about how and how much the broker is

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6 We note that AARMR and CSBS released model examination guidelines implementing their version of the Subprime Lending Statement. *See, e.g.*, http://www.aarmr.org/pdf/MEGs%20-%20Version%201.pdf (July 31, 2007).

compensated. Additionally, the Board should clarify that if a lender provides a similar disclosure, the lender is not liable for a broker's failure to provide such a disclosure. The CMC believes the Board has the authority to require these disclosures now under its Section 129(l) authority. Additionally, Brokers should be subject to the same mechanisms to protect consumers as are lenders. The CMC urges the Board to take part in broader reform which would require brokers (1) to be licensed and be permitted to engage in brokering activities only if in good standing in the applicable jurisdiction; (2) to register with a nationwide database that provides information about the broker, such as licensing, disciplinary or legal actions, etc.; (3) to have increased minimum net worth requirements and bond/insurance requirements to cover borrower losses or claims; and (4) be required to maintain and submit for approval fair lending plans (similar, for example, to the fair lending plan the New York Banking Department requires for licensed mortgage lenders).

3. One of the main reasons for the dysfunction in the subprime market was that too many entities participating in that market had very little, if any capital at risk. The surest way to prevent similar market dysfunction in the future is to require that all participants in the mortgage lending process (e.g., brokers, appraisers, etc.) either meet specific capital requirements themselves, or align themselves (as agent or otherwise) with an entity that meets such capital requirements. Owners of thinly capitalized entities have little to lose if the entity engages in questionable business practices. On the other hand, owners of capitalized entities are more focused on the long-term survival of the entity, and generally focus much more on long-term prospects, including how the entity's reputation for fairness affects such prospects.[7] Requiring capitalization, or alignment with capital, will both engage market forces to ensure that all participants in the mortgage market have a greater incentive to act fairly, and ensure that borrowers subjected to unfair or deceptive practices have a source from which they can seek recourse. "[A] lasting improvement in the functioning of the non-prime market is most likely if we correct the fundamental problems that seem to be causing the greatest difficulties, rather than attacking mere symptoms of the problem."[8]

4. Since no accepted bright-line definition of "subprime" exists, the CMC recommends that lenders be permitted to define subprime through prudent underwriting guidelines. Indeed, the federal banking agencies had difficulty defining "subprime" more precisely than this in their 2001 Expanded Guidance. While the CMC believes that specific "subprime" standards are inappropriate, if the Board concludes thresholds should be set, the CMC urges the Board to adopt a bright-line rule. Additionally, to avoid being over-inclusive and applying the label of "subprime" to loans that are not "subprime" by any reasonable definition, any new thresholds should be below the HOEPA thresholds but above the Home Mortgage Disclosure Act ("HMDA") price-reporting cutoff. The CMC suggests

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7 *See* Poole, *supra* note 5.

8 *Id.*

that a loan be considered "subprime" only if (1) it exceeds a threshold at 3 percentage points below the HOEPA threshold,[9] and (2) the loan is either a non-traditional loan (as defined in the Agencies' non-traditional loan guidance) or a "payment shock" loan. A loan is a "payment shock" loan if the initial rate is more than a 3 percent discount from the fully-indexed rate, and either (a) if the rate can increase more than 6 percent during the life of the loan, or (b) if the rate can increase more than 2 percent in any year during the loan's initial four years. Thus, if the difference between the loan's annual percentage rate (APR) and the yield on Treasury securities having comparable periods of maturity is equal to or greater than 4 percentage points for loans secured by a first lien on a dwelling, or equal to or greater than 6 percentage points for loans secured by a subordinate lien, and if the loan is a non-traditional loan or payment shock loan, the loan would regarded as subprime. In any event, if the Board adopts rules applying to subprime loans, the definition of subprime loans must be clearly and objectively defined so that lenders can know in advance which loans are subject to the rules and so that the definition of subprime is not left to costly and imprecise litigation.

5. Additionally, any additional limitations or restrictions on subprime lending products or on underwriting or disclosure practices should be narrowly tailored to address only those subprime products that give rise to the Board's concerns, subprime products with very low, below-market teaser rates that expire in relatively short time frames. Any restrictions on credit should apply only to these products, and not to other subprime credit products.

6. The Board should not take action with respect to "jumbo" loans, as defined by Fannie Mae. Because they have higher incomes and thus a higher degree of sophistication, borrowers who obtain jumbo loans do not need as much protection as borrowers of lesser amounts. Borrowers eligible for jumbo loans should have the freedom to choose from the widest range of financial options.

7. Any action taken by the Board will be most effective it is equally applicable to lenders and, as appropriate, brokers in all 50 states. States laws or regulations that establish requirements different than those established by the Board would be inconsistent with the Board's regulations and would undermine the Board's efforts at addressing key issues. The Board should clarify that its actions preempt any inconsistent state laws or regulations.

8. Complaints made and concerns raised by consumers should be provided to the regulatory agency with jurisdiction over the entity that is the subject of the complaint or concern. The Board, in cooperation with the other federal banking agencies and with state regulators, can create a system whereby complaints made to state regulators are routed to the appropriate federal agency, and vice versa.

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[9] Home-Equity Lines of Credit (HELOCs) are exempted from HOEPA's requirements. The CMC urges the Board similarly to exempt HELOCs from those loans subject to the "subprime" threshold.

B. The Board's Authority to Address Lending Practices

TILA, as amended by HOEPA, contains two different provisions that authorize the Board to take action against abusive lending practices. These two sections—Section 129(l) and Section 105(a)—are discussed below.

1. The Board's Authority Under Section 129(l)

The Board has authority under HOEPA to establish substantive requirements with respect to abusive mortgage lending applicable to all lenders, not just those subject to the authority of the Board or of another federal banking agency. HOEPA provides:

> The Board, by regulation or order, shall prohibit acts or practices in connection with –
>
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
>
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[10]

By the plain language of the statute, the Board's authority under Section 129(l) is not limited to loans referred to in Section 103(aa), nor is it limited to actions by "creditors" as that term is defined in TILA.[11] Rather, the Board is authorized to prohibit any acts or practices "in connection with" mortgage loans the Board determines to be unfair or deceptive.

The Board's authority under Section 129(l) is not unlimited, however. The plain language of the statute limits the Board's authority to address either (1) loans that are "unfair," "deceptive," or intended to evade HOEPA's requirements; or (2) refinancings that are abusive or not in the best interests of the borrower. Unless a lending practice falls within one of these categories, the Board lacks authority to address it under Section 129(l).

Additionally, the legislative history of Section 129(l) emphasizes that the Board is to take care in using this authority to ensure it does not inadvertently limit the availability of credit. While Congress was concerned with abusive lending practices in enacting HOEPA, Congress also recognized that the imposition of numerous specific prohibitions in an area as complex as residential mortgage lending could prohibit transactions that

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10 TILA § 129(l)(2), *codified at* 15 U.S.C. § 1639(l)(2).

11 We note that the Board's use of its authority under Section 129(l)(2) would have no impact on the definition of a loan referred to in § 103(aa) or on the thresholds described therein. This is appropriate because the Board's prohibition of unfair and deceptive practices should not be tied to loans that meet the § 103(aa) definition.

benefit consumers. Concerned that such specific prohibitions would preclude refinancing and result in "endless litigation," Senator Riegle—then chairman of the Senate Banking Committee—introduced Amendment 1524 which replaced the specific prohibitions with the "discretionary regulatory authority" contained in Section 129(l).[12] Indeed, Section 129(l) was intended "to make sure this legislation [HOEPA] does not have the unintended consequence of making less fair credit available."[13] Any actions that decrease the availability of credit are inconsistent with the congressional intent of Section 129(l).

2. The Board's UDAP Guidance

Congress has instructed the Board when determining whether a practice is "unfair" or "deceptive" to look "to the standards employed for interpreting state unfair and deceptive trade practices acts and the Federal Unfair and Deceptive Practices Act (15 U.S.C. § 45(a)(1))."[14] The Board, together with the Federal Deposit Insurance Corporation ("FDIC"), has provided comprehensive guidance regarding what it considers to be unfair or deceptive acts or practices (UDAP).[15] Because Congress has directed the Board to look to UDAP guidance in exercising its authority under Section 129(l), the CMC urges the Board to follow its previous UDAP guidance.

The Board has recognized that the determination of whether an act or practice is unfair or deceptive frequently depends on the specific facts or circumstances involved: "Whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances."[16] The Board also has clarified that the standards for "unfairness" and "deceptiveness" are different.[17] These two standards are discussed in detail below. The CMC suggests that, in light of the congressional intent underlying Section 129(l), it would be inappropriate for the Board to take actions to address any act or practice that does not satisfy the Board's tests of "unfairness" or "deceptiveness" discussed below.

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12 140 Cong. Rec. S3056 (Mar. 16, 1994); *see also id.* S3044.

13 *Id.* S3175 (Mar. 17, 1994).

14 H.R. Conf. Rep. 103-652 (1994), 1994 U.S.C.C.A.N. 1977, 1992.

15 Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, *Unfair or Deceptive Acts or Practices by State-Chartered Banks* (Mar. 11, 2004) (hereinafter "UDAP Guidance"), *available at* http://www.federalreserve.gov/BoardDocs/Press/bcreg/2004/20040311/attachment.pdf. The Board and FDIC based their guidance on the FTC's previous guidance. *See* FTC *Policy Statement on Unfairness* (December 17, 1980); *FTC Policy Statement on Deception* (October 14, 1983)

16 *Id.* at 2.

17 *Id.*

Guidance Regarding "Unfairness"

In determining whether a specific act or practice is unfair, the Board has explained that it employs a three-part test:

> An act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, <u>and</u> (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair.[18]

The Board has indicated that an act or practice is deemed unfair only if it satisfies <u>all</u> three of these criteria.

While the Board will consider an act or practice that causes "substantial injury" to consumers, the Board clarified that "[t]rivial or merely speculative harms are typically insufficient for a finding of substantial injury."[19]

Additionally, an act or practice is not considered unfair if the consumer reasonably can avoid injury. The Board has indicated that there are circumstances under which a consumer may be prevented from reasonably avoiding injury, such as where an act or practice interferes with a consumer's ability effectively to make decisions, where material information is withheld until after a consumer makes a decision, or where undue influence or coercion is employed. Importantly, however, the Board has clarified that it "*will not second-guess the wisdom of particular consumer decisions*."[20] Instead, the Board will consider whether a particular act or practice "unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making."[21] Thus, the touchstone is whether the consumer is free to make his or her own decisions. If the act or practice does not impede a consumer's ability to make decisions, the act or practice is not "unfair" for purposes of a UDAP analysis irrespective of whether the Board agrees with the consumer's decision.

Furthermore, the Board explained that "[t]o be unfair, the act or practice must be injurious in its net effects—that is, the injury must not be outweighed by any offsetting consumer or competitive benefits that are also produced by the act or practice." Importantly, the Board further explained that "[o]ffsetting benefits may include lower prices or a wider availability of products and services."[22] Additionally, the Board has explained that --

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18 *Id.* (emphasis in original).

19 *Id.* at 3.

20 *Id.* (emphasis added).

21 *Id.*

22 *Id.*

> Costs that would be incurred for remedies or measures to prevent the injury are also taken into account in determining whether an act or practice is unfair. These costs may include the costs to the bank in taking preventive measures and the costs to society as a whole of any increased burden and similar matters.[23]

Finally, the Board explained that public policy considerations may factor into the unfairness analysis, although such considerations "will not serve as the primary basis for determining that an act or practice is unfair."[24] For example, "the fact that a particular practice is affirmatively allowed by statute may be considered as evidence that the practice is not unfair."[25]

Guidance Regarding "Deceptiveness"

The Board also follows a three-part test in determining whether a representation, act or omission is deceptive:

> First, the representation, omission, or practice must mislead or be likely to mislead the consumer. Second, the consumer's interpretation of the representation, omission, or practice must be reasonable under the circumstances. Lastly, the misleading representation, omission, or practice must be material.[26]

In determining whether a representation, omission or practice is deceptive, the Board has explained it will evaluate it in context.[27] Additionally, a representation, omission or practice is deceptive for purposes of a UDAP analysis only if "the consumer's expectations or interpretation are reasonable in light of the claims made."[28] Finally, the Board has explained that a representation, omission or practice is material "if it is likely to affect a consumer's decision regarding a product or service."[29]

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23 *Id.*

24 *Id.* at 3-4.

25 *Id.*

26 *Id.* at 4.

27 *Id.*

28 *Id.*

29 *Id.* at 5.

3. The Board's Guidance Regarding "Abusive" Lending Practices

The Board, along with the other federal banking agencies, also has provided guidance on what constitutes "abusive" or "predatory" practices in subprime lending. In the Interagency Guidance on Nontraditional Mortgage Product Risks ("Nontraditional Mortgage Guidance"), the agencies reiterated that the 2001 Expanded Guidance contains the agencies' guidance regarding what constitutes "abusive" practices.[30] The Expanded Guidance rightly acknowledges that "subprime lending that is appropriately underwritten, priced and administered" is not abusive.[31] The agencies then note that generally abusive practices involve one or more of the following elements:

- "Making unafforadable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
- "Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ('loan flipping'); or
- "Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower."[32]

The CMC urges the Board to follow its existing guidance and categorize a practice as abusive only if the subprime loan (1) is unaffordable and "based on the assets of the borrower" rather than a prudent assessment of the borrower's ability to repay; (2) involves "loan flipping"; and/or (3) involves fraud or deception.

The CMC also urges the Board to follow its UDAP guidance in refusing to "second-guess the wisdom of particular consumer decisions."[33] As is discussed in greater detail below, borrowers make sensible decisions regarding the size of house they buy based on prospects for future income.[34] The CMC suggests it would be inappropriate for the Board to second-guess borrowers' sensible decisions.

4. "Materiality" Under Section 129

As the Board is aware, violations of the requirements of Section 129 are subject to far greater damages than are violations of other requirements of TILA. Unlike other TILA provisions, a violation of a requirement of Section 129 may be subject to enhanced damages and even the most draconian remedy available under TILA: an extended right of rescission. These heightened damages threaten to span substantial amounts of

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30 71 Fed. Reg. 58609, 58614 (Oct. 4, 2006); *see also Statement on Subprime Lending*, 72 Fed. Reg. 37569, 37570 (July 10, 2007).

31 *Expanded Guidance for Subprime Lending Programs*, at 10 (2001) (hereinafter "Expanded Guidance").

32 *Id.* at 10-11.

33 *See supra* note 14 and accompanying text.

34 *See infra* note 46 and accompanying text.

litigation, including vexatious litigation. As noted above, actions that would result in "endless litigation" are inconsistent with the congressional intent of Section 129(l).[35] Additionally, the costs of such punishments and litigation would drive substantial numbers of lenders from the market, reducing the availability and affordability of mortgage credit and thereby harming consumers.

Nevertheless, these draconian punishments are available only when a failure to comply is "material." Under Section 130(a)(4) of TILA, a creditor is liable for enhanced damages unless "the creditor demonstrates that the failure to comply is not material." A failure to provide "material" disclosures under Sections 103(u) or 129(j) also could be considered to extend the right of rescission. Moreover, any failure to comply with a requirement adopted under Section 129(l) could be viewed as an unfair or deceptive practice under state UDAP laws—and subject a lender to the substantial damages provided by state UDAP laws.

In its UDAP guidance, the Board has explained that the analysis of whether a particular act or practice is unfair or deceptive is an inherently individualized one: "Whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances."[36] In light of the fact-dependent nature of the evaluation of unfairness and deceptiveness, and the Board's previous guidance to that effect, a failure to comply should be determined to be "material" only on an individual (i.e., not on a class-wide) basis. The CMC requests that the Board clarify that the evaluation of "materiality" can be made only on an individual basis.

Furthermore, Section 129(j) by its terms applies only to contractual "provisions" prohibited by Section 129. It does not apply to any lending practices the Board might prohibit under its Section 129(l) authority. The CMC requests that the Board clarify that Section 129(j) does not apply to any regulations the Board promulgates relating to lending practices more generally (and solely with respect to loans defined in Section 103(aa) under Section 129(l).

5. The Board's Authority Under TILA Section 105(a)

In addition to Section 129(l), the Board has broad authority to require disclosures under Section 105(a) of TILA. Section 105(a), codified at 15 U.S.C. § 1604(a), gives the Board broad authority to require disclosures to "effectuate the purposes" of TILA.

Historically, the Board has interpreted its authority under Section 105 broadly. For example, Section 105 is the only statutory provision cited as authority for the Board to promulgate rules requiring use of the Consumer Handbook on Adjustable Rate Mortgages (the "CHARM" booklet).[37] The CMC believes that if Section 105 gives the Board the authority to require use of the CHARM booklet, it similarly gives the Board

[35] *See supra* note 12 and accompanying text.

[36] UDAP Guidance, *supra* note 15, at 2.

[37] *See, e.g.*, 50 Fed. Reg. 20221 (May 15, 1985).

authority to require all lenders to disclose information that would address the Board's concerns.

Additionally, any new disclosure requirements the Board may wish to implement are more appropriately promulgated under Section 105(a) than under 129(l). Indeed, Section 129(l) only authorizes the Board to prohibit unfair or deceptive "acts or practices," not to require new or additional disclosures. Only Section 105(a) expressly authorizes the Board to require new or different disclosures.[38]

Given the potential for substantially greater liability under Section 129(l), as discussed above, the CMC requests that the Board clarify that any new disclosure requirement is promulgated pursuant to the Board's authority under Section 105(a).

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[38] Additionally, since Section 129(a)(1) applies only to mortgages referred to in Section 103(aa), and since Section 129(a) does not otherwise authorize the creation of additional disclosure obligations, Section 129(a) does not authorize additional disclosure requirements.

IV. Answers to Specific Questions

A. Prepayment Penalties

- *Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period of an ARM be prohibited?*

The CMC supports a rule limiting prepayment fee options to the initial fixed rate period. We believe such a limitation is consistent with the purpose of many subprime hybrid ARMs and will allow consumers to freely refinance to avoid potential payment shock. The CMC also supports limiting prepayment fee options for subprime ARMs to the initial fixed rate period or three years, whichever is less.

The CMC does not believe that prepayment fees must expire before the expiration of the fixed-rate period. If the consumer is informed of the date on which the fixed-rate period ends, the consumer can take the steps necessary to refinance the loan prior to experiencing any significant "payment shock" but without incurring a prepayment fee. If the Board chooses to require expiration of prepayment fees in advance of an adjustment date, the CMC suggests that 60 days prior to the initial payment reset date is sufficient time to allow the consumer to avoid any significant "payment shock."

Any further limitations on prepayment fee options are inappropriate under the Board's guidance. Mortgage loans that contain prepayment fees generally cost less than loans without prepayment fees. And, this lower cost generally benefits all borrowers who obtain such loans, while only borrowers who pay off their loan within the prepayment period must pay a prepayment fee. The countervailing benefit of lower cost mortgage credit coupled with notice of the existence and terms of the fee means that a prepayment fee is not "unfair" under the Board's UDAP guidance and is not "abusive" under the Board's Expanded Guidance. Consequently, a broad limitation on prepayment fees is not authorized under Section 129(l)[39].

- *Would enhanced disclosure of prepayment penalties help address concerns about abuses?*

Yes, the CMC believes that consumers will benefit by improved disclosures that more effectively communicate the existence of and details regarding any prepayment fee. The CMC long has advocated that the best way to address pricing or other concerns in the subprime market is to encourage more competition and more entry into the market, not less. Only competition will be able to reduce prices and increase consumer choices in this market. As discussed in greater detail below, a prepayment fee disclosure should be part of a simplified and improved disclosure, and should be limited to the term of the prepayment penalty and the maximum amount that may be assessed.

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[39] Given the strong association between prepayment fees and lower interest rates, it would similarly be difficult for the Board to determine that prepayment fees are uniformly "not in the interest of the borrower" under Section 129(l)(2)(B).

As the Board is aware, there are a number of interesting proposals to simplify the current disclosure scheme that are worthy of serious examination. These proposals are intended to enhance consumer understanding of the terms of the loan the consumer proposes to obtain. The CMC has made numerous efforts over the past decade to simplify the current welter of loan disclosures that consumers almost uniformly find confusing. The Federal Trade Commission also recently released a study finding that consumers find current mortgage disclosures confusing, but that such disclosures can be improved.[40] The CMC renews its recommendation that the Board consider rationalizing—rather than simply adding to—consumer credit disclosures to make the disclosures simpler and easier to understand.

- *How would a prohibition or restriction on prepayment penalties affect consumers and the type and terms of credit offered?*

The CMC believes that a prohibition on prepayment fees as recommended above would not have a significant impact on the availability or cost of mortgage credit to subprime borrowers. However, any prohibition that goes beyond the recommendations above could decrease the availability and/or increase the cost of mortgage credit to subprime borrowers.

B. Escrow for Taxes and Insurance on Subprime Loans

- *Should escrows for taxes and insurance be required for subprime mortgage loans? If escrows were to be required, should consumers be permitted to "opt out" of escrows?*

The CMC believes that such a requirement should be limited to first mortgages only, and that consumers should be permitted to opt out of such an escrow requirement if they choose. Nevertheless, because such complying with such a new requirement will require significant operational and systems changes by many lenders, the CMC urges the Board to provide for a significant transition period during which lenders can make these changes. Additionally, because consumers can pay (and many wish to pay) taxes and insurance premiums on their own, permitting consumers to opt out of an escrow requirement is consistent with the Board's UDAP guidance and would not be abusive.

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[40] *See* James M. Lacko & Janis K. Pappalardo, Federal Trade Commission Bureau of Economics Staff Report, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* (June 2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.; *see also* James M. Lacko & Janis K. Pappalardo, Bureau of Economics, Federal Trade Commission, *Information Regulation is Tricky: Lessons from Mortgage Disclosure Research*, presentation before the Behavioral Economics and Consumer Conference, Federal Trade Commission, Washington, D.C. (Apr. 20, 2007); James M. Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Federal Trade Commission Bureau of Economics Staff Report (2004), *available at* http://www.ftc.gov/os/2004/01/0301/030123mortgagefullrpt.pdf.

Escrows for taxes and insurance should not be required for second mortgages and HELOCs for several reasons. First, the loan secured by the first mortgage loan in many cases includes an escrow that includes taxes and insurance. If the borrower is making timely payments on the first mortgage loan, whether taxes and insurance are escrowed or not, imposing such an escrow requirement on a second mortgage loan or HELOC is unnecessary. If the Board chooses to apply an escrow-related requirement on lenders making second mortgage loans, the lender making the second mortgage loans should be allowed to accept and rely upon a representation by the consumer that the consumer's first mortgage loan has an escrow covering taxes and insurance. Second, offering an escrow option for taxes and insurance on a second mortgage loan or HELOC is very complicated, would involve very substantial operational changes for lenders that do not currently escrow taxes and/or insurance, and creates an unduly large regulatory burden on all lenders, including responsible lenders.

Additionally, in deciding whether to adopt a rule requiring escrows for taxes and insurance, the CMC recommends that the Board take into account that some state laws (e.g., Illinois) permit borrowers to opt out of escrow requirements.[41] If the Board chooses to adopt a rule inconsistent with such state laws, the Board should clarify whether its rule preempts inconsistent state law and/or how the rule interacts with inconsistent state law.

Finally, the CMC asks the Board to consider that most lenders already account for taxes and insurance in underwriting.

- *Should lenders be required to disclose the absence of escrows to consumers and if so, at what point during a transaction? Should lenders be required to disclose an estimate of the consumer's tax and insurance obligations?*

Yes, if taxes and insurance are not escrowed, this fact should be disclosed to the consumer. As discussed below in more detail, lenders face substantial operational difficulties in providing meaningful written disclosure earlier than the time at which the Good Faith Estimates (GFEs) are provided.

The CMC also believes it is appropriate for lenders to disclose an estimate of the costs for taxes and insurance. Such a disclosure also should be provided at the time of the GFEs or later.

In addition, the CMC believes that TILA's advertising rules should be amended to require lenders and brokers that are advertising monthly payment amounts that do not include escrows to asterisk the amount with a footnote that states that the monthly amount quoted does not include such additional amounts. The CMC believes it would be appropriate to consider adopting such a change in conjunction with a more general review of the advertising rules to consider whether they need to be modernized to address new developments in the marketplace.

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41 *See, e.g.*, 765 ILCS § 5 (permitting borrower to opt out of escrow requirement when mortgage loan is reduced to 65% of original value); *id.* § 6 (permitting borrower to an interest bearing time deposit in lieu of an escrow).

- *How would escrow requirements affect consumers and the type and terms of credit offered?*

The CMC believes that requiring disclosure of (1) the costs of taxes and insurance, and (2) whether or not taxes and insurance will be escrowed would not negatively impact the availability or cost of mortgage credit to subprime borrowers. Requiring that taxes and insurance be escrowed would limit consumer choice to a certain extent and may limit or even foreclose credit to individuals who find it difficult to fund the escrow cushions. The CMC does not believe this would significantly raise the costs of mortgage credit.

Additionally, consideration should be given to options to fund escrow cushions over time. RESPA's escrow provisions currently permit the establishment of an escrow account with a deposit that does not include amounts for a cushion, but provides a mechanism for making up that shortage over time.[42] The Board should preserve that flexibility.

C. Stated Income or "Low Doc" Loans

- *Should stated income or low doc loans be prohibited for certain loans, such as loans to subprime borrowers?*

No. The CMC continues to believe that stated income and low-documentation loans serve an important purpose and provide important benefits to certain populations. For example, for some borrowers (e.g., small business owners), past W-2s may not accurately reflect significant portions of current earnings, such as tips, commissions, bonuses or raises. Additionally, members of immigrant populations often rely on the financial resources of multiple family members who are not named as co-borrowers on the loan, and whose income or financial resources would not be included on documentation such as a W-2. Prohibitions on stated income or low-doc loans would impair the ability of these consumers to obtain mortgage credit. Such prohibitions also would prevent borrowers (prime and non-prime) from benefiting from inexpensive streamlined refinances, often offered at competitive prices, to borrowers who appear poised to pay off a loan. The CMC believes these benefits outweigh any detriments so that stated income or low documentation loans are not "unfair" under the Board's UDAP guidance or abusive under the Expanded Guidance—and, consequently, prohibitions on stated income or low documentation loans are not authorized under Section 129(l).

If, however, the Board chooses to limit stated income and low-documentation loans, the CMC urges the Board to allow lenders the flexibility to be able to make loans to borrowers for whom funds come from non-traditional sources, such as borrowers who are self-employed or are from immigrant communities. Additionally, if the Board decides to create such a limitation, the CMC urges the Board to make a proposal clarifying exactly which types of documentation are acceptable to document a loan. Only in this way can lenders know if they can continue making loans to certain populations (e.g., members of immigrant communities who rely on family support to make payments, employees in

[42] *See* RESPA § 10, 12 U.S.C. § 2609; 24 C.F.R. § 3500.17.

service professions whose tips may appear on tax returns but not on other documents such as W2s, small business owners whose income and assets may not be documented on certain documents, etc.).

Additionally, as mentioned above, the Board should limit any actions under Section 129(l) to the subprime mortgage market. The causes of concern in the subprime market do not exist in the prime market. Imposing additional requirements on the prime market therefore is unnecessary and inappropriate.

- *Should stated income or low doc loans be prohibited for higher-risk loans, for example, for loans with high loan-to-value ratios?*

No. Although the CMC would agree with the general concept that there should be mitigating factors when a lender accepts a lesser level of documentation or makes a simultaneous-second lien mortgage, creating specific requirements is inappropriate. Using only one factor, such as LTV ratio, to qualify a borrower for a stated income or low-documentation loan could prevent borrowers who have other criteria demonstrating they are sufficiently creditworthy (e.g., good credit scores, low DTI ratios, etc.) from obtaining mortgage credit. Rather than basing the permissibility of stated income or low-documentation loans on any single factor, lenders should be directed to use prudent but flexible underwriting standards without imposing any particular mitigation factor or setting any particular threshold for any factor. Based on the performance of the 2006 cohort of such loans, the marketplace has already prudently carved back the availability of these products, a development that leaves open the possibility that in the future, lenders will be better able to discern which borrowers can benefit from those loans and which ones should not receive them. If the Board takes any action limiting the use of stated-income or low doc loans, such action should apply only to those products with the potential to cause payment shock.

Nevertheless, because of the potential for significant liability exposure that would accompany a new rule promulgated under the Board's Section 129(l) authority—if the Board chooses to implement such a rule—the Board should establish objective, bright-line criteria regarding (1) to whom such a rule would apply, and (2) what "stated income" and other such terms mean. For example, the Board should make clear whether stated income loans would be permitted if the borrower would be receiving assistance from other family members to repay the loan (as is the case in many households in immigrant communities. Additionally, the Board should clarify whether the terms "stated income" or "low doc" loans would be defined so broadly as to apply to streamlined refinancings, where the lender has a relationship and experience with the borrower.

- *How would a restriction on stated income or low doc loans affect consumers and the type and terms of credit offered?*

As discussed above, some borrowers (e.g., self-employed individuals or members of immigrant populations) may not adequately or easily be able to document their incomes, depending on the documentation requirements imposed. Without stated income or low-documentation loans, these borrowers may be unable to obtain or may have to pay more to obtain mortgage credit.

- *Should lenders be required to disclose to the consumer that a stated income loan is being offered and allow the consumer the option to document income?*

The CMC would support such a disclosure requirement, provided the timing of such a disclosure does not create additional and unreasonable burdens on lenders. Such a disclosure should be given no later than the time at which the lender provides the good faith estimate.

D. The Borrower's Ability to Repay

- *Should lenders be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments?*

The CMC generally agrees that underwriting standards should evaluate the borrower's ability to service the debt, but we urge the Board not to require that all loans be underwritten at the long-term rate, regardless of the period to which the initial rate applies. We note that the recent Statement on Subprime Mortgage Lending requires lenders to use "[p]rudent qualifying standards [that] recognize the potential effect of payment shock in evaluating a borrower's ability to service a debt," and that such an analysis "should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate."[43] The CMC continues to believe that while underwriting to the fully-indexed rate may be appropriate in some circumstances, it creates an inappropriate limitation on credit in many other circumstances. As noted in greater detail below, housing economists recently have found that "people make sensible housing decisions in that the size of the house they buy today relates to their future income, not just their current income and that innovations in mortgages over 30 years gave many people the opportunity to own a home that they would not have otherwise had, just because they didn't have enough assets in the bank at the moment they needed the house."[44] However, should the Board decide to impose a requirement to underwrite to the fully-indexed rate, the CMC urges the Board to impose this requirement only loans that truly are "subprime", as that term is defined above, and have the potential for causing payment shock to the borrower.

Notwithstanding the federal banking agencies guidance in the Statement on Subprime Mortgage Lending, the CMC continues to believe that a requirement to underwrite to the fully-indexed rate is inappropriate for many reasons. First, this requirement likely would greatly exacerbate default and foreclosure rates by preventing borrowers who have already been successfully carrying a subprime loan, such as a hybrid ARM, from refinancing that loan. Requiring that loans be underwritten at the fully-indexed rate will drastically reduce the maximum debt-to-income ratio for many products—likely to a

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43 *See Statement on Subprime Mortgage Lending*, 72 Fed. Reg. 37569, 37573 (July 10, 2007).

44 *See infra* notes 46-49 and accompanying text.

level so low that few consumers who currently have subprime loans will be able to qualify. (This would still be true, though to a lesser degree, if the definition of "fully indexed" rate is adopted from the Nontraditional Mortgage Guidance as discussed below.) Many consumers obtain subprime hybrid ARMs fully intending to refinance prior to or upon adjustment. However, if this requirement is imposed, many of these consumers—consumers who otherwise are making their payments on a timely basis—will be unable to qualify for refinancing. Indeed, many of these borrowers are seasoned, have demonstrated that they can service a mortgage debt, and have known payment history. Yet, notwithstanding these positive criteria, these borrowers may be unable to refinance their loan, may be unable to make payments after the adjustment period, and may be foreclosed upon. Thus, a requirement to underwrite to a fully-indexed rate will have the perverse effect of increasing, not decreasing, foreclosures. Indeed, in such cases the requirement to underwrite at the fully-indexed rate is "not in the interest of the borrower."[45] Thus, the Board has authority under section 129(l) to grant lenders the flexibility to refinance loans for borrowers who otherwise would be foreclosed upon. Such authorization is essential if the Board wishes to avoid the negative impact the fully-indexed rate underwriting requirement will have on the national economy.

Second, the requirement to underwrite to the fully-indexed rate wrongly assumes that borrowers will keep a loan for the entire term of the loan. In the experience of CMC and its members, the vast majority of subprime borrowers refinance long before the loan term expires. Indeed, thirty-year subprime mortgages have an average duration of around three years. Subprime borrowers access credit and use their home as security in many different ways and for many different reasons. These reasons generally result in restructuring or refinancing the debt over short-term periods. As noted above, subprime loans often serve as a critical bridge over financial setbacks and as a means of repairing credit. Requiring that lenders underwrite to the fully-indexed rate when few borrowers will still be obligated on the loan when the fully-indexed rate applies is a requirement that is not consistent with how borrowers use subprime mortgage products.

Third, this requirement wrongly assumes that a borrower's income at the moment of origination will be the same as the borrower's income when the loan adjusts to the fully-indexed rate. Some of the country's leading housing economists—Kristopher Gerardi and Paul S. Willen of the Federal Reserve Bank of Boston, and Harvey S. Rosen of Princeton University—recently released a study showing that borrowers frequently base credit decisions on future rather than present income, and that borrowers have been quite rational in making those decisions.[46] As Professor Rosen stated, "Our findings suggest that people make sensible housing decisions in that the size of house they buy today relates to their future income, not just their current income and that innovations in mortgages over 30 years gave many people the opportunity to own a home that they would not have otherwise had, just because they didn't have enough assets in the bank at

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[45] TILA § 129(l)(2)(B), *codified at* 15 U.S.C. § 1639(l)(2)(B).

[46] Gerardi, Kristopher et al., *Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market*, NBER Working Paper No. W12967 (Mar. 2007), *available at* http://ssrn.com/abstract=971601.

the moment they needed the house."[47] Professor Rosen further explains that requirements like underwriting to a fully-indexed rate could harm the very people such requirements are intended to protect: "The main thing that innovations in the mortgage market have done over the past 30 years is to let in the excluded: the young, the discriminated against, the people without a lot of money in the bank to use for a down payment."[48] In reviewing this study, Professor Goolsbee of the University of Chicago cautions "that regulators should be mindful of the potential downside in tightening [underwriting requirements] too much."[49]

Finally, any requirement to underwrite to the fully-indexed rate and fully-amortized payment would, in effect, require that lenders apply a "stress test" to each individual loan, rather than to their entire portfolio. This "loan-level" stress test is unprecedented and, if taken literally, would drastically reduce the availability of subprime mortgage products. If the same approach were applied to traditional lending, it would also significantly reduce the amount of credit available. Lenders can prudently make long-term fixed-rate loans, as they can prudently offer subprime mortgage products, because they have sophisticated models that allow them to manage their financial risk on a portfolio basis. Using these models, they can take into account the probability that the vast majority of loans will be paid off before the end of the term. As the Board is aware, in subprime loans as in other mortgage loans, borrowers have the option of paying off the loan at any time, and they do so for a variety of reasons, including sale of the residence, cashing-out equity, moving from a variable to a fixed rate, or moving from a subprime to a prime loan.

Instead of imposing a rigid requirement that lenders underwrite to the fully-indexed rate, the Board should allow lenders to underwrite using prudent but flexible underwriting guidelines that, among other things, allow reasonable projections of an applicant's income to meet future payment increases, manage risk at the portfolio level, and thus allow lenders the flexibility to offer consumers products that meet their needs. Such flexibility is essential for lenders to be able to meet not only the needs of borrowers, but also the needs of communities—particularly communities with large immigrant populations.[50]

The CMC notes that the Statement on Subprime Mortgage Lending departs from the federal banking agencies' previous Nontraditional Mortgage Guidance regarding what constitutes a "fully indexed" rate. The Nontraditional Mortgage Guidance provides:

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47 *Quoted in* Austan Goolsbee, *"Irresponsible" Mortgages Have Opened Doors to Many of the Excluded*, N.Y. TIMES, Mar. 29, 2007.

48 *Id.*

49 *Id.*

50 *See, e.g.*, Edward L. Yingling, *Viewpoint: Subprime Loans Helping a Texas Town*, AM. BANKER, May 4, 2007 (describing how a bank used flexible criteria to help many borrowers in the small town of Van Horn, Texas buy homes who likely would not otherwise have been able to do so).

> The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. *In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.*[51]

Thus, in the Nontraditional Mortgage Guidance, the federal banking agencies appropriately gave lenders the flexibility to use a "credible market rate" when qualifying borrowers. As the text italicized above makes clear, the agencies correctly recognized that in many interest rate environments, the difference between an ARM's margin plus index and the rate of a 30-year fixed-rate loan can be substantial. Unless lenders are permitted to use a "credible market rate," as they are under the Nontraditional Mortgage Guidance, when such substantial rate differences exist many consumers would be able to qualify for a 30-year fixed-rate mortgage but could not qualify for an ARM. Thus, the consumers could qualify for a loan with a higher monthly payment but not a loan with a lower monthly payment. Additionally, when rates are low, underwriting to a fully-indexed rate would result in loose underwriting standards—and underwriting to a rate that likely can only increase.[52] Such results are arbitrary and absurd, and do not benefit consumers. If a consumer has demonstrated an ability to service a long-term debt—such

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[51] 71 Fed. Reg. 58609, 58614 n.5 (Oct. 4, 2006) (emphasis added).

[52] For example, in the testimony of FDIC Chairman Sheila Bair before the House Subcommittee on Financial Institutions and Consumer Credit, she used the example of a 2/28 ARM with an introductory rate of 8.30% and a margin at reset of 6.99%. The fully-indexed rate used in her example, based on an index of 5.375% was 12.365%. *See* Sheila C. Bair, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, at 10 (Mar. 27, 2007), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbair032707.pdf. However, if that same 8.30% loan with a 6.99% margin had been made in 2003, the fully-indexed rate could have been as low as 7.97%, because the low point for the index was 0.98%. Additionally, a recent UBS study indicates that the average original weighted-average coupon for subprime ARMS originated in 2003 was 7.5%, with an average margin of 6.036%. *See* UBS, *Servicing in a Subprime Meltdown: Loan Modifications and Servicing Transfers* (Apr. 17, 2007). On a simple daily average basis the index was 1.23%, so the average fully indexed rate was 7.27% for 2003. Thus, in 2003 the initial rate could have been, and often was, higher than the fully-indexed rate—a premium rate, rather than a teaser.

as by qualifying for a 30-year fixed-rate loan at the same risk class—the consumer should not be prevented from choosing loan products that the consumer prefers, including ARM products that provide the benefit of lower monthly payments. The CMC continues to believe that the standard in the Nontraditional Mortgage Guidance better addresses market realities, and urges the Board and other agencies to return to the standard in the Nontraditional Mortgage Guidance.

As discussed above, the CMC continues to oppose any requirement that lenders underwrite to a fully-indexed rate. However, if the Board decides to impose such a requirement, to maintain both flexibility and consistency CMC urges the Board to adopt the definition of fully-indexed rate from the Nontraditional Mortgage Guidance and permit a lender to qualify a consumer for an ARM loan of a particular risk class if the consumer qualifies for a 30-year fixed-rate mortgage of the same risk class. In addition, the Board should recognize that, especially when underwriting to a fully indexed rate and a fully amortizing payment, consideration of reasonable increases in the borrower's income is not an unfair or abusive lending practice. To benefit consumers, lender flexibility in qualifying borrowers must be maintained.

- *Should there be a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income ratio exceeds 50 percent (at loan origination)?*

No. Debt-to-income ratio is only one factor that must be evaluated in determining whether a borrower can repay a loan. Many circumstances exist where a borrower may have a DTI ratio over 50 percent and still be able to repay their loans (e.g., borrowers with above-average incomes, or co-borrowers when one of the co-borrowers has recently lost a job but anticipates re-joining the work force). Such a requirement also would restrict the availability of credit to borrowers who rely on income from other family members to repay a mortgage loan, including many members of immigrant communities. Additionally, such a requirement wrongly assumes that the borrower's income at loan origination will remain constant (as discussed in greater detail above). For these reasons, a presumption that a loan is unaffordable if the borrower's DTI ratio is over 50 percent is inappropriate. Lenders should not be placed in the difficult position of having to rebut a negative presumption when there are so many instances where the presumption is unfounded.

Indeed, creating such a presumption could have the undesirable effect of making mortgage credit less available to consumers that would have a DTI over 50 percent—even if the consumer could reasonably afford to repay the loan. Lenders likely would be reluctant to make loans that have a presumption of unaffordability, even if all other indications show that the borrower in fact can afford the loan.

- *Are there specific consumer disclosures that would help address concerns about unaffordable loans?*

As discussed in greater detail below, the CMC believes that more effective disclosure of the costs of mortgage credit will enable consumers to make better decisions regarding whether they can afford particular products. If consumers have the information they need to make informed decisions regarding the affordability of mortgage products, neither the Board nor the lender should "second-guess the wisdom of particular consumer decisions."[53]

- *How would such provisions affect consumers and the type and terms of credit offered?*

As discussed in greater detail above, requiring that lenders underwrite to a "fully indexed rate" would prove disastrous to consumers, both in terms of the availability and affordability of mortgage credit. Additionally, a presumption that a loan is not affordable if the borrower's DTI ratio is over 50 percent may lead to further decreases in the availability of mortgage credit to those that reasonably can afford it. Requirements such as these that would decrease the availability and increase the cost of mortgage credit should be avoided.

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53 *See* UDAP Guidance, *supra* note 15, at 3.

V. Additional Recommendations

The CMC respectfully suggests that the Board can take steps other than those mentioned in the hearing notice. These are discussed in greater detail below, and are grouped into two general categories: (1) steps the Board could implement now to improve the mortgage lending process; and (2) changes the Board can implement, or can work with other agencies to implement, over a longer term to resolve some of the more fundamental and structural issues challenging the mortgage lending market.

A. Recommendations the Board Can Address Now

1. Do Not Lower HOEPA Thresholds

The CMC urges the Board not to lower the thresholds contained in section 103(aa) defining a loan that is subject to HOEPA. As the Board is aware, HOEPA contains a provision creating for assignee liability quite different from any other provision in TILA. Section 131 provides:

> Any person who purchases or is otherwise assigned a mortgage referred to in section 103(aa) shall be subject to all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage, unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine, based on the documentation required by this title, the itemization of the amount financed, and other disclosure of disbursements that the mortgage was a mortgage referred to in section 103(aa).[54]

This assignee liability has resulted in a substantial decrease in the availability of mortgage credit. While rating agencies are willing to rate transactions that include HOEPA loans, the rating agencies have concluded that HOEPA loans have a high indicative loss severity. For example, S&P calculates the indicative loss severity to be 119%.[55] Given this high loss severity, it is not surprising that few secondary market participants are willing to purchase HOEPA loans (and no major secondary market participants are willing to do so), even if the agencies are willing to rate transactions that include them.[56] It also is no surprise that so few lenders are willing to make HOEPA loans that the HOEPA thresholds function in practice as usury ceilings, rather than thresholds triggering additional requirements. Such steps that decrease the availability of mortgage credit should be avoided.

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54 15 U.S.C. § 1641(c).

55 *See, e.g.*, Standard & Poor's, *Criteria: Anti-Predatory Lending Law Update* (Oct. 20, 2006).

56 *See, e.g.*, Gov. Edward M. Gramlich, *Remarks at the Texas Association of Bank Counsel* (Oct. 9, 2003), *available at* http://www.federalreserve.gov/Boarddocs/speeches/2003/20031009/default.htm.

The alternative to assignee liability is requiring capital at the origination end of the process. This is a better solution because it creates responsibility at the point of creation.

2. Require Appraisers to Report Instances of Pressure

Mortgage fraud involving faulty appraisals causes serious losses and increases foreclosure rates. The Board can use its authority under Section 129(l) to require appraisers to report contemporaneously [to the Board][and to the lender's or broker's regulator] any instances of pressure from lenders or brokers to inflate appraisals and to prohibit lenders and brokers from pressuring appraisers to inflate values. Contemporaneous reporting is necessary to prevent appraisers from only later stating that they were pressured, once a property has been determined to be of a much lower value. The Board also should prohibit the inflation of appraisals.

Additionally, the process in the Financial Institutions Reform Recovery and Enforcement Act 's ("FIRREA") process should be used to impose insurance requirements to cover losses from inflated appraisals and establish the ability to decertify appraisers involved in fraud or pattern of inflated valuations. FIRREA's requirements for appraisals should be amended to apply only to commercial mortgages, so that AVMs could be used more broadly in connection with residential mortgages. For properties for which AVMs available to an acceptable level of accuracy, AVMs offer a more cost effective valuation procedure free of undue influence. Any inaccuracy in appraisals, or pressure related thereto, should not, however, affect whether a loan is considered an above-threshold loan, as such an after-the-fact recalculation would mean that a lender or investor could never be sure if a loan exceeded a given threshold unless and until the loan became involved in litigation.

3. Broker Disclosures

Mortgage brokers have been described recently as "one of the big vulnerabilities in the business."[57] Consumers would benefit greatly if the total compensation the broker will receive in the transaction (including any factors affecting the amount of such compensation) were clearly disclosed. The Board should exercise its Section 129(l) authority to require brokers to disclose how the broker is compensated, whether such compensation is borrower-paid, lender-paid, or paid in the form of a yield spread premium. The Board also should make clear that a broker that does not provide these disclosures, after obtaining any necessary consent from the lender, has engaged in an unfair and deceptive act or practice. Additionally, the Board should make clear that a lender that provides similar disclosures is not liable for a broker's failure to provide the disclosures. In contrast to other rules the Board is considering, these requirements should be imposed for all loans, not just subprime or "payment shock" loans.

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[57] *See* Ruth Simon & James R. Hagerty, *The Middlemen: Mortgage Mess Shines Light on Brokers' Role*, WALL ST. J., July 5, 2007, at A1.

Brokers also should be required to provide stated income, prepayment, payment shock and home equity disclosures of the type required by the Nontraditional Mortgage Guidance (which has now been adopted by most states). Since brokers are required to provide a good faith estimate, brokers should be required to provide the aforementioned disclosures no later than that time. The CMC suggests that the Board has authority to require the aforementioned disclosures under Sections 129(l) and 105(a). The CMC also believes brokers will be most inclined to comply with such disclosure requirements if noncompliance carries the threat of liability to the broker (rather than to another party to the mortgage transaction). The CMC suggests that the Board has the authority to impose liability on any broker that does not provide the aforementioned disclosures as required.

Furthermore, the CMC recommends that the Board work with the other federal banking agencies and other parties, as necessary, to effect broader reform of the brokers' participation in the residential mortgage market. The CMC believes that in addition to broker disclosures, brokers should be subject to similar consumer protection mechanisms as are lenders. For example, brokers should (1) be licensed in every jurisdiction and be permitted to engage in brokering activities only if the broker is in good standing in each jurisdiction where licensed; (2) register with a nationwide database that provides information about the broker, such as licensing, disciplinary or legal actions, etc.; (3) have minimum net worth requirements and bond/insurance requirements—requirements that would increase as volume of business increases—to cover borrower losses or claims; and (4) be required to maintain and submit for approval fair lending plans (such as New York requires for mortgage lenders licensed in that state) which would be made available to consumers and would include steps to ensure the broker or lender does not engage in illegal discrimination in making loan decisions or in the pricing of loans. As noted above, requiring additional capital at the origination end of the loan process will go a long way to solving the problems that caused the subprime mortgage failures.

If the Board determines that any or all of these requirements are beyond its Section 129(l) authority, the CMC recommends that the Board require brokers to enter into written agreements with borrowers and disclose (1) whether the broker is licensed; (2) whether the broker has ever been the subject of disciplinary or legal actions; (3) how a borrower can be protected and can be recompensed by the broker's net worth, bond or insurance; and (4) where the borrower can obtain a copy of the broker's fair lending plan.

B. Recommendations the Board Can Address in the Long Term

1. Need for Capital and Constraints

Since, as discussed above, the problems of the mortgage market are in industrial organization, the principal solutions must also reside there. To some extent markets are self correcting, but markets surprisingly have short memories. Without some institutional changes, these problems are likely to reemerge.

Also, as discussed above, some have proposed greater regulation of mortgage origination practices such as limiting the types of loans allowed or establishing minimum underwriting requirements. And with the issuance of guidance on nontraditional mortgage products and subprime lending, the banking agencies have set some limits. However, solutions which address allowable loan types and underwriting requirements may be counterproductive since they may limit the availability of credit to those who need and deserve it. They lead to innovation focused on circumventing regulation rather than in providing credit. Also such regulations have the greatest impact on closely regulated institutions such as banks, which, for the most part, were not the ones engaged in the egregious subprime practices.

We believe regulatory action should be directed at reducing the separation between origination and investment. Capital is the key to this process. Fundamentally, there was too little capital at risk in key parts of the mortgage origination and investment chain.

This leads to two macro-level recommendations. First, there needs to be capital at the origination end of the process. Without capital, representations and warranties have little value. To achieve this, mortgage brokers should be licensed and bonded and firms in the chain of representations and warranties need to maintain sufficient reserves to support their financial promises. This capital would also be potentially available for payments in the case of fraudulent or predatory practices that hurt borrowers and homeowners.

In this regard, we note that the CMC members, all of which are well-capitalized, and many of which are federally regulated, have the capital to stand behind representations and warranties and were much more conservative in their underwriting practices than some of the more prominent subprime lenders, who didn't even have sufficient capital to cover their repurchases of loans with early payment defaults (typically an investor may put back a loan that defaults in the first 4-6 months), let alone the capital for breaches of representations and warranties down the road.

Second, there needs to be a constraint on the leverage of CDOs relative to other financial institutions. This can arise through regulation of rating agencies or through direct regulation of certain types of leveraged investment vehicles. The poor performance of structured finance CDOs (which are the subprime CDOs) will likely lead to reduced investor interest for some time. However, CDOs continue to operate in other markets and are likely to return to the mortgage market in the future. Rating agencies whose fees are inversely proportional to the strictness of their criteria should not become the *de facto* arbiter of leverage in the financial markets. These issues are highly complex, and there should be a thorough examination of the precise causes of the market failures before solutions are developed. However, there are constraints, whether structured as a condition of preferential tax treatment under the Internal Revenue Code, or as a direct limit on the compensation schemes that will ameliorate conflicts of interest, than can ensure greater integrity for traditional market mechanisms.

By adding capital to these key players in the mortgage chain, the capital markets would address many of the other problems that were created. Ultimately the mortgage market can only function properly when those who bear the risk of mortgage investment are closely involved in the process of mortgage origination.

Finally, the CMC opposes calls some have made to impose assignee liability on investors in the secondary market. Assignee liability would reduce the flow of capital into the residential mortgage market, and thereby make mortgage credit less available and less affordable to consumers. The CMC believes the structural challenges facing the mortgage market can be remedied without resort to such a damaging step. Again, the alternative to assignee liability is requiring capital at the origination end of the process. This is preferable because it creates responsibility at the point of creation.

2. The Time Has Come for Mortgage Disclosure Reform

Any additional regulation by the Board to protect borrowers from deception and abuse must include mortgage disclosure reform. The CMC has long proposed reform of the Federal laws and regulations governing the way in which borrowers are informed of the costs of mortgage loans. The CMC would be pleased to work with the Board and other federal banking agencies to streamline mortgage disclosures.

It is time for federal regulators to make use of reformed mortgage disclosures, not only as a means of lowering costs for consumers, but as a key deterrent of potential borrower deception and abuse. Under a new reformed approach, for example, consumers could receive relevant, guaranteed information about a loan early in the process to promote comparison-shopping. Moreover, simplifying comparisons would increase the likelihood of consumer understanding and make more difficult the deception that characterizes abusive loans. No longer would there be unwelcome surprises at the closing table of increased or hidden fees. Borrowers would be empowered under reformed and streamlined disclosures to make logical, informed choices about settlement fees and costs in the context of a single number that is firm, and loan originators and packagers would have to abide by this firm disclosure.

The CMC believes that the time is now for the Board to take a leading role in this effort. Effective mortgage disclosures that yield greater understanding and provide more certainty in the cost of a mortgage are critically important in any market, but especially in the subprime market where loans involve a higher risk of default. The Board is the best positioned agency to make mortgage disclosure reform happen. Its deep experience in consumer credit disclosures and issues and its independence from significant industry pressures allows it to adopt rules that both streamline existing mortgage disclosures and protect consumers. Some changes may require legislation and others may require working with HUD, but the Board's leadership and expansive reach on this issue we believe is critical for its success.

The CMC urges the Board to exercise its authority under Section 105(a) of TILA to create a single disclosure of the total closing costs of a mortgage transaction. Additionally, just as creditors who comply with the disclosure requirements of section 5b of Regulation Z for HELOCs are exempt from the good faith estimate (GFE) requirements,[58] so too should creditors who provide such a total closing costs disclosure be exempt from providing the less helpful GFEs.

[58] *See* 24 C.F.R. § 3500.7(f).

To the extent the Board determines it lacks the authority to exercise such regulatory oversight, the CMC invites the Board to join with it in working to bring the rating agencies under the authority of a federal regulator.

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We appreciate the opportunity to present our views. Please do not hesitate to call (202) 742-4366 with any questions.

Sincerely,

Anne C. Canfield
Executive Director