AARP
The power to make it better.

AARP comments to Federal Reserve Board on The Home Ownership and Equity Protection Act (HOEPA) Docket No. OP-1288 8/15/2007

Introduction

Homeownership, a key to building wealth, increased dramatically in the last decade in the U.S., reaching 69 percent of all Americans in 2005. Efficient access to fair and affordable mortgage financing is vital to homeownership, especially for those traditionally underserved, including low-income and minority communities. Yet for millions of American families caught in unaffordable loans, many of whom are in the subprime or Alt-A markets, this dream of homeownership has turned into the nightmare of foreclosure. For older Americans especially, who may have their entire life savings in their home, predatory mortgage lending ("PML") may result in the loss of a lifetime of equity in their home.

At the heart of the problem are lax or nonexistent underwriting standards, combined with abusive loan terms and conditions. This combination has resulted in millions of American families being put into loans that they simply cannot afford in the long term. The Center for Responsible Lending ("CRL") estimates that in the next few years, 2.2 million American families face the nightmare of foreclosure – foreclosures that could have been *prevented* if sensible underwriting procedures had been used in the middle of the housing boom.[1] In 2006, there were over 1 million foreclosures – a more than 40 percent increase from 2005. At the end of the first quarter of 2007, over five percent of subprime loans were in foreclosure and another eight percent were over 90 days delinquent.

It is in this context that AARP submits these comments to the Federal Reserve Board ("Board") on the Board's powers to ban unfair or deceptive acts or practices under the Home Ownership and Equity Protection Act ("HOEPA"). AARP urges the Board to enact rules to adequately protect consumers from the most abusive predatory terms and practices, such as prepayment penalties, no income no asset (NINA) and stated income loans, lack of escrow for insurance and taxes, and lack of proper underwriting standards.

Although AARP believes that these protections should be provided to all borrowers, we recognize that the majority of the current abuses – and of the existing and anticipated foreclosures – have been concentrated in the subprime and Alt-A markets. It is therefore particularly important that all the recommended protections be extended to borrowers in these more vulnerable markets. AARP has consistently recognized the role of the subprime and Alt-A markets in allowing consumers with

[1] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending, December 2006. Available at http://www.responsiblelending.org/pdfs/CRL-foreclosure-rprt-1-8.pdf.

imperfect credit to obtain mortgage financing, and we understand that not all subprime and Alt-A loans are predatory. It is important to recognize, however, that most predatory mortgage loans are in the subprime and Alt-A markets, and as a result these markets especially need consumer protections. The Board should act to ensure that these markets exist to promote *sustainable* homeownership.

For years, public policy has been focused on the goal of extending homeownership to as many Americans as possible. This may have been an acceptable goal when homeownership meant building up equity for families. Today, however, homeownership can mean just the opposite; predatory mortgage lenders use equity stripping practices to eat up the savings of hard-working Americans. We therefore suggest that the Board's policies should reflect the goal of *sustainable* homeownership, rather than simply homeownership. In our view, sustainable homeownership ensures that borrowers – whether in the prime, subprime, or Alt-A markets – build equity and stay in their homes over the long run. Sustainable homeownership is the key to an individual or family having a stable financial future and – as is increasingly coming clear – of great importance to the overall economy.

<u>Impact of PML on Older Homeowners</u>

AARP's research has shown that homeowners 65 and over are three times more likely to be in subprime loans than those under the age of 35. And because predatory loans are concentrated in the subprime and Alt-A markets, we know that these older homeowners are at risk for predatory loans. Predatory lenders and brokers target older homeowners because they have spent years building up the equity in their homes; that is, these lenders go where the money is.

When older homeowners who are cash-poor (living on a fixed income) but equity-rich (mortgage-free) need substantial funds to pay for home repairs, long-term care, or other expenditures, predatory mortgage lenders often represent the path of least resistance to tapping into their home equity. Usually, there are much better options for these older homeowners, including traditional (non-predatory) refinancings, home equity lines of credit, reverse mortgages, and selling the home to move into a smaller, more suitable rental or ownership property. But aggressive marketing practices on the part of predatory lenders and brokers pull these vulnerable homeowners into these inappropriate loan products.

AARP Foundation has brought several lawsuits in which older homeowners on fixed incomes, living on just their Social Security benefits and perhaps a small pension, are offered "exploding" adjustable rate mortgage ("ARM") refinancing products that they could afford for only the first two or three years of the loan, at which point the rate jumped to an unaffordable level. These homeowners were forced to refinance (often difficult because of substantial prepayment penalties), sell the home, or go into default and, eventually, foreclosure. Many of these abusive refinancings could have been prevented if sensible underwriting policies had been used; such underwriting would have revealed that these homeowners simply could not afford the loan terms offered. The borrowers could then have been put into more appropriate loans or offered other options (e.g., reverse mortgages, selling the home and downsizing, a home equity line of credit, etc.).

For example, in 1999, after HOEPA had been in effect for several years, the AARP Foundation represented ten elderly and unsophisticated District of Columbia homeowners in a consolidated predatory mortgage lending case against a single lender. While a few of these homeowners had

HOEPA loans, the points, fees, and interest rates on most of their mortgages squeaked just under the HOEPA thresholds. All had one thing in common: none could afford their mortgages. These older homeowners were all retired and living on fixed incomes consisting of Social Security benefits and perhaps small pensions; many were in failing health. AARP attorneys were surprised when, in reviewing the clients' loan documents, they discovered "self-prepared" tax returns that misidentified their clients as self-employed bookkeepers, accountants, and seamstresses. One gentleman, an 86-year old stroke victim in a wheelchair, had a tax return that described him as a computer programmer who made $30,000 a year.

As the case progressed, it became clear that the broker and lender had worked together to fabricate these tax returns to make it appear that the elderly homeowners could afford mortgages whose monthly payments in some cases exceeded their incomes. Because the clients had owned their homes for decades, they had equity, and that was what the broker or lender cared about. At the start of the case, the clients were all in default or had refinanced out of these mortgages into other, equally unaffordable ones.

The AARP Foundation filed another case in December 2005 in Brooklyn, New York, involving a property flipping scheme perpetrated by a group of property investors, lenders, appraisers, and attorneys. The case alleges that the group conspired to sell the clients, all of whom were first-time home buyers, damaged houses that had been bought cheaply, cosmetically repaired, and rapidly resold at vastly inflated prices. The clients' six homes were over-appraised by an average of $137,000.

AARP attorneys could not fathom how these low and modest income clients had qualified for mortgages on homes costing $315,000 to $419,000. The investigation revealed that two of these homeowners were deemed "qualified" for their mortgages using the "no income, no asset" ("NINA") guidelines, and a third did so using stated income that was inflated by the lender. One recipient of a NINA loan had been a salaried employee of the New York City Housing Authority for many years and therefore had stable (though modest) income, with clear documentation showing that her income was too low for her to afford the loan they were offering. Another was in her 70s and living only on Social Security benefits. All had income that was readily verifiable. But the homes would not have been sold – nor the mortgage origination and other fees generated – if their verifiable incomes had had to be considered.

In order to make the deal work, the lender piled on additional risks, for example by putting the clients into not one, but two mortgages each, commonly called "piggyback" lending. The first mortgage provided 75-80 percent of the purchase price, and the second mortgage, charging a much higher interest rate, made up the remaining funds needed to close the deal. For people like these clients, who are living on fixed incomes, piggyback mortgages, unreliable appraisals, and NINA loans were a recipe for disaster that set them up for the defaults that inevitably occurred.

The Board could help immensely to curb these abusive practices by using its existing HOEPA authority to require sensible underwriting and banning abusive practices, as outlined in these comments.

The Board's HOEPA Authority and the Definition of "Unfair" or "Deceptive"

The Board took an important first step in helping to curb these practices through issuance of its subprime lending guidance. We encouraged the Board to adopt this guidance and applaud it for having done so in the face of strong industry opposition. But AARP believes that the nature of guidance – which is enforceable only through the examination process and applies only to those who are regulated by the agencies that adopted the guidance – limits its usefulness. The Board can and should go further by using its authority under HOEPA to ban unfair or deceptive practices in the mortgage lending arena. Such a ban would apply to all originators, whether or not they are regulated by the Board, and would bring with it the full panoply of enforcement available under HOEPA. Simply put, the Board should use its HOEPA authority to establish a strong consumer protective rule to root out the most abusive lending practices and lack of underwriting, particularly in the subprime and Alt-A markets.

The Board's authority to do so is clear. HOEPA gives the Board this authority through the following language (15 USC 1639(l)(2)):

> (2) **Prohibitions**
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> The [Federal Reserve] Board, by regulation or order, shall prohibit acts or practices in connection with—
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> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
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> (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.

This language clearly states the Board's authority to create rules to ban "unfair" or "deceptive" acts or practices. In these comments, we will demonstrate why certain practices and terms are both unfair and deceptive, based on the definition that the Federal Trade Commission ("FTC") uses for these terms.

The FTC defines "unfair" and "deceptive" through its policy statements. Specifically, it defines "unfairness" as a practice that "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers and to competition."[2] AARP believes that many of the tactics and practices used by unscrupulous actors in the mortgage marketplace – particularly in the subprime and Alt-A markets – qualify as unfair under this definition, as they can directly lead to foreclosure and the loss of a lifetime of savings. This outcome could be avoided if abusive practices were banned and proper underwriting required.

Deception, on the other hand, occurs when "there is a representation, omission or practice that is likely to mislead the consumer acting reasonably in the circumstances, to the consumer's detriment."[3] We provide evidence below that many of the most abusive policies and practices in the subprime and Alt-A markets are also deceptive. For example, as described above, the AARP Foundation has brought cases in which unscrupulous lenders and brokers have offered "no documentation" or "low documentation" loans to individuals who have verifiable income. In addition, cases have been brought in which unscrupulous lenders or brokers falsify income in order to qualify borrowers for unaffordable loans. These misrepresentations result in direct harm to borrowers – namely, foreclosure and the loss of a lifetime of savings. These loans would not have

[2] FTC Policy Statement on Unfairness, December 17, 1980, see http://www.ftc.gov/bcp/policystmt/ad-unfair.htm.
[3] FTC Policy Statement on Deception, October 14, 1983, see http://www.ftc.gov/bcp/policystmt/ad-decept.htm/.

been made if rules had been in place to require proper documentation of income using the best and most appropriate form of documentation, as outlined below.

We now turn to the specific questions on which the Board requested comment. Please note that AARP has organized these comments to address the Board's question in the order asked. We wish to emphasize, however, that the most critical issue in AARP's eyes – reestablishing sensible underwriting standards that are the key to sustainable homeownership – came last on the Board's list of questions. We believe the most critical component of any federal response to predatory mortgage lending is establishing strong underwriting standards that ensure the ability of borrowers to repay the loans that they have been offered. Without this protection, the other actions the Board is considering are not nearly as effective.

Prepayment Penalties

A. Problem: Prepayment penalties are both unfair and deceptive.

AARP believes that prepayment penalties (PPPs) are both unfair and deceptive. PPPs trap consumers in loans by preventing them from refinancing out of the abusive terms into more appropriate loan products. The penalties – typically six months' interest, or around 4.5 percent of the initial loan balance – often translate into thousands of additional dollars required for refinancing. Although virtually non-existent in the prime market, PPPs are widespread in the subprime market, where consumers are often hit with additional abusive terms such as exploding ARMs in loans without proper underwriting, lack of escrow for insurance and taxes, etc. Ironically, subprime and Alt-A borrowers in such higher cost loans are the ones who most need to refinance – and they are also the ones who face hefty prepayment penalties that keep them from doing so.

The mortgage lending industry maintains that subprime and Alt-A borrowers trade off PPPs for lower interest rates. That is, they claim that borrowers have a real choice in these markets for PPPs and a lower interest rate or no PPPs and higher interest rates. If this were the case, one would expect the rate of PPPs to be approximately equal in the prime and subprime markets. Yet although PPPs are very common in the subprime market – indeed, 70 percent of subprime loans include them – they are virtually non-existent in the prime market, where only two percent of loans include them.[4]

CRL has published reports showing that the tradeoff between PPPs and interest rates in the subprime and Alt-A markets is illusory. Using conservative assumptions, CRL estimates that the cost of PPPs to the average borrower is 3 to 4 times the savings in interest payments.[5]

One key reason that PPPs are so common in the subprime market is the connection between yield-spread premiums ("YSPs") and prepayment penalties. YSPs in theory offer a tradeoff with the interest rate; borrowers pay YSPs in order to receive lower interest rates. Yet CRL finds that consumers in subprime loans with PPPs can actually pay *higher* interest rates because lenders offer brokers YSPs to steer consumers into more expensive loans. CRL cites a ContiMortgage

[4] The figures on frequency of prepayment penalties come from Martin Eakes, CEO Self-Help Bank and Center for Responsible Lending, testimony before the Senate Banking Committee on 2/2/07, available at http://www.responsiblelending.org/pdfs/martin-testimony.pdf.

[5] "Why Prepayment Penalties Are Abusive in Subprime Lending," Center for Responsible Lending Policy Paper, April 2, 2003. See http://www.responsiblelending.org/pdfs/PPP_Policy_Paper2.pdf.

Corporation rate sheet as a telling example: For loans without PPPs, the maximum YSP is 2.5 percent, whereas for mortgages with PPPs the maximum YSP jumps to 4.25 percent.

PPPs are unfair because they specifically target the most vulnerable borrowers, who are often in loans with additionally abusive terms and desperately need to refinance into a sustainable home loan. They inherently inhibit competition by creating economic incentives for borrowers in predatory loans to stay in those loans rather than refinancing into more appropriate, sustainable loans. In a truly competitive market, borrowers in such loans would be able to refinance more easily, creating a more competitive marketplace for *sustainable* home loans in the subprime and Alt-A markets.

PPPs are also deceptive because, as demonstrated above, there is no real tradeoff between PPPs and interest rates. Instead, subprime and Alt-A borrowers are steered into loans with substantial PPPs and at times pay a *higher* interest rate because of the connection between YSPs and PPPs.

B. Solution: Eliminate PPPs in all loans.

AARP believes that prepayment penalties inhibit competition in the Alt-A and subprime marketplaces so much that the best solution is to ban them. Certainly, it is insufficient to require the penalties to expire at the time that the teaser rate expires, as the Board suggests in its question. Doing so would result in borrowers having to make payments for at least several months on loans at higher interest rates to which they have not been underwritten and cannot afford. If they missed the payments, did not pay them in full, or made late payments, their credit score would drop further, and they would have an even more difficult time refinancing. The practice of having PPPs expire at the time of expiration of the teaser rate would itself be both unfair and deceptive.

If the Board falls short of an outright ban on PPPs, at a minimum it should do both of the following:

a) require that PPPs expire at least six months prior to the expiration of teaser rates that are common in exploding ARMs found in today's subprime and Alt-A mortgage markets, and
b) require the lender to send a separate letter in plain language explaining that the teaser rate will expire on the specific date, the new rate and monthly payment,[6] and the borrower's right to refinance with any lender without a prepayment penalty.

Although not as strong as a full ban on PPPs, such a rule would ensure that borrowers would be notified about the upcoming rate change and provide them with time to refinance into a more appropriate vehicle.

C. The role of disclosure.

Disclosure alone is not sufficient, because PPPs are inherently abusive. However, if the Board falls short of banning PPPs altogether, it can limit them (as outlined above) and improve disclosure. Specifically, we recommend specific changes to the Truth In Lending Act ("TILA") disclosure. Currently, TILA requires lenders to state when a borrower "may" be subject to a prepayment penalty; this disclosure should be changed to state that the borrower "will" be subject to the specific

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[6] The lender could also provide a reasonable approximation of the expected new interest rate and monthly payment, such as what the what they would be if the reset occurred on the date that the letter was sent

prepayment penalty amount (in minimum and maximum terms) if the borrower pays off or refinances the mortgage before the specific PPP expiration date.

We recommend the following language for the TILA disclosure:

> "If you wish to refinance or pay off this loan before *DATE*, you will have to pay a prepayment penalty of between *MINIMUM* and *MAXIMUM*."

D. The impact of a prohibition or restriction on PPPs on consumers and terms of credit offered.

The elimination or restriction of PPPs, as outlined in these comments, would create a more fair and efficient marketplace by ensuring that subprime and Alt-A borrowers with inappropriate loans did not face economic disincentives from refinancing into better loan products. Today, PPPs create a "sticky" marketplace where borrowers remain stuck in inappropriate loans, even if a better loan exists that could lead them into sustainable home ownership. AARP believes that the elimination of PPPs, combined with sensible underwriting standards, would help create a subprime and Alt-A marketplace that helped borrowers with less-than-stellar credit build wealth through sustainable homeownership.

Escrow for Taxes and Insurance

A. Problem: Lack of escrow for taxes and insurance is both unfair and deceptive.

When escrows are included in monthly payments, borrowers make one monthly payment to lenders – including interest, principal, taxes, and insurance – and lenders pay the taxes and insurance on behalf of the borrowers. Escrows are very important in all markets – prime, subprime, and Alt-A – because they simplify the payment process for borrowers and ensure that property taxes and hazard insurance are paid, which must be done in order to avoid foreclosure. Ironically, however, although escrow accounts are common in the prime market, they are unusual in the subprime and Alt-A markets. That is, those who are most strapped for cash and least likely to be able to save the money necessary to make separate tax and insurance payments are the ones who are also least likely to receive the benefit of the escrow.

AARP sees escrows and underwriting standards as going hand in hand. One reason that subprime and Alt-A lenders are unlikely to escrow for taxes and insurance is that if they did so, it would become even clearer that the loans they were offering to borrowers were unaffordable. Sound underwriting should evaluate the ability to repay the loan, taxes, and insurance, because all three are required to stay in the home. We address the need for such underwriting later in this document.

The lack of escrow in the subprime and Alt-A markets is unfair because by not including substantial escrow payments in underwriting, lenders offer unsustainable loans to consumers that cannot be repaid for the life of the loan. From the consumer perspective, the cost of buying a home includes not only the principal and interest, but also the taxes and insurance. Consumers in the subprime and Alt-A markets often can barely afford to make their monthly payment to the lenders; the additional tax and insurance payments may be impossible to make. This can lead to the loss of the home and the loss of any equity that the consumer has managed to build. Consumers in the subprime and Alt-A markets are led to believe that they can afford the monthly payment when in fact they cannot afford the true monthly cost of the home.

The lack of escrows in the subprime and Alt-A markets is also inherently deceptive because borrowers are presented with a seemingly low monthly payment that does not reflect the true monthly cost. In fact, some borrowers who start out with loans with escrows are offered seemingly low monthly payments in loans that do not include escrows, and as a result they refinance into an inferior loan product <u>and</u> pay substantial refinancing fees. This is another loan feature that creates an unbalanced, inefficient, and complicated marketplace that is difficult for consumers to navigate.

That the prime market typically includes escrows for taxes and insurance highlights the unfair and deceptive nature of the practice of not escrowing in the subprime and Alt-A markets. Logic would dictate that prime borrowers are those who are most likely to be able to save to pay for taxes and insurance separately. Yet subprime and Alt-A borrowers, who are the most vulnerable and have the lowest additional income to save for taxes and insurance, do not receive the benefit of the escrow. Instead, to the extent that they are underwritten at all, they are underwritten to a deceptively low level that does not include required payments to avoid foreclosure.

B. Solution: Require escrow for taxes and insurance without an opt-out provision.

AARP believes that escrows for taxes and insurance should be required in all markets, particularly in the Alt-A and subprime ones, without an opt-out option. This would achieve two important goals:

a) ensure that borrowers who make their monthly mortgage payments are able to stay in their homes, and
b) ensure that underwriting includes taxes and insurance, when implemented in tandem with the underwriting rules we urge the Board to adopt later in these comments.

An opt-out provision could actually make matters worse for subprime and Alt-A borrowers. Lenders would likely bury opt-out notices in complicated documents that borrowers do not understand. Lenders surely would encourage borrowers to opt out to receive a lower monthly payment, yet Alt-A and subprime borrowers might not have the discipline or ability to save for taxes and insurance. We suspect that an opt-out option would fuel the practice by allowing originators to claim that consumers who could not afford the loan with the escrow included were requesting to opt out of the escrow.

Another benefit of a requirement for escrows with no opt-out provision is that it would ensure that borrowers comparing loan offers were making apples-to-apples comparisons. This would make them better able to find the loans that were most suitable for them.

C. Disclosure of the absence of escrows is not sufficient.

The Board asks whether lenders should be required to disclose the absence of escrows to consumers and, if so, at what point during the transactions. Because the lack of escrows in the Alt-A and subprime markets is inherently abusive, we believe that disclosure is not adequate. Instead, the practice should be banned.

D. Effect of escrow requirements on the type and terms of credit offered.

As discussed above, the lack of escrow in the subprime and Alt-A markets (as opposed to the prime market) creates confusion among consumers. When they receive loan offers, they do not know whether they are comparing apples to apples. Worse, some believe that they are comparing comparable loan offers when they are not in fact doing so. That is, some borrowers refinance from a loan product that includes escrows into a loan product that does not do so because of a seemingly low monthly payment. Because the new monthly payment does not include the escrow, however, they actually refinance into an inferior loan product.

An escrow requirement would not only help consumers navigate the complex home loan and refinancing marketplace; if combined with AARP's recommended underwriting standards (covered later in these comments), it would help create greater levels of sustainable homeownership.

Stated Income, Low Doc, No Doc, and NINA Loans

A. Problem: These types of loans are both unfair and deceptive.

As the examples of the AARP Foundation's cases demonstrate, stated income, low documentation ("low doc"), and no documentation ("no doc") loans are sometimes used by lenders to misstate income without the knowledge of the borrower.[7] In addition, borrowers whose income is easily verifiable are sometimes offered these types of loans at higher interest rates. The NINA loans take the deception a step farther: the lender does not even ask for the borrower's income, making the loan with no consideration of income at all. Such practices are unfair because they cause substantial injury to consumers, who receive unaffordable loans because their income is artificially inflated, or end up paying a higher interest rate for an undocumented loan when they actually have income that can be documented, which should qualify them for lower interest rates. These types of loans are also inherently deceptive because they rely on misrepresentation or omissions that result in direct harm to consumers.

Industry has argued that some of the practices outlined above are already illegal. For example, falsifying income is fraudulent. Yet fraud laws offer an after-the-fact solution based on litigation. We hope that the Board will institute strong, consumer-protective rules that will ensure that these abusive loans are prevented from being made in the first place.

B. Solution: Require income and asset verification for all loans and ban NINA loans.

The Board should declare that a lender's failure to verify and document all sources of income using the best and most appropriate source of documentation, including payroll and tax records, bank account statements, and/or any reasonable alternative or third-party verification is both unfair and deceptive. In addition, the Board should ban NINA loans; originators should not be allowed to make loans where no income and no assets are reported. AARP is aware of no reasonable basis for such lending. NINA loans fly in the face of sensible underwriting standards that are the basis of sustainable homeownership.

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[7] Industry has noted in the past that borrowers sometimes misrepresent their incomes through these loans. We are interested in reviewing industry's evidence for this; however, we note that no matter who is responsible for the inflation in income, the lack of verification means that borrowers are approved for unaffordable and unsustainable loans. The practice should be stopped no matter who is responsible.

C. Effect of these policies on consumers and type and terms of credit offered.

Requiring income reporting and verification and banning NINA loans would make the marketplace more efficient and ensure that underwriting is based on accurate data. This would improve the marketplace and prevent the issuance of loans based on inflated income – loans that are at higher risk of default and foreclosure. These policies would contribute to sustainable homeownership by ensuring that borrowers could afford to make payments based on their actual income and assets for the life of the loan.

<u>Sensible Underwriting Standards – the Lynchpin of Sustainable Homeownership</u>

A. Problem: Lack of underwriting standards is both unfair and deceptive.

Although all the protections we've discussed in these comments are important, the most essential element to sustainable homeownership is a strong underwriting standard based on the ability to repay the home loan. This is particularly important in the subprime and Alt-A markets where today, to the extent that underwriting does occur, it is largely limited to underwriting at the teaser rate, excluding taxes and insurance. The proliferation of 2/28 and 3/27 loans – which include a teaser rate valid for just two or three years, with an ARM for the remaining life of the loan – have fueled the foreclosure crisis because underwriting has been wholly inadequate. Other exotic products are also problematic. For example, interest-only and payment option ARMs can come with teaser rates of 1-3 percent in effect for just days or weeks; these enormously complex products present different, but equally dangerous risks to homeowners.

For many of AARP's members, who are more likely to be living on fixed incomes than the general population, these exploding ARM loans and other exotic mortgages are particularly inappropriate. An exploding ARM may be appropriate in some instance, for example, a medical or law student in the prime market who needs a low monthly payment in the short term and can afford a much higher monthly payment in a few years; it is inappropriate, however, as a refinancing tool for an elderly homeowner living on a fixed income with all her savings in her home. Yet because of lax underwriting standards, exploding ARMs have been marketed for years to people for whom they are inappropriate because they have been underwritten for the initial teaser rate only (if they have been underwritten at all). Perhaps more dangerous are the payment options ARMs that begin to negatively amortize on Day 1 of the loan and reset once the loan principal increases to 110-125% of the original amount – such loans are time bombs for all but the most financially sophisticated consumers.

Lack of underwriting is an unfair practice because it leads to the proliferation of unaffordable loans, particularly in the subprime and Alt-A markets. This lack of affordability translates into unsustainability – with the result being default and eventual foreclosure. We are seeing the result of this unfair practice today with record levels of defaults and foreclosures that could have been prevented if proper underwriting had occurred.

Lack of underwriting is also a deceptive practice. Older consumers who own their homes are targeted by misleading advertising that emphasizes the initial low monthly payments in exploding ARM mortgages. When they are subsequently approved for those mortgages, these consumers mistakenly assume that they can afford the monthly payments because they believe they have been underwritten for the life of the loan. Older homeowners who took out a mortgage many decades ago, when tight underwriting standards were the norm, do not understand that underwriting standards have changed and, in some cases, do not exist. They assume that when they are approved for a loan, they can afford it, which is how loans were commonly made until relatively recently.

B. Solution: Underwriting to the fully indexed rate plus 100 basis points, including taxes and insurance.

AARP urges the Board to require underwriting at the fully indexed rate plus 100 basis points. Underwriting should be based on the true cost of homeownership to the borrower – principal, interest, property taxes, and hazard insurance.

We believe the fully indexed rate plus 100 basis points represents a valid underwriting standard, as it reasonably approximates what borrowers will pay under ARMs. In a rising interest rate environment, it is possible that borrowers will pay substantially more under the ARM; they could pay up to the maximum allowable amount under the mortgage. The fully indexed rates plus 100 basis points helps ensure that borrowers will be able to afford ARMs, but it does not require underwriting to the maximum allowable rate (which would be unlikely except in a time of unusually high inflation).

C. The need for a rebuttable presumption of unaffordability when DTI exceeds 50 percent.

AARP agrees that there should be a rebuttable presumption that a loan is unaffordable when the debt-to-income ratio ("DTI") exceeds 50 percent. This would place the onus on the lender to show that the loan was not unaffordable when DTI exceeds an already-high level. In addition, we suggest that the Board consider a residual income test, such as the one used by Department of Veterans Affairs, since a low DTI does not guarantee that there will be enough monthly income to cover basic living expenses such as health care, food, and clothing.

D. Ban or severely restrict certain exotic products.

The Board should use its HOEPA authority to ban negatively amortizing ("neg am") mortgages (except for reverse mortgages, which by definition negatively amortize). Such loans are often offered in the form of payment option ARMs, where at least one payment option does not cover the cost of the interest. Consumers do not understand that when they pay this seductively low payment, the principal balance increases. They can easily get into debt over their heads. Such loans are both unfair and deceptive and can directly lead to loss of the home and should be banned.

Summary

The subprime and Alt-A marketplaces today are set up to facilitate the equity-stripping practices of predatory mortgage lenders. The Board has the ability to make significant changes in the entire mortgage marketplace, and especially in the subprime and Alt-A markets, to help ensure that borrowers enter into sustainable home loans. The most critical step the Board could take is to ensure that lenders use proper underwriting techniques so that borrowers can afford the loans they are offered. In addition, the Board should act to ban anti-competitive, deceptive, and unfair practices, such as prepayment penalties, lack of escrow for taxes and insurance, and lack of income reporting and verification.

We would be happy to work with the Board as it moves forward in the rulemaking process. Board staff should feel free to contact Susanna Montezemolo in AARP's Federal Affairs Department for further assistance at (202) 434-3800 or smontezemolo@aarp.org.

Sincerely,

David Certner
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