

COMMENTS
of the
National Consumer Law Center¹
and the National Association of Consumer Advocates²
to the
Board of Governors of the Federal Reserve System

Regarding
the Board's Authority under HOEPA
to Prohibit Unfair Acts or Practices in Connection with Mortgage Lending
[Docket No. OP-1288]

For over a decade, abuses in the subprime market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership. For many, it is their only source of wealth accumulation. Since 1980, foreclosures have increased almost 300 percent, but homeownership has increased only five percent.³ Last year, homeowners suffered over one million foreclosures, more than a 40 percent increase from the previous year.⁴ As of 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.⁵

¹ **The National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments are filed on behalf of NCLC's low-income clients and were written by Alys Cohen, Carolyn Carter, Margot Saunders, and Diane Thompson.

² **The National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

³ NCLC analysis based on data through 2005 from Mortgage Bankers Association, *National Delinquency Survey*; U.S Census Bureau, *Statistical Abstract of the United States*; Census Bureau, *American Housing Survey and American Community Survey*.

⁴ RealtyTrac, *More Than 1.2 Million Foreclosure Filings Reported in 2006* (Jan. 25, 2007), available at <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=1855&acct=64847>.

⁵ Mortgage Bankers Association, *National Delinquency Survey* (2007, first quarter). The pressures of

The importance of this issue is magnified in communities of color; more than half of African-American and 40 percent of Latino families who received home loans in 2005 received subprime mortgages.⁶ Moreover, African-Americans suffer a loss of homeownership at a rate 2.5 times that of whites and Latino families at a rate 1.5 times that of whites.⁷ The average time for a homeowner to again attain homeownership after foreclosure—to recover the status most likely to lead to any wealth accumulation—is over ten years, and 3.5 to 4 years longer for people of color.⁸

Accordingly, it is incumbent upon the Board to restrict abuses and give homeowners the ability to directly protect their homes.

Specifically:

- **The Board should prohibit “stated income” or “low/no doc” loans.** Higher priced loans without income verification have become a standard practice in the subprime market. Many of these loans are made to borrowers who can provide (and in some cases *do* provide) documentation, and therefore can obtain loans that are truly affordable for them. In fact, many prime lenders already use alternative forms of documentation to allow for underwriting for a wide array of consumers. Creditors should be required to use the best and most appropriate form of documentation.
- **The Board should require that creditors originate loans only where the borrower has the ability to repay the loan under the terms of the contract.** For too long, loan originations have been based on the assessed risk to the creditor and the investor. The borrower’s risk must be front and center in this analysis. The Board should define origination of a loan that the borrower does not have the ability to repay as an unfair practice.
- **The Board should require escrowing for taxes and insurance.** Subprime lenders generally do not escrow and this often results in borrowers receiving the unwelcome surprise of higher mortgage costs than expected. Failure to escrow facilitates deception and is associated with expensive and unfair force-placed insurance. The Board should define failure to escrow as an unfair and deceptive practice.

unaffordable loans are accompanied by a backdrop of exploding energy prices, which also burden these homeowners. In addition to housing costs, borrowers also must pay for food, transportation/insurance, health insurance premiums and medications, child care and other unavoidable costs of daily living.

⁶ Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin A123, A160-161 (Sept. 8, 2006), available at <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>.

⁷ Haurin & Rosenthal, *The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells* (Dec. 2004), www.huduser.org/publications/homeown.html.)

⁸ *Id.*

- **The Board should ban prepayment penalties.** Research indicates that borrowers do not receive an interest rate benefit for such provisions. Moreover, prepayment penalties are disproportionately associated with loans to people of color, and to loans that result in foreclosure.
- **The Board should require lenders and servicers to engage in reasonable loss mitigation efforts before foreclosing on a home.** Currently, much of the market is operating without any enforceable mandate to engage in any loss mitigation. Requiring reasonable loss mitigation would not only prevent loss of homes, but would also deter lenders from making unaffordable loans.

I. The Practices Identified in These Comments Are Unfair and Deceptive.

The Board's authority to address abusive practices in the mortgage marketplace is broad. 15 U.S.C. § 1639(I)(2)(A) *mandates* that the Board prohibit acts and practices "in connection with mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section." The terms "unfair and deceptive" have universally been construed to be broad and flexible.⁹

Section 1639(I)(2)(B) is even broader, mandating that the Board prohibit acts and practices in connection with the 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 allows the Board to prohibit refinancing practices that are not abusive in and of themselves, but that are merely *associated with* abusive lending practices, or that are not in the borrower's interest.

Assuming that the Board adopts the interpretive standards for "unfair" and "deceptive" that have been developed under the FTC Act, each of the practices we address in these comments falls within the FTC Act's definition of unfair or deceptive acts or practices. First, all of these practices contribute to borrowers receiving loans that are either unaffordable, or more expensive than those for which they qualify. Borrowers believe that loan originators are giving them the best deal for them,¹⁰ and certainly believe that the underwriting process ensures the affordability of the loan. Practices that undermine these expectations—expectations created by the loan originators—are deceptive. Yet such practices are rife in mortgage lending. Unknown to most borrowers, the broker's incentive structure is at odds with the borrowers' interests. Lenders reward brokers for placing consumers in loans at higher interest rates, with prepayment penalties, and sometimes, most nonsensically, for arranging loans without documentation.

⁹ FTC v. Colgate-Palmolive Co., 380 U.S. 374, 384-5 (1965); Am. Fin. Servs. Ass'n v. FTC, 767 F.2d 957, 968 (D.C. Cir. 1985) (referring to FTC's "broad discretionary authority ... to define unfair practices on a flexible, incremental basis").

¹⁰ Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* http://www.trfund.com/policy/pa_foreclosures.htm, *citing* Fannie Mae's 2002 National Housing Survey.

Moreover, the practices are unfair. The FTC has stated that to justify a finding of unfairness any consumer injury must satisfy three tests: (1) the injury must be substantial; (2) it must not be outweighed by any offsetting benefits to consumers or competition; and (3) the injury must be one that consumers could not reasonably have avoided.¹¹ Abusive loans clearly meet these standards.

These practices cause consumers substantial injury. Abusive loans lead to grievous consumer injury in the form of loss of equity and wealth. Worse, many borrowers lose the home itself, often the major source of stability and savings for their families.

The injury to consumers - and society - caused by these practices is particularly grievous because of their disproportionate impact on minority homeowners. Discretionary broker pricing has contributed significantly to the most basic unfairness in the mortgage market, the racial disparities in loan pricing. African Americans in particular pay far more than whites for home mortgage loans, largely as a result of the origination channel.¹² Disparities between whites and African Americans exist at every income level and credit level.¹³ The disparities increase as the income and credit levels

¹¹ Letter from the Federal Trade Commission to Hon. Wendell Ford and Hon. John Danforth, Committee on Commerce, Science and Transportation (Dec. 17, 1980), *reprinted in International Harvester Co.*, 104 F.T.C. 1070 (1984). Although public policy has been listed as a separate consideration, it is used most often to provide additional evidence on the degree of consumer injury caused by specific practices. *Id.* The Commission applied and formally adopted its 1980 *Unfairness Statement* in 1984. *International Harvester Co.*, 104 F.T.C. at 1060-62. In 1994, Congress amended the FTC Act to effectively codify this interpretation. 15 U.S.C. § 45(n).

¹² Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A159 (2006) (controlling for lender reduces gap between whites and blacks from 37.5%, with 54.7% of blacks receiving high cost loans and 17.2% of non-Hispanic whites receiving high cost loans, to 10%), *available at* <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>; Robert B. Avery & Glenn B. Canner, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, Fed. Reserve Bulletin 344, 380, 394 (Summer 2005), *available at* <http://www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf>; cf. Jim Campen, Saara Nafici, Adam Rust, Geoff Smith, Kevin Stein & Barbara van Kerkhove, *Paying More for the American Dream: A Multi-State Analysis of Higher Cost Home Purchase Lending 10* (2007), *available at* http://www.nedap.org/pressroom/documents/2007_Report-2005_HMDA.pdf (confirming that African Americans and Latinos disproportionately end up in *subprime* lending channels).

¹³ See, e.g., Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 11* (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf; see also Jim Campen, *Borrowing Trouble VII: Higher-Cost Mortgage Lending in Boston, Greater Boston and Massachusetts, 2005* at 8 (Mass. Community & Banking Council, Jan. 2007), *available at* www.masscommunityandbanking.org (highest income Latinos received high-cost home purchase loans at 6 times the rate of the highest income whites; highest income African Americans 7.6 times to receive a high-cost home purchase loan than highest income whites); Geoff Smith, Woodstock Institute, *Key Trends in Chicago Area Mortgage Lending: Analysis of Data from the 2004 Chicago Area Community Lending Fact Book 10* (2006) (African-Americans and Hispanics more likely to receive high-cost loan than white borrowers, disparity increases as income increases); Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces*

of the borrowers increase. In other words, the wealthiest and most credit-worthy African Americans are, compared to their white counterparts, the most likely to end up with a subprime loan. One stark example: African Americans with a credit score above 680 and a loan to value ratio between 80% and 90% are nearly three times as likely as similarly situated whites to receive a subprime loan.¹⁴ This result should shock our conscience.

The harm from these practices is not outweighed by benefits to consumers or competition. There is no benefit to consumers or competition from these loans. They reveal a serious lack of competition and clearly offer no silver lining to the borrower in distress. (Until recently, they did offer such solace to the investor...). Indeed, these practices cause injury to competition. For example, prepayment penalties also reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders. Allowing lenders not to escrow enables bait and switch tactics that disadvantage more responsible lenders.

Consumers cannot reasonably avoid the injury caused by these practices. Consumers generally cannot avoid these abusive mortgage lending practices. Market dysfunctions limit consumers' ability to shop, understand the terms of the loans, or negotiate. To the extent that loan originators are compensated based on origination volume, they have a strong economic incentive to originate loans regardless of whether the loan is in the borrower's interest. This is true whether the originator is an internal loan officer or an independent mortgage broker. Lender-paid compensation to loan officers and mortgage brokers lacks transparency almost completely and rewards originators for selling borrowers loans at inflated rates. Broker and loan officer compensation is often tied to the imposition of prepayment penalties and sometimes to originating stated income loans. These perverse incentives--hidden from the borrower--apply to both brokered and retail loans.

The problems can be particularly acute for brokered loans, where the borrower may believe that the broker is acting in the borrower's interest. Lender compensation often is the lion's share of a broker's total pay. Usually, the amount of lender compensation to the broker is not disclosed until closing; seldom is the reason for the compensation disclosed; and never do the lender and broker disclose the interest rate

of Race and Class Exploitation in the United States, 88 *Geografiska Annaler*, Series B: Human Geography 105 (2006) (finding geographic racial disparities in lending in Baltimore that cannot be explained by income); Stephanie Casey Pierce, *Racial Disparities in Subprime Home Mortgage Lending: Can the Difference Be Explained by Economic Factors?* (2006) (unpublished M. Pub. Pol'y thesis, Georgetown University), available at http://dspace.wrlc.org/bitstream/1961/3612/1/etd_smc54.pdf (a survey of 2004 HMDA data from Louisiana found that blacks were 13.82% more likely than whites to receive a high cost, first lien purchase loan); cf. Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A138 (2006) (piggyback loans more common in minority census tracts, even holding income constant), available at <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>.

¹⁴ See, e.g., Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* 13 (May 31, 2006), available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

bump or other benefit the lender receives as its part of the quid pro quo. Even weak disclosures of the yield spread premiums are often confusing and ineffective to consumers.¹⁵ Compensation structures for internal loan officers are even more opaque and, therefore, possibly more pernicious.

These powerful economic incentives and the enormous imbalance in information between loan originators and borrowers produce a highly dysfunctional market. The current structure incentivizes the lender and broker to collude in misleading the borrower into a high-priced loan rather than to engage in substantive risk-based underwriting and pricing.¹⁶

Any possibility that consumers might be able to avoid these practices is further reduced by the complexity, obscurity, and contingent nature of many of the disadvantageous loan terms (particularly those that are common in the subprime market); the bait and switch tactics that are rife among marketers of mortgage loans; and the fact that accurate and binding Truth in Lending disclosures are required to be presented only at closing, at which point it is usually too late for the borrower to back out without significant personal and financial cost. In addition, pricing of mortgage products, at least in the subprime market, lacks transparency: lenders' rates are not readily available to consumers, and may even be treated as trade secrets.¹⁷

II. The Protections We Propose Should Apply to the Entire Mortgage Market

The restrictions we propose should apply to the entire mortgage market. A practice that is unfair or deceptive remains so no matter who the borrower is. Moreover, the recent implosion in the mortgage market makes it clear that problems are not restricted to subprime loans.¹⁸

Every homeowner should have the right to receive an affordable loan on fair terms. If the Board imposed certain restrictions only on one portion of the market, it would send a signal that abuses can be committed in the other portion of the market. By applying rules across the board, all originators will be able to employ similar standards in all markets, and will be able to originate a diversified pool of loans without claiming that any one kind of loan is "too hard to make" because it must be affordable.

¹⁵ James M. Lacko & Janis K. Pappalardo, Fed'l Trade Comm'n., *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment* (Feb. 2004).

¹⁶ See, e.g., Lloyd T. Wilson, *A Taxonomic Analysis of Mortgage Broker Licensing Statutes: Developing a Programmatic Response to Predatory Lending*, 36 N.M. L. Rev. 297, 329 (2006) ("YSPs reward a broker for engaging in opportunistic loan pricing instead of risk-based pricing.").

¹⁷ See Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 *Housing Policy Debate* 503, (2004) (documenting secret nature and complexity of subprime mortgage rates).

¹⁸ For example, HomeBanc Mortgage, a *prime* lender, filed bankruptcy on August 9, 2007. "HomeBanc Mortgage Files Chapter 11 Bankruptcy," American Banker Online, www.americanbanker.com, visited on August 10, 2007.

In the event the Board still chooses to restrict some protection to the “subprime” portion of the market, the definition of “subprime” should be based on loan terms, not the borrower. Many borrowers who qualify for prime loans receive subprime loans instead, due to steering, push marketing or discrimination. Loans are subprime because of their terms, not because of who receives them. Further, any definition of subprime should be based on an objective, clear standard. We favor a link to a rate or index established by the government, such as Treasury plus several hundred basis points. Nevertheless, there may be some years when such a measure is underinclusive, depending on the spread between short and long-term interest rates. If the Board limits new protections to the subprime market, we urge it to strive for an objective, inclusive standard that accounts for changes in interest rates and differing rate structures for fixed and adjustable rate loans.

The restrictions we propose should also apply to all loans, whether originated by brokers or by lenders themselves. The rules should not depend on whether a lender has outsourced the loan origination function to mortgage brokers rather than retaining loan origination as an in-house function.

III. Stated Income Loans Should Be Banned

Stated income loans are called “liar loans.” That name connotes that it is the *borrower* who is doing the lying, that it is the *borrower* who wants to qualify for a higher payment loan than the income on the tax return will justify. The predominant problem, however, comes from the loan originator, not the borrower. The loan originator creates the fictional income to qualify the unsuspecting homeowner into a loan which is destined to fail because the homeowner generally cannot afford the payments.

If the borrower detects the unaffordable payment amount at closing (not an easy task given the great number of documents presented at closing and the speed with which the borrower is often urged to sign them) and complains about it, the originator typically promises that the loan will be refinanced after some short period of on-time payments. (Indeed, it may be impossible for the borrower to ascertain the monthly payment, even at closing, for the adjustable rate loans that have come to dominate the mortgage market. Under current Truth in Lending rules, no disclosure is required of the amount that the monthly payment may reach if the index rate goes up. Disclosures for payment option ARMs are particularly uninformative.)

Typical stated income loans include:

- homeowners who live exclusively on Social Security, yet their applications include falsified income from babysitting, an export business, or the like;
- homeowners whose income is entirely derived from wages reflected on a W-2, yet the amount of the wages is inflated on the loan application;
- homeowners whose income is solely derived from public benefits but the amount of those benefits is inflated.

Many cases have documented falsification of borrowers' qualifications by loan originators.¹⁹

One reason that stated income loans have proliferated is the pricing structure. Lenders typically offer brokers additional compensation, above and beyond what the broker's contract with the consumer requires, for upselling the borrower into a higher interest rate loan. These yield spread premiums have become a standard fixture in much of the subprime marketplace. Most empirical evidence of broker pricing confirms that

¹⁹ Examples of mortgage loan cases in which the broker's or lender's falsification of information on the loan applications was an issue or at least mentioned as part of the facts include: *United States v. Robinson*, 2004 WL 370234 (4th Cir. Mar. 1, 2004) (affirming conviction of mobile home seller for falsifying buyers' employment and income information and inflating down payments; defendant recruited accomplices to set up phone lines in their homes and verify bogus information when lenders called); *Wilson v. Toussie*, 260 F. Supp. 2d 530 (E.D.N.Y. 2003) (documenting allegations of intentional inflation of appraisals); *Cunningham v. Equicredit Corp. of Ill.*, 256 F. Supp. 2d 785 (N.D. Ill. 2003) (denying motion to dismiss; borrowers allege that broker instructed them to misstate income); *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874 (S.D. Ohio 2002) (denying motion to dismiss fraud, conspiracy, and other claims where loan originator added fictitious income to mortgage loan application); *Hoffman v. Stamper*, 843 A.2d 153 (Md. Ct. Spec. App. 2004) (loan officer complicit in the property seller's practice of creating false gift letters in order to qualify home buyers for FHA-insured loans), *aff'd in part, rev'd in part*, 867 A.2d 276 (Md. 2005) (affirming in all respects except emotional distress damages); *Haser v. Wright*, 2002 WL 31379971 (Mass. Super. Ct. Sept. 4, 2002) (finding that mortgage brokers made intentionally false statement of borrowers' income on loan application); *Opportunity Mgmt. Co. v. Frost*, 1999 WL 96001 (Wash. Ct. App. Feb. 16, 1999). Cases in which falsification was documented, but the court declined to award relief to the consumers, include *Taylor v. Nelson*, 2006 WL 266052 (E.D. Pa. Jan. 31, 2006) (finding lender not liable for fraud based on inflated appraisal absent evidence lender intended to mislead homeowner); *Kuehn v. Stanley*, 91 P.3d 346 (Ariz. Ct. App. 2004) (affirming summary judgment for defendants where homeowners failed to demonstrate detrimental and justifiable reliance on inflated appraisal). As of August, 2007, over 9,100 appraisers had signed a petition to the Federal Financial Institutions Council asking for action to protect them from pressure they feel from lenders, mortgage brokers, and real estate brokers to assess a predetermined value to property. See Concerned Appraisers from Across America Petition, *available at* <http://appraiserspetition.com>.

Examples of falsification by lenders in non-mortgage consumer lending include: *U.S. v. Hernandez*, 2006 WL 861002 (D. Conn. Mar. 21, 2006) (denying defendants' motion for judgment of acquittal or a new trial where defendants, car salesmen, falsified customer credit applications, charged customers for add-ons that were never installed, concealed the MSRP, and charged customers prices higher than the MSRP); *United States v. Rivera*, 2004 WL 3153171 (D. Conn. Aug. 5, 2004); *Knapp v. Americredit Fin. Serv., Inc.*, 245 F. Supp. 2d 841 (S.D. W. Va. 2003) (denying defendants' summary judgment motion on claims of conspiracy and joint venture based on testimony that lender trained auto dealer to create false pay stubs and false down payments); *Gelco Corp. v. Major Chevrolet, Inc.*, 2002 WL 31427027 (N.D. Ill. Oct. 30, 2002) (denying motion to dismiss assignee's claim of "massive pattern of fraud" by auto dealer); *Gelco Corp. v. Duval Motor Co.*, 2002 WL 31844949 (N.D. Ill. Dec. 26, 2002); *Chavarria v. Fleetwood Retail Corp.*, 143 P.3d 717 (N.M. 2006) (affirming judgment against mobile home seller based on fraudulent conduct of two employees in inflating trade-in value of borrower's previous mobile home and including fictitious home improvements in the loan amount). Decisions that document falsification by the dealer or creditor but deny relief to the consumer for other reasons include: *Sumler v. East Ford, Inc.*, 915 So. 2d 1081 (Miss. Ct. App. 2005) (affirming directed verdict for car dealer where borrower failed to demonstrate harm caused by dealer's fraudulent conduct); *Dunn v. Northgate Ford, Inc.*, 16 A.D.3d 875, 794 N.Y.S.2d 449 (App. Div. 2005) (finding consumer's allegations that car dealer inflated her income insufficient to state fraud claim because she herself did not rely on the misstatements); *Peabody v. Northgate Ford, Inc.*, 16 A.D.3d 879, 794 N.Y.S.2d 452 (App. Div. 2005) (same).

brokers do no additional work for additional compensation from lenders,²⁰ and practitioners report that individual brokers confirm this at deposition.

Additionally, lenders charge a higher interest rate for loans arranged with no documentation, whether it was the broker or the borrower who sought the no documentation loan. Borrowers are seldom, if ever, told the cost of applying for a loan without documentation; the broker and the lender agree as to the cost between themselves without disclosure to the borrower.

Even where the lender is not paying the broker more for a stated income loan, the broker - whose compensation typically depends on origination volume - has the incentive to minimize the work involved in originating the loan by instructing the borrower to seek a loan application with reduced or no documentation.

Stated income loans have a history of being unaffordable. Increasing the interest rate for stated income loans does not insulate the lender from the increased risk created by a stated income loan and, for marginal borrowers, may contribute to the risk of eventual default. An unaffordable loan is by definition responsible for substantial injury that has no countervailing benefit. Additionally, income falsification is generally done without the borrower's knowledge and thus is not reasonably avoidable by the borrower. Applications generally are filled out by the loan originator and the borrower simply signs a copy of it as part of the stack of papers quickly presented at closing.

Failure to properly document income allows these practices to flourish. By requiring proper income verification, the Board would minimize opportunities for such practices. The Board should provide the following: *Documentation of income is required for all loans; when the source of income cannot verify the amount of income, bank statements, tax returns and other similarly reliable types of documentation may be used. Failure to document income in accord with this requirement is an unfair and deceptive practice.*

IV. Lending Without Ability to Pay - Based on the Maximum Possible Payment for the First Seven Years of the Loan - Should Be Declared Unfair and Deceptive.

Even when income and assets have not been inflated, many borrowers have received unaffordable loans. These are loans which are designed to fail - either from the

²⁰ See, e.g., Howell Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums at 8 (Jan. 2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (in a survey of mortgage transactions, when yield spread premiums are not paid, brokers received on average no more than 1.5% of the loan amount); cf. Jack Guttentag, *Another View of Predatory Lending* 7-12 (Wharton Financial Institutions Center Working Paper No. 01-23-B, Aug. 21, 2000) (reporting on a survey of mortgage brokers showing no correlation between effort as measured by time expended and payment; brokers largely compensated based on size of loan).

outset,²¹ or as soon as the fixed rate period ends and the payment begins to adjust upward. These loans are made because the individuals and entities involved in the lending process make enough money from the loans so that it does not matter whether the borrower ultimately is forced to refinance or face foreclosure.

The extent to which making unaffordable loans has come to dominate mortgage lending is shown most tellingly by subprime lenders' own words: "[M]ost subprime borrowers cannot afford the fully indexed rate, and . . . it will hurt liquidity for lenders and effectively force products out of the marketplace."²²

Such lending cannot be preserved in the name of access to credit. Borrowers need access to affordable, constructive credit; not just *any* credit.

In determining affordability, loan originators must consider the cost of the loan and the income available to pay that loan. With regard to available income, it is essential that loan originators be required to consider residual income as well as debt-to-income ratio. Simply using a debt-to-income ratio fails to account for the low dollar amounts available to very low-income families.²³ After making housing related monthly payments, and all other regularly scheduled debt payments due as of the date the home loan is made, sufficient residual income must be available to cover basic living necessities, including but not limited to food, utilities, clothing, transportation and known health care expenses.

In Section V of these comments we urge the Board to define as an unfair and deceptive practice the failure to escrow for taxes and insurance. Whether or not the Board adopts that recommendation, however, it should require taxes and insurance to be taken into account in determining the affordability of a loan. If the borrower can afford the mortgage payment but not the tax and insurance payments, the loan is designed to fail just as surely as if the borrower could not afford the mortgage payment.

There has been a lot of discussion about the yardstick that should be used to determine the affordability of an adjustable rate loan. In the Subprime Statement, the federal regulators articulated a standard to determine repayment capacity which "should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule." While this is an important first step and will deter at least federally-regulated lenders from qualifying borrowers only for the teaser rate, it does not go far enough.

²¹ In particular, many borrowers are defaulting prior to loan reset dates or early on in fixed rate loans. These borrowers apparently were not even qualified for the loan at the initial payments and will benefit from an ability to repay standard.

²² Wright Andrews, representing the subprime mortgage lenders, complaining about a Freddie Mac policy, as quoted in *American Banker*, February 29, 2007, at 4.

²³ See Michael E. Stone, *What Is Housing Affordability? The Case for the Residual Income Approach*, Housing Policy Debate, Vol. 17, Issue 1 (Fannie Mae Foundation, 2006), available at http://www.fanniemae.foundation.org/programs/hpd/pdf/hpd_1701_stone.pdf.

There are several problems with this standard. First, the fully indexed rate is a rate which in most loans will *never* actually be the rate that is charged to the borrower. It is a fictional rate which is based on the application of the index at or shortly prior to origination plus the margin that will apply at the end of the first (two or three year) period of fixed rates. If, as is almost certain to be the case, the index rate changes during the fixed-rate period, the rate that will apply at the end of the fixed rate period will be different from the “fully indexed rate” that was calculated when the loan was originated. Assessing the affordability of a loan based on a rate that will never actually be applied to it makes little sense.²⁴

Second, and even more importantly, assessing affordability based solely on the fully indexed rate does not protect homeowners from the risk of increasing payments when the underlying index, for example the LIBOR rate, increases.

Almost all 2/28 and 3/27 loans include terms by which the interest rate that applies for the initial fixed period of the loan is the *lowest* rate that can ever be charged. In other words, the interest rate can climb, but even if the index upon which the interest rate is based drops, the interest rate charged the borrower can never go down.

The interest rates and thus the payments do rise on these loans. Almost all of the subprime loans that we see are based on the six month LIBOR index. During the past eight years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).²⁵ The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

Consider the following changes in interest based on the six month LIBOR history and the effect on the payments on a loan for \$100,000 made in December 2002.²⁶ Note that this example is based on a loan *without* a teaser rate, so the payment shock is *less* than many borrowers are experiencing.

²⁴ Another problem is that the fully indexed rate is often not even the payment that would be required if the index rate remained unchanged during the fixed rate period. In years when the LIBOR rate was low, loans were often made where the initial rate of the loan was *higher* than the fully indexed rate. This has been true in instances when the initial indexed rate was very low. For example, in loans which were initiated between early 2002 and late 2004, when the six month LIBOR varied from 1.99 (in January, 2002) to 2.78 (in December, 2004), typically initial rates were at 8 or 9%, with margins of 5 or 6 over the index.

²⁵ HSH Associates Financial Publishers, <http://www.hsh.com/indices/fnmalibor-2007.html>.

²⁶ We are assuming a \$100,000 principal amount in a standard sub-prime 2/28 adjustable loan, with an initial rate based on the LIBOR rate plus a margin of 6.

Months	LIBOR rate	LIBOR + index	Payment
1-24	1.38% (Nov. 2004)	7.38%	\$691.02
25-30 ²⁷	2.63% (May 2004)	8.63%	\$774.81
31-36 ²⁸	3.51% (Nov. 2005)	9.51%	\$835.51
37-42 ²⁹	4.58% (May 2006)	10.58%, but capped at 10.51%	\$905.30
43-48 ³⁰	5.32% (Nov. 2006)	11.32%	\$962.78
49-54 ³¹	5.35% (May 2007)	11.35%	\$964.91

If interest rate increases on adjustable rate loans are not considered in underwriting, borrowers will continue to feel pressured to return to the closing table for a refinancing, where their equity may be used for closing costs, and where their wealth will continue to dwindle. Others will be unable to refinance, and will lose their homes.

A requirement that the lender ensure that the borrower can pay the fully indexed rate is akin to throwing a drowning swimmer a life preserver with a rope that only reaches halfway. In most situations, the homeowner will drown because the payments required by the adjusted rate will have increased to a point which is more than the borrower can afford. By only requiring underwriting to the fully indexed rate, and ignoring the *highly likely* effect of the payment increases resulting from the interest rate increases, the Board would essentially agree to the continued practice of ignoring the effect of likely interest rate increases on payments. The Board would be placing its imprimatur on behavior that will cause homeowners to be locked into expensive adjustable rate loans that they cannot afford when those loans do what they are designed to do: adjust.

To sustain homeownership and preserve precious equity, the Board should adopt a rule that *it is an unfair and deceptive practice for a lender to make a loan without ensuring, at the time a home loan is made, that the homeowner has the capacity to pay all housing related debt, including taxes and insurance, based on the maximum possible rate and payment which could apply under the terms of the loan for the first seven years.*

This standard would ensure that the borrower would have at least seven years in an affordable loan—the mean length for prime loans—and would provide an incentive to originators to create loan terms that truly reflect the amount the borrower will have to

²⁷ After the 24th payment, the new principal balance is \$98,040.47 and there are 336 installments left.

²⁸ After the 30th payment, the new principal balance is \$97,614.46 and there are 330 installments left.

²⁹ After the 36th payment, the new principal balance is \$97,237.03, and there are 324 installments left.

³⁰ After the 42nd payment, the new principal balance is \$96,907.89, and there are 318 payments left.

³¹ After the 48th payment, the new principal balance is \$96,609.23, and there are 312 payments left.

pay, and the amount the borrower will be able to afford.³²

V. The Board Should Define Failure to Require Escrowing for Taxes and Insurance as an Unfair Practice.

Paradoxically, it is often the least sophisticated borrowers who are most often sold loans without escrows. This is because omitting the tax and insurance payment can fool either a first time homebuyer or an existing homeowner refinancing into thinking that the loan is affordable. Omitting the tax and insurance payment is a favorite trick of brokers and loan officers who promise lower monthly payments.

The failure to require escrow leads to unaffordable loans and inflated foreclosure rates. We have over the years seen many clients who, a year or two into their loans, are faced with losing their homes as a result of unplanned-for tax bills. Additionally, lenders who fail to escrow tax and insurance payments often force-place expensive insurance. Force-placed insurance is not only more expensive than normal insurance; it typically provides less coverage for the homeowner. The failure to escrow permits and encourages the use of expensive and unfair force-placed insurance. There is no reason to permit lenders to create a profit center from force-placed insurance.

By and large, lenders whose primary concern is loan performance require escrows. Lenders whose primary concern is maintaining loan volume for securitization pools typically do not require escrows. Lenders should not be permitted to understate the cost of homeownership by failing to escrow payments.

The Board should adopt a rule that *failure to require taxes and insurance to be escrowed is an unfair and deceptive practice.*

VI. The Board Should Define Contracting for a Prepayment Penalty as an Unfair Practice.

The abusive practices described above - stated income loans, lending without regard to the consumer's ability to repay the true payment, and failure to require escrow - are tactics that put borrowers into bad loans. Prepayment penalties keep them there.

Over 70% of subprime loans include prepayment penalties.³³ Payment of the yield spread premium is often conditioned on the borrower's acceptance of a prepayment penalty.³⁴ Thus, brokers have an incentive not only to put borrowers into a high cost loan

³² Another approach, which has been raised by Rep. Ellison's bill, H.R. 3018, is to qualify borrowers at the fully indexed rate plus additional basis points.

³³ David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (Dec. 11, 2006), available at <http://www.ots.treas.gov/docs/4/48978.pdf>. See also Doug Duncan, *Sources and Implications of the Subprime Meltdown*, Manufactured Housing Institute (July 13, 2007), available at <http://tondahall.com/tlhdocuments/lagunapresentation.pdf>.

³⁴ See Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, *Unfair Lending:*

in order to receive a YSP, but also to make sure the borrower is locked into the high cost loan.

Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest. In addition, prepayment penalties are disproportionately imposed on borrowers in minority neighborhoods.³⁵ Data is accumulating that borrowers in brokered loans receive no interest rate reduction from the imposition of a prepayment penalty: for most borrowers, it is a lose-lose proposition.³⁶

Prepayment penalties harm consumers. They are associated with an elevated risk of foreclosure.³⁷ By keeping the consumer in an unaffordable product, the *quid pro quo* between lender and broker thus contributes to the foreclosure crisis. These harms are not outweighed by benefits to consumers or to competition. Indeed, prepayment penalties reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders. Finally, borrowers cannot reasonably avoid prepayment penalties. A prepayment penalty is a complex and contingent contract term that would be relatively immune to the comparison shopping even if the disclosure regime were drastically improved.

The Board should adopt a rule that *inclusion of a prepayment penalty is an unfair and deceptive practice*.

The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (noting that payment of yield spread premiums is often conditioned on the imposition of a prepayment penalty).

³⁵ Debbie Gruenstein Bocian and Richard Zhai, Center for Responsible Lending, Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans (January 2005), *available at* http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf.

³⁶ *See, e.g.*, Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for “borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate,” in which case the difference shrank); *see also* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* 3-4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

³⁷ *See, e.g.*, Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category* 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* 21 (Dec. 2006), *available at* <http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf> (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation).

VI. The Failure to Engage in Meaningful Loss Mitigation Before Initiating Foreclosure Should Be Declared an Unfair Trade Practice

The Board should require that reasonable loss mitigation efforts must be pursued before a foreclosure can be initiated on a home mortgage. By doing so, servicers would be required to evaluate affordable and reasonable alternatives to foreclosures and save money for their investors while preserving homeownership. *We specifically request that the Board make it an unfair practice for a lender to proceed to foreclosure on a home mortgage unless reasonable loss mitigation alternatives have been attempted.*

There are significant losses when a home is sold through a foreclosure. The homeowner loses the equity built up in the home,³⁸ which for many families is their chief form of wealth-building. The family suffers a disruptive move away from its support systems. Children may face academic difficulties because of changing schools. The neighborhood and the community deteriorate.³⁹ “Every new home foreclosure can cost stakeholders up to \$80,000, when you add up the costs to homeowners, loan servicers, lenders, neighbors, and local governments.”⁴⁰

As a result there should be every effort to avoid the foreclosure. Loss mitigation offers all parties the opportunity to reduce these financial losses, save homes, and maintain neighborhoods. So long as the cost of the loss mitigation effort is less than the cost of the foreclosure for the investor, the effort is sensible and cost effective.

Reasonable loss mitigation activities generally include a range of alternatives –

1. *A delay of the foreclosure sale* to allow time to work out a foreclosure avoidance agreement;
2. *A repayment plan* to cure a default by allowing the homeowner to make scheduled monthly payments as they are due, together with partial monthly payment on the arrears;
3. *A forbearance plan* to provide a more formal agreement to repay the arrears over

³⁸ According to the Center for Responsible Lending, By the end of 2006, “2.2 million households in the subprime market either have lost their homes to foreclosure or hold subprime mortgages that will fail over the next several years. These foreclosures will cost homeowners as much as \$164 billion, primarily in lost home equity.” Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, Center for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, December, 2006 at 2.

³⁹ A foreclosure is quite damaging to the neighborhood in which it occurs. Some examples of this include the drop in property values in low- and moderate-income neighborhoods in Chicago and Minneapolis directly resulting from home foreclosures. Crime rates increase as well when homes are abandoned. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosures: The Impact of Single-Family, Mortgage Foreclosures on Property Values* (Dec. 30, 2005), Housing Policy Debate.

⁴⁰ Joint Economic Committee, U.S. Senate, *Sheltering Neighborhoods from the Subprime Foreclosure Storm* at Summary. April 11, 2007.

a period of time while making regular monthly payments;

4. A *temporary interest rate reduction* for homeowners who have financial problems which appear to be temporary in nature, but which preclude full payment of the mortgage for a foreseeable period of time;
5. *Deferral of missed payments* by which missed payments are no longer treated as missed but are instead added to the end of the loan obligation;
6. A full *modification of the loan* which can include one or more of a combination of interest rate reduction, extension of the loan terms, reamortization, and cancellation of principle. Loan modification will generally be the necessary response to the multitude of subprime, adjustable rate loans, which are currently adjusting to unaffordable payments.⁴¹

Indeed the FHA,⁴² as well as Fannie Mae⁴³ and Freddie Mac,⁴⁴ recognize the financial loss to their investors, as well as the devastation to homeowners from foreclosure, and specifically require loss mitigation before foreclosure should be pursued when a homeowner is in default. Most Pooling and Servicing Agreements (“PSAs”), governing the trusts in which most home mortgages are held, permit loss modification.⁴⁵ The federal banking agencies have also issued encouragement for loss mitigation.⁴⁶

However, for all of the mention of loss mitigation by these housing agencies, the permission included in the PSAs, or even the recommendations by the banking regulators, nothing *requires* that loss mitigation be pursued before foreclosure. None of these entities *enforce* any requirement to consider alternatives before initiating the process that will cost a family their home. Homeowners can only occasionally raise them as a defense to a foreclosure, and the investors have no institutional mechanisms to police loss mitigation efforts.

Moreover, there are no specific loss mitigation requirements – other than those

⁴¹ See National Consumer Law Center, *Foreclosures – Defenses, Workouts, and Mortgage Servicing*, Chapter 2 (1st Ed. 2005) and 2006 Supplement.

⁴² U.S. Dep’t of Hous. & Urban Dev., Loss Mitigation Program-Comprehensive Clarification of Policy and Notice of Procedural Changes, Mortgagee Letter 00-05, at 1 (Jan. 19, 2000). See also *Wells Fargo Home Mortg., Inc. v. Neal*, 2007 WL 1310141 (Md. May 7, 2007).

⁴³ Fannie Mae Single Family Selling and Servicing Guide, Part VII, Chapter 3.

⁴⁴ Freddie Mac Single Family Servicing Guidelines 65.1.

⁴⁵ American Securitization Forum, Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007; Kenneth Harney, Mortgage Mod Squad, Washington Post, April 14, 2007, at F01.

⁴⁶ The federal banking regulators have encouraged financial institutions to work with “financially stressed” borrowers. FFIEC, “Statement on Working with Mortgage Borrowers,” April, 2007. This seems intended to specifically permit and facilitate loss mitigation techniques to avoid foreclosures. This is good in so far as it goes, yet there no *requirements* on these financial institutions to avoid foreclosures through loss mitigation. Further, many home mortgages are not serviced by federally regulated financial institutions.

vaguely included in some PSAs – applicable to the millions of subprime loans which are not subject to FHA, Fannie Mae or Freddie Mac rules. Yet these are often mortgages that need most intervention.

Indeed, there are powerful market forces that work to actively discourage meaningful loss mitigation efforts prior to foreclosure. Servicers have clear incentives to encourage default, and have strong financial disincentives to spend the extra time and expense required to engage in foreclosure avoidance techniques. Servicers receive only a small part of their income from a monthly fee in return for the regular business of receiving monthly payments and forwarding appropriate portions of principal and interest to the investors.⁴⁷ Servicers also receive income from the “float income”⁴⁸ as well as *ancillary* fees.

Ancillary fees consist of late fees and other “service” fees. Such fees are a crucial part of servicers’ income. For example, one servicer’s CEO reportedly stated that extra fees, such as late fees, appeared to be paying for all of the operating costs of the company’s entire servicing department, leaving the conventional servicing fee almost completely profit.⁴⁹ *Consequently, servicers have perverse incentives to charge borrowers as much in fees, both legitimate and illegitimate, as they can. For example, just one improper late fee of \$15 on each loan in one average size loan pool (3500 loans) would generate an additional \$52,500 in income for the servicer.* The charging of these fees by servicers make recovery from default more difficult for homeowners, making foreclosure more likely.

Lenders, investors and servicers for years have been publicly stating that they dislike foreclosures, that foreclosures cost them money, and that they only engage in them as a last resort. As advocates working with the lawyers who represent these homeowners, we find that these statements are – unfortunately – rarely true.⁵⁰ Servicers

⁴⁷ The basic fees received by servicers for processing monthly payments are based on the outstanding principal loan balance and typically range from 25 basis points (prime loans) to 50 basis points (subprime loans). For example, a securitized loan pool with an outstanding balance of \$900 million and a 38 basis point servicing fee would generate yearly income of approximately \$3.42 million for the servicer. Payments to servicers range from 1/4 of 1% of the note principal to 1 3/8%. See, e.g., Fannie Mae Singly Family Selling Guide, Part I: Lender Relationships, Chapter 2: Contractual Relationship (June 30, 2002), 201: Mortgage Selling and Servicing Contract (Sept. 28, 2004), 201:04: Servicing Compensation (June 30, 2002), available at www.allregs.com/efnma/. See also Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Policy Debate 753 (2004) (issue 3).

⁴⁸ Float income is the amount earned on funds invested between the collection of the payment from the borrower and the disbursement to the owner. For loans with escrow accounts, float income may also be earned on collected funds until they are disbursed to the taxing authority or insurance provider. Important factors affecting float earnings include escrow disbursement timing and escrow analysis and cushion requirements.

⁴⁹ Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Policy Debate 753 (2004) (issue 3) at 758.

⁵⁰ We regularly work with attorneys in almost every state in the nation on their efforts to save homes from predatory lending. We provide assistance through our books, our trainings, regular case consultations, and our provision of expert witness services. We learn about the problems in the marketplace from these

appear to pursue foreclosure at the first opportunity, and too often engage in strategies that make it near impossible for homeowners to recover from a default.⁵¹

These negative incentives on servicers mean that servicing of a loan often affects homeowners as much as or more than how the loan was originated.⁵² In other words, the negligence or the malfeasance of mortgage servicers has directly and considerably contributed to the rising rates of foreclosures almost as much as problems resulting from predatory loan terms.

Even in these days of dramatically escalating foreclosures of subprime mortgages⁵³ and recognized losses from foreclosures in the newspapers on almost a daily basis, loss mitigation does not appear to be widely and routinely engaged in before foreclosures are initiated. As a response to these potentially astronomical losses, investors are encouraging – with fairly loose and vague standards – loan modifications when they can be made in such a way as to reduce these losses to investors.⁵⁴ A number of subprime lenders have also committed to engage in loan modification efforts.

However, despite the new public attention on loss mitigation efforts, as well as

attorneys, and in turn, help frame viable solutions both through litigation strategies as well as policy changes, to the problems these attorneys describe.

⁵¹ *Id.* There are currently hundreds of lawsuits, both individual and class actions, against scores of servicers for – among other claims – breaching the duty of good faith and fair dealing, for pushing homeowners into unnecessary and illegal foreclosures. Just a few examples include, *In re: Ocwen Loan Servicing, LLC Mortg. Servicing Litigation*, --- F.3d ---, 2007 WL 1791004, C.A.7 (Ill.), June 22, 2007 (NO. 063132); *Hauf v. Homeq Servicing Corp.*, 2007 WL 486699 (M.D. Ga. Feb. 9, 2007) (wrongful foreclosure after forbearance agreement paid in full); *Hukic v. Aurora Loan Servicing*, 2006 WL 1457787 (N.D. Ill. May 22, 2006) (servicer's clerical error in recording amount of payment left homeowner battling with subsequent servicers and fending off foreclosure for nearly five years); *Rawlings v. Dovenmuehle Mortgage, Inc.*, 64 F. Supp. 2d 1156 (M.D. Ala. 1999) (servicer failed for over 7 months to correct account error despite borrowers' twice sending copies of canceled checks evidencing payments); *Choi v. Chase Manhattan Mortg. Co.*, 63 F. Supp. 2d 874 (N.D. Ill. 1999) (home lost to tax foreclosure after servicer failed to make tax payment from borrowers escrow account and then failed to take corrective action to redeem the property); *Monahan v. GMAC Mortg. Co.*, 893 A.2d 298 (Vt. 2005) (affirming \$43,380 jury award based on servicer's failure to renew flood insurance policy and subsequent uninsured property damage).

⁵² See, e.g. Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 *Housing Policy Debate* 753 (2004) (issue 3); Zalski, Walter E. 2003. *Mortgage Loan Servicing: The Rest of the Compliance Iceberg*, Paper Presented at Current Issues in Mortgage Loan Servicing at the Annual Meeting of the American Bankers Association, San Francisco, August 10.

⁵³ Over one million homes will be lost to foreclosure between last year, this year and next year due to the loosened underwriting standards applicable to adjustable rate, no or low doc loans offered in the subprime market. 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) at 11–15.

⁵⁴ Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Fixed Income Research, April 5, 2007, <http://www.credit-suisse.com/researchandanalytics>; American Securitization Forum, *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans*, June 2007; Kenneth Harney, *Mortgage Mod Squad*, Washington Post, April 14, 2007; F01.

the recognition that modifying the problem subprime loans can save many homes,⁵⁵ there is little clear, consistent guidance on how these loss mitigation programs should be carried out, and reports from the field are that homeowners see little, if any, difference in efforts to avoid foreclosure.

Investors may lose money from most foreclosures, but servicers do not. Currently, servicers rarely are provided sufficient financial incentives to engage in meaningful loss mitigation. If everyone loses money from the foreclosure *except* the party responsible for initiating it and pushing it through, there will have to be some other powerful push to make those parties – the servicers – engage in pre-foreclosure loss mitigation. The damage to homeowners from foreclosures – especially those foreclosures which could be avoided by effective loss mitigation techniques – is manifest. This is the perfect opportunity for the Board to act in a way that protects homeowners from an industry-wide practice that they cannot avoid.

The Board should declare that it is an unfair practice for a foreclosure to be pursued before meaningful loss mitigation alternatives have been considered with the homeowner. The key elements of a loss mitigation requirement are not complex and need not be re-invented.⁵⁶ All loss mitigation efforts should be premised on saving the home for the borrower and family – unless the homeowner indicates that is not his/her desire. A range of alternatives should be available, depending on the borrower’s circumstances. As is recognized in all of the existing loss mitigation programs, ensuring that the homeowner can afford and sustain the new terms of the mortgage is a key factor to a successful loss mitigation effort.⁵⁷

⁵⁵ See, e.g. Freddie Mac 65.28: “If the Borrower wants to keep the property and has a stable source of monthly income, then consider whether to recommend a loan modification”; Fannie Mae, Part VII, Chapter 502 – Mortgage Modifications: “A servicer should consider modification of a delinquent mortgage under circumstances similar to the following: . . .the terms of the mortgage (such as those imposed by a nonstandard adjustable-rate mortgage) contribute toward a greater risk of borrower default; or any other situation in which changing the terms of the mortgage would cure the present delinquency, avoid acquisition of the property, or prevent future delinquencies.”

⁵⁶ Fannie Mae and Freddie Mac have engaged in loss mitigation for years; in addition, Senator Reed has just introduced a bill to, among other things, require loss mitigation efforts before a foreclosure can be initiated. See, S.1386. Many of the proposals in these comments are spelled out in code form in Senator Reed’s bill.

⁵⁷ See, e.g., Freddie Mac, Single Family Seller Servicer Guide, Volume II, Chapter B65. §