CENTER FOR RESPONSIBLE LENDING

COMMENTS

On

HOME EQUITY LENDING MARKET

72 Fed Reg. 30380 (May 31, 2007)

Docket OP-1288

August 15, 2007

VIA ELECTRONIC MAIL

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The Center for Responsible Lending[1] submits the following comments in response to the questions posed by the Board in conjunction with the June 14, 2007 hearing on the home equity lending market and the Board's authority to address concerns about abusive lending practices.

Summary of Recommended Regulations:

In this Comment, CRL urges the Board to issue regulations, pursuant to its authority under 15 U.S.C. § 1639*l*, to: (1) ban two unfair or deceptive practices not prohibited by the federal agencies' recent Subprime Statement and Guidance on Nontraditional Mortgage Product Risks; and (2) codify and extend three essential protections discussed in the Statement and Guidance. As detailed below, for subprime mortgage loans, the Board should ban prepayment penalties, which lock borrowers into unaffordable loans, and yield-spread premiums, which place brokers into a conflict of interest with their clients. At a minimum, the Board should ensure that lenders do not profit from the conflict they create by paying yield-spread premiums, and should therefore hold lenders liable for broker acts and omissions where the lender pays the broker a yield-spread premium. Additionally, for both subprime and nontraditional mortgage loans, the Board should promulgate rules concerning affordability, documentation of income and escrows of real estate taxes and property insurance.

Specifically, in order to adequately respond to the pervasive, systemic failures in the subprime market, the Board should amend Regulation Z, 12 CFR § 226 *et seq.* to:

- Prohibit the imposition of prepayment penalties on subprime loans, as defined herein; and

- Prohibit the payment of yield-spread premiums on subprime loans. At minimum, the Board should establish lender liability for broker acts and omissions in cases where the lender pays the broker a yield-spread premium.

- Codify the ability to repay, income verification and escrowing of taxes and insurance protections addressed in the Nontraditional Mortgage Guidance and Subprime Statement. The Board should therefore also amend Regulation Z to require lenders, for subprime and nontraditional mortgage loans, to:

    - Determine the borrower's ability to repay in accordance with the loan terms, based on a fully amortizing loan schedule, at the fully indexed rate, taking account of the borrower's obligations to pay real estate taxes and property insurance;

[1] The Center for Responsible Lending is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, one of the nation's largest non-profit community development financial institutions.

- Verify and document all sources of income using either tax or payroll records, bank account statements or any reasonable alternative or third-party verification;

- Escrow taxes and insurance.

In applying these rules to the subprime market, we suggest that the Federal Reserve adopt a new "bright-line" definition of subprime that focuses on the terms of the loan. This will ensure that the industry is able to determine easily which loans are subject to the rules.

The federal agencies previously defined subprime with reference to the characteristics of the borrowers who typically receive subprime loans.[2] However, because subprime lenders frequently steer prime-qualifying borrowers into subprime loans,[3] effective regulation should define the covered loans with reference to the characteristics of the loans themselves. As we explain in detail in Section IV below, we offer a bright-line definition of "subprime:" loans in which the APR exceeds the greater of the HMDA reporting threshold, or the Freddie Mac survey rate plus 1.75%.[4] Where we recommend inclusion of nontraditional mortgages, we recommend using the definition in the nontraditional guidance.

We also recommend that the Board codify the definition of nontraditional mortgage loans set out in the Guidance.

This Comment addresses these recommendations more fully and responds to the specific questions that the Board posed about abusive practices such as prepayment penalties and the need for regulations concerning the ability to repay, verification of income and escrowing of taxes and insurance. The *Introduction* describes the scope of the crisis affecting homeowners in the subprime market. *Section I* discusses the Board's authority to promulgate rules and the legal standards that apply. *Section II* applies those standards to the recommendations that the Federal Reserve prohibit prepayment penalties and yield-spread premiums on subprime loans and

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[2] Expanded Guidance for Subprime Lending Programs, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision (Jan. 31, 2001) ("2001 Expanded guidance") at 2-3, *available at* http://www.ots.treas.gov/docs/2/25137.pdf.

3 For most types of subprime loans, African-Americans and Latino borrowers are more likely to be given a higher-cost loan even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages,* Center for Responsible Lending, (May 31, 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010. *See also* Darryl E. Getter, *Consumer Credit Risk and Pricing,* Journal of Consumer Affairs (June 22, 2006); Mike Hudson & E. Scott Reckard, More Homeowners with Good Credit Getting Stuck with Higher-Rate Loans, Los Angeles Times p.A-1 (October 24, 2005); Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* 533, 562, 569, Housing Policy Debate 15(3) (2004).

[4] The basis for these rates are explained in detail in Section III, and Appendix D charts the relative movement of the two over the past seventeen years.

addresses the Board's questions regarding prepayment penalties and other predatory and abusive practices. *Section III* provides recommendations for codifying the existing subprime and nontraditional guidance into unfair and deceptive rules for the subprime and nontraditional mortgage markets and addresses the Board's questions concerning underwriting, the critical need to assess ability to repay and the escrowing of taxes and insurance. *Section IV* offers a bright-line definition of subprime loans to which all of the recommendations apply and *Section V* discusses how HOEPA remedies will apply to the rules as recommended. The full text of the regulations suggested in this Comment is set out in Appendix A.

Introduction

As of year-end 2006, there were approximately 7.5 million subprime home mortgage loans outstanding, reflecting a total of $1.4 trillion in debt.[5] While subprime loans are 13% of the total outstanding mortgage loans in the U.S., these loans account for more than 60% of foreclosures in recent years, a rate that is 10 times the foreclosure rate for less dangerous, conventional home loans. CRL has estimated that approximately 20% of subprime mortgage loans originated in 2005 and 2006 will end in the loss of the home to foreclosure. This represents over one million homes lost.[6] And this figure is conservative. Lehman Brothers forecasts a subprime loan foreclosure rate of 30% on loans originated in 2006.[7]

High foreclosures in the subprime market have been driven by increasingly loosened underwriting standards combined with dangerous loan products that are designed to force borrowers to refinance. The predominant such product is the 2-28 and 3-27 exploding hybrid ARM, which effectively operate as two- or three-year balloon loans, typically carrying a relatively low introductory interest rate that increases sharply after a short period of time, followed by upward rate adjustments every six months for the remainder of the loan term.[8]

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[5] Remarks by Chairman Ben S. Bernanke At the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois (May 17, 2007).

[6] CRL's research projects that 19.4% of mortgage loans originated in 2005 and 2006 will end in the loss of the home to foreclosures. CRL estimates that the foreclosure rate for all loans originated between 1998 and 2006 is 15.4%. Because many of the earlier vintage loans have already ended in foreclosure, and because subprime loans are typically refinanced within 30 months, most of the 7.5 million outstanding loans are from the later vintages. CRL estimates that the weighted average foreclosure rate for all subprime loans originated between 2003 and 2006 is 17.5%. Applying this rate to the 7.5 million outstanding results in the projection of over 1.3 million homes yet to be lost to foreclosure. 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) ("*Losing Ground*") at 11-15.

[7] *Mortgage Finance Industry Overview*, Lehman Brothers Equity Research, p. 1 (December 22, 2006).

[8] *See*, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* p. 2 Fitch Ratings Credit Policy (August 21, 2006). Hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector." *Id.* Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002. *Structured Finance*, note 12.

Lenders extending these loans typically fail to escrow for required taxes and insurance. Until recently, faced with increases in monthly payment of as much as 40% in a brief period, families refinanced repeatedly to avoid unmanageable increased payments, achieving temporary relief and sacrificing considerable equity with each transaction. However, as housing price appreciation has slowed, accumulated equity is no longer available, making it more difficult for the homeowner to refinance the loan or to sell the home, increasing the number of foreclosures in the subprime market dramatically.

We estimate that the prevalence of such subprime loans over the last several years will result in over 2.2 million families losing their homes to foreclosure, as well as up to $164 billion in wealth.[9] These numbers do not include the loss of wealth by households located near foreclosures.[10] The costs of subprime foreclosures fall heavily on African-American and Latino homeowners, since subprime mortgages are disproportionately made in communities of color. In fact, the foreclosure crisis and stripping of equity through abusive subprime loan terms will likely constitute the largest loss of African-American and Latino wealth in American history.[11]

The federal agencies' recently promulgated Statement on Subprime Lending is "intended to protect consumers from unfair, deceptive, and other predatory practices, and to ensure that consumers are provided with clear and balanced information about the risks and features of these loans."[12] The Statement is an extremely welcome and positive start, but more is needed to assure that they are enforceable, and that they apply to all subprime lenders. More critically, the statement does not address two practices that are central to market imperfections that have come to define the subprime market and have contributed to the damage of the current foreclosure crisis: prepayment penalties and yield-spread premiums. Meaningful action must go beyond the guidance to address these practices, and it must also ensure that the standards apply to all subprime lenders.

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[9] "Losing Ground," *supra* note 6, at page 3. This figure includes homes already lost, and those projected to be lost. Unlike MBA foreclosure statistics, foreclosures as used in this study means completed foreclosures, not initiated foreclosures. *Id* p. 10.

[10] *See* Dan Immergluck and Geoff Smith, *Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute (2004); *See also* Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 66, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006), available at: http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.

[11] "Losing Ground," *supra* note 6, at 11, 23. *See also* Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending, (January 2005) at http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf.

[12] Federal Reserve System Docket No. OP-1278 (June 29, 2007) ("Subprime Statement") at 3. The guidance was preceded by an Interagency Guidance on Nontraditional Mortgage Products, which applies to interest-only and payment-option ARMs. Because of the increasing level of abuse of these products, we also believe that certain rules should apply to these products as well.

Faced with overwhelming evidence linking subprime lending practices to the causes of the current crisis, lenders are now encouraging policymakers to eschew substantive regulation in favor of increased disclosure of lending terms. Such regulation would be insufficient to address market needs, or satisfy the Board's HOEPA obligations. As noted by the National Association of Attorneys General, disclosures are wholly inadequate to properly address the current problems:

> "We specifically urge the Board not to rely on further disclosure requirements as the exclusive remedy for any of these problem areas. Mortgage lending is already a disclosure-laden process, and disclosures have been of minimal utility in deterring abusive practices. While we support continuing efforts to improve and streamline disclosures, we recognize that these efforts do not adequately address the core unfair and deceptive lending problems." [13]

Further action is necessary to restore fairness in the marketplace. To re-establish a stable marketplace for lenders and consumers, a return to common-sense underwriting is needed to drive out unfair and deceptive practices that ensnare borrowers and shunt them away from responsible lenders providing opportunities for sustainable homeownership. The race to the bottom must be replaced with a return to common-sense underwriting in the subprime market which will, in turn, bolster confidence in the larger marketplace and minimize the aftershocks of the current subprime foreclosure crisis.[14]

The Board has the opportunity to promulgate regulations banning certain predatory lending practices that are linked to elevated foreclosure risk, and the obligation to ban practices that are unfair, deceptive, and abusive within the meaning of 15 USC § 1639(*l*)(2). The Board's authority to provide necessary safeguards extends to a broader segment of the market than those that are defined as high-cost loans under 15 USC § 1602(aa) and covers all loans that are the subject of unfair or deceptive acts and practices. The evidence now is beyond dispute that there are significant abuses in the market for mortgages at rates below "high cost" as HOEPA defines it. Therefore, existing rules must be tightened, and applied more broadly.

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[13] *See* National Association of Attorneys General, *Letter to Hon. Ben Bernanke, Re: Docket No. OP-1288,* p.4 (August 13, 2007).

[14] *See, e.g.* Floyd Norris and Eric Dash, *In a Credit Crisis, Large Mortgages Grow Costly*," New York Times (Sun. Aug. 12, 2007), (summarizing, "For months after problems appeared in the subprime mortgage market — loans to customers with less-than-sterling credit — government officials and others voiced confidence that the problem could be contained to such loans. But now it has spread to other kinds of mortgages, and credit markets and stock markets around the world are showing the effects."), available at: http://www.nytimes.com/2007/08/12/business/12mortgage.html?ref=todayspaper#

I. The Board Has a Mandate to Prohibit Unfair or Deceptive Practices in Connection with Mortgage Lending.

Congress enacted the Home Ownership and Equity Protection Act (HOEPA) in response to evidence of considerable abuse in the subprime mortgage market, and the disproportionate impact those abuses had on minority homeowners.[15] Recognizing that abuses in the marketplace continually change and evolve, Congress built into HOEPA a mechanism to deal with problems as they develop, without the necessity of further legislation. It assigned to the Board the duty to monitor the market to examine the "adequacy of existing regulatory and legislative provisions" to protect consumers, particularly low-income consumers,[16] and directed the Board to prohibit unfair or deceptive acts or practices – practices designed to evade HOEPA – and refinancings associated with practices that are abusive or otherwise not in the interest of the borrowers. 15 USC 1639 (*l*)(2).

Cautious about the unintended consequences of "overregulation," both Congress and the Board initially took very limited steps to respond to reckless underwriting and improper use of prepayment penalties that trapped borrowers in unaffordable, harmful loans, problems that were even then evident in the market.[17] Events since that time have demonstrated that the unintended consequences of *under*-regulation can be of even greater concern and can be catastrophic for consumers and the market. Central to the current crisis are some of the same problems identified in 1993 and 1994: prepayment penalties that lock people into unaffordable loans, inadequate attention to borrowers' ability to sustain payment on the loans, and broker abuses.[18] In that time,

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[15] *See, e.g. Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining and Home Equity Lending,* Hearings Before the Senate Comm. On Banking, Housing and Urban Affairs, 103d Cong. 1st Sess. (Feb. 3, 17, 24, 1993).

[16] Pub. L. No. 103-325, Title I, § 158.

[17] H.R. Conf. Rep. No. 652, 103d Cong. 2d Sess. 147, 160 (1994), S. Rep. No. 103-169, at 25-26, *reprinted in* 1994 U.S.C.C.A.N 1881. Limitations on prepayment penalties applied only in narrow circumstances, such as when loan has very high fees or APR and when the penalty is longer than 5 years, 15 USC § 1639(c), Reg. Z,§ 226.32(d)(6)&(7). The prohibition on asset-based underwriting did not protect any individual consumer, a defect that led one judge to note that corrective amendments were called for. *Newton v. United Co. Fin. Corp.* 24 F. Supp. 2d 444, 455 (E.D. Pa. 1998) (though the company made unaffordable HOEPA loans to plaintiffs, the "pattern and practice" requirement in HOEPA's ability to pay requirement precluded relief.). A 1998 joint FRB-HUD report to Congress also noted continued reports of loans that "degrade financial stability," by being made without concern about the borrower's repayment ability. Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July, 1998), at 61-62, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

[18] The 1998 joint FRB-HUD report noted the continuation of such problems in the market, and further observed that "it is unlikely that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and abusive practices." *Id* at 51. In that report, HUD also recommended in that report further limitations on lending without regard to ability to pay, further restrictions on prepayment penalties, and applying such reforms to a broader segment of the market than 1602(aa) loans. Id. at p. 74-75. Like

these problems have grown more pervasive and more extreme, demanding substantial regulatory reform. New solutions are required, and those solutions must be adequate to today's task.

In implementing the HOEPA requirements, Congress directed the Board to utilize both state and federal precedent in identifying unfair or deceptive practices.[19] These standards are discussed in detail in Appendix B and summarized below.

Unfairness: Under the current federal standard, an unfair practice is one that:

- causes substantial consumer injury;
- is not outweighed by countervailing benefits to consumers or competition; and
- is not reasonably avoidable by consumers.

State standards for unfairness are typically broader than the current federal definition.[20] A common standard, used by courts in at least a dozen states, formerly used by the FTC and noted with approval by the Supreme Court[21] considers whether a practice:

- "without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise – whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness;"

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opportunistic infections, these abuses have continued to spread in the last decade, making clear that the time has come to take the necessary action.

[19] House Conf. Rep. 103-652, at 161("In making any determination, the Board should look to the standards employed for interpreting *state unfair and deceptive trade practices acts and the Federal Unfair and Deceptive Practices Act* (15 U.S.C. S 45(a)(1))." (emphasis supplied)). For discussions of state and federal standards for unfairness and deception, *see generally* National Consumer Law Center, *Unfair and Deceptive Acts and Practices,* Chap. 4 (6th Ed. 2004 and supp.); Michael M. Greenfield, *Consumer Law: A Guide for Those Who Represent Sellers, Lenders and Consumers.* (1995). For cases discussing the application of state and federal UDAP laws as they relate to mortgage lending issues discussed herein, *see esp.* NCLC, *Unfair and Deceptive Acts and Practices* §§ 5.1.3, 5.1.4 – 5.1.8.

[20] The 1994 codification of the 1980 FTC unfairness standard was not intended to affect state laws on unfair or deceptive practices. "Sound principles of federalism limit the impact of this section to the FTC only." Sen. Rep. No 130, 103d Cong. 2d Sess. 13 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1788. In this Comment, we discuss our individual recommendations only under the current federal standard, though they would even more readily pass muster under these broader state standards.

[21] *See FTC v. The Sperry and Hutchinson Co.,* 405 U.S. 233 (1972). Courts in Alaska, California, Connecticut, Florida, Hawaii, Illinois, Louisiana, Massachusetts, Minnesota, New Hampshire, North Carolina, Rhode Island, South Carolina and Washington have used the S&H standard in interpreting their state UDAP laws. *See* cases collected in National Consumer Law Center, *Unfair and Deceptive Acts and Practices,* Sec. 4.3.3.4 note 567 (6th Ed. 2004 and 2006 supp.) and Michael M. Greenfield, *Unfairness Under Section 5 of the FTC Act and Its Impact on State Law,* 46 Wayne L. Rev. 1869, 1914-23 (Winter 2000).

- "is immoral, unethical, oppressive, or unscrupulous;" and
- "causes substantial injury to consumers (or competitors or other businessmen)."[22]

Thus, if a practice is "exploitive or inequitable" and, in addition, is "seriously detrimental" to consumers or others, it is unfair.[23]

Deception: Deception includes misrepresentations, as well as failure to disclose material facts, or telling half-truths to leave misleading impressions.[24] Of particular importance in credit transactions, misleading sales representations that obscure proper written disclosures can be deceptive.[25] The infamous "Monster Track" sales presentation developed by First Alliance Mortgage Company was a classic example of this. Turning Truth in Lending (TIL) on its head, the company's accurate TIL disclosures were integrated into a sales presentation that effectively obscured the fact that the loans financed as much as 20 points.[26]

II. Eliminate Two Unfair and Deceptive Practices Not Banned by Prior Subprime Statement: Subprime Prepayment Penalties and Yield-Spread Premiums.

The Board has asked the following questions concerning prepayment penalties:

- Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited?
- Would enhanced disclosure of prepayment penalties help address concerns about abuses?
- How would a prohibition or restriction on prepayment penalties affect consumers and the type and terms of credit offered?

As detailed below, the answer to the Board's question is, yes, prepayment penalties should definitely be restricted; in fact, on subprime loans, they should be banned outright to facilitate the movement of borrowers into lower-cost loan products as soon as they qualify. A regulation that merely required prepayment penalties to extend to an ARM's first adjustment period would not improve current practice at all, as the current crisis arises out of loans whose

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[22] 405 U.S. at 244, citing *Statement of Basis and Purpose of Trade Regulation Rule 408, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking*, 29 Fed. Reg. 8355 (1964).

[23] *Id.*

[24] F.T.C. Policy Statement on Deception, *6 (October 14, 1983) (Appended to Cliffdale Associates, Inc., 103 F.T.C. 110, 174 (1984)).

[25] *See*, e.g. *FTC v. Cyberspace.com*, 453 F.3d 1196 (9th Cir. 2006): *FTC v. Direct Marketing Concepts*, 2004 WL 1399185 (D. Mass. June 23, 2004); *FTC v. Horizon Corp.*, 97 F.T.C. 464 (1981).

[26] *See, e.g. Federal Trade Commission v. First Alliance Mortgage Co.*, No. SACV00-064, *complaint Para.* 18-21.

prepayment penalties extend to the first adjustment. Nor is it sufficient to require a "reasonable" 60 day refinance period between the end of the prepayment penalty and the first adjustment, as suggested by the recent Statement, as this affords insufficient opportunity to refinance, could be abused by lenders who extend their teaser period by also extending the prepayment lockout period beyond the current market standard of two years, and precludes the borrower from walking away from an abusive loan whose terms are fully disclosed only at the closing.

Disclosures are insufficient to address the problem, as written disclosures are frequently negated or undermined by the oral representations of the brokers or originators on whom subprime borrowers rely and the blizzard of technical closing documents involved. More fundamentally, disclosures – of the "benefit" to the borrower of a prepayment penalty – a purported rate reduction – are fundamentally misleading, because of the inherent market distortions in pricing, which we discuss below. Disclosures, then, are not only insufficient to act as a solution, they are more likely to be yet another part of the problem.

In response to the Board's request for comments concerning other lending practices that commenters identify as problematic, we also discuss the abuses associated with yield-spread premiums, and their relationship with abusive prepayment penalties. Finally, banning subprime prepayment penalties and yield-spread premiums will not have an adverse impact on the cost or availability of credit, as shown by the research discussed below.

It is imperative that the Board ban prepayment penalties and yield-spread premiums. These two unfair and deceptive practices create structural problems in the subprime market, incentivize brokers and other originators to push borrowers into abusive loans, and make it costly or impossible for them to escape. These two pricing practices are intertwined in a way that harms both consumers and competition. Further, the intertwining of these anti-competitive features undoubtedly goes a long way to explaining why and how this market has so ill-served families of color. Borrowers in minority neighborhoods are more likely to receive prepayment penalties,[27] and minorities are at greater risk for receiving higher-priced loans than white borrowers, after controlling for legitimate risk factors.[28] Together, prepayment penalties and yield-spread premiums as used in the subprime arena represent precisely the sort of dysfunctional market that demands corrective action.

1. The Board Should Ban Subprime Prepayment Penalties.

The abusive and pervasive application of prepayment penalties in the subprime market has been a concern since Congress first turned the spotlight to this market sector in 1993. It has been recognized for at least fourteen years that this feature serves to trap borrowers in

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

[28] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May, 2006).

disadvantageous, higher cost loans. But it has also now become apparent that these penalties increase cost on the front end, as well, because they are linked to higher rates on loans that pay higher yield-spread premiums to brokers. It is this market-distorting relationship that has made subprime prepayment penalties the "glue" for steering borrowers into higher-cost loans than loans for which they qualify. Further, prepayment penalties reduce the likelihood that subprime borrowers will transition into more affordable prime loans. They also undercut the benefits of homeownership by stripping equity upon refinance, and have been documented to increase the borrower's vulnerability to foreclosure. Understanding of flipping, and the fact that subprime prepayment penalties are commonly paid by borrowers, has risen. And their prevalence has increased significantly.

As we discuss below, twice during the past decade and a half federal policy recognized the problems with prepayment penalties in the subprime market and took partial corrective steps. But the evidence is clear today that those steps were insufficient, as the problems stemming from them have grown exponentially. The unintended consequence of the earlier half-measures in addressing this market-distorting feature has been to allow prepayment penalties to become the standard product in the subprime market, a drain on wealth-building through equity accumulation, a contributor to higher foreclosures, and a bar to effective competition.

Prepayment penalties, as they operate in the subprime market, create the kind of structural market imperfection that meets the FTC's unfairness test and are inherently deceptive.

(a) Subprime prepayment penalties cause substantial consumer injury.

As federal policy has long recognized, prepayment penalties trap borrowers in high-cost, disadvantageous loans. Congress recognized that prepayment penalties functioned this way when it first enacted HOEPA. In 1994, trying a cautious approach, Congress created complicated and narrow restrictions on prepayment penalties in very high-cost (Section 32) loans.[29] That the HOEPA rule was insufficient to curb the problem was evident during a joint HUD-FRB review of the market in 1998. In that report, HUD recommended further restrictions on prepayment penalties, and applying reforms to a broader segment of the market.[30]

Mounting evidence that prepayment penalties contributed to the problem of predatory lending led the Office of Thrift Supervision in 2002 to repeal its 1996 regulation that preempted state prepayment penalty laws as applied to non-depository lenders for "alternative mortgages," as "wide-spread use of prepayment penalties not only may deter consumers from seeking to

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[29] H.R. Conf. Rep. No. 652, 103d Cong., 2d Sess. 147, 160; S. Rep. No. 103-169, 25-26. (1994 USCCAN. 1977, 1990-91; 1995 USCCAN 1881, 1909-10.) Limitations on prepayment penalties applied only in narrow circumstances, 15 U.S.C. §1639(c); Reg. Z, 226.32(d)(6) & (7).

[30] Joint Report to Congress Consumer Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July, 1998), at 74-75, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

refinance high cost loans that have burdensome provisions, but also may have other adverse consequences for sub-prime borrowers, such as increasing the overall lending cost for a consumer who refinances to avoid default."[31]

While these efforts represented progress, they did not yield success. Prepayment penalty abuses factored into major public enforcement actions against Household and Ameriquest, for example.[32] Indeed, prepayment penalties have become even more widespread, as has the harm they bring to consumers. Today prepayment penalties are imposed on about 70 percent of all subprime loans,[33] compared to about 2% of prime loans.[34] This disparity belies any notion that subprime borrowers freely "choose" prepayment penalties. All things being equal, a borrower in a higher-cost loan, or in an unpredictable, adjustable rate loan with a very high margin, would not choose to be inextricably tied to that product by a high exit tax.[35] Indeed, a market that has often justified its role as a "bridge to prime" should not impose a toll so high as to make the bridge uncrossable. Yet that is what has happened with prepayment penalties in the subprime market. The consumer is trapped, and competitors lose, as many borrowers are unable to refinance with more responsible lenders.[36]

The explanation for the phenomenal growth in prepayment penalties in the subprime market lies instead in the perverse pricing incentive in the subprime market. In exchange for

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[31] 67 Fed. Reg. 60542, 60548, *see generally* 60547-48. The perverse unintended consequence of that federal preemption rule, first adopted in 1996, was to make ARMs a staple in the subprime market even in the years of declining and low fixed rate interest environment, as only "alternative mortgages", such as ARM and balloon loans, were entitled to take advantage of that OTS preemption, while fixed rate loans were not. *See* 12 U.S.C. § 3802(1).

[32] *See*, e.g. *State v. Household International,* Consent Judgment, Para. 15 *available at* http://www.state.ia.us/government/ag/latest_news/releases/dec_2002/hhconsent.pdf; and States' Settlement Agreement with Ameriquest, IV-G, http://www.state.ia.us/government/ag/latest_news/releases/jan_2006/Ameriquest_SETTLMNT_FINAL.pdf for the injunctive requirements flowing from the abuses relating to prepayment penalties.

[33] *See, e.g.* 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 (December 11, 2006). According to MBA data, there was a 69.2% penetration rate for prepayment penalties on subprime ARMs originated in 2006. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, (July 13, 2007). A recent CRL review of 2007 securitizations showed a penetration rate for prepayment penalties averaging over 70%.

[34] *See* Berson, *id***.** A recent MBA analysis shows that 97.6% of prime ARMs originated in 2006 had no prepayment penalty, and 99% of 2006 prime FRM had no penalty. Doug Duncan, *id.*

[35] Marketing jargon in the industry is more honest about the role of prepayment penalties, along with high- LTV loans: "Build a fence around the customer:" or bring them in and "close the back door" are phrases that surfaced during regulatory investigations of subprime lenders in which one of the authors of this Comment was involved.

36 *See, e.g.* Ruth Simon, MORTGAGE REFINANCING GETS TOUGHER; As Adjustable Loans Reset at Higher Rates, Homeowners Find Themselves Stuck Due to Prepayment Penalties, Tighter Credit, *The Wall Street Journal* (February 8, 2007) at D1.

getting loans with a prepayment penalty, lenders pay brokers more in the form of a higher yield-spread premium. In order to maximize his own compensation, the middle-man maximizes the cost to the consumer. The result is added consumer costs on both the front- and back-end of the loan.

The lose-lose nature of the prepayment penalty-yield-spread connection for consumers can be seen from a July, 2007 rate sheet from the subprime lender with the biggest market share in broker and correspondent production in the first quarter of 2007.[37] (See rate sheet at Appendix F.)

- The default product is a 3/27 with a 2-year prepayment penalty (until recently, of course, the default was the 2/28).
- An "AA" borrower with a 620 FICO score and an 85% LTV qualifies for a 9.45% rate on a fully-documented loan. (If steered to a stated income loan, the rate would be 11.1%, more than a 1.5% rate bump.)
- To get a loan without any prepayment penalty, the borrower would pay either 1.5 points upfront, or add 1% to the 9.45% rate. The borrower, then, could get a 10.45% loan with no prepayment penalty. (See Appendix. F, Row C.[38])
- However, the lender does not allow the broker to get any yield-spread premium if the loan has no prepayment penalty, a result that is common in the subprime sector.[39] (See Appendix F, Row C, "YSP not permitted.")
- For the broker to get a 2 point YSP to maximize his compensation, the interest rate increase that the borrower would pay is 1.10%.
- The broker therefore has the option of presenting these two loans to his client:

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[37] *Inside B&C Lending*, p. 5 (June 15, 2007) (Option One ranked # 1, with a 9.1% market share for Q107 in broker and correspondent lending production.)

[38] Interestingly, if state law prohibits prepayment penalties entirely, the rate bump is only 40 basis points, and if state law allows only a partial prepayment, the bump is 20 basis points. See App. F, Row B.

[39] The lender's rule applies in a state where a standard prepayment penalty would be allowed. Lender restrictions or bans on YSPs where there are no prepayment penalties or shorter than its standard prepayment penalties are common among subprime lenders. A Washington Mutual / Long Beach Mortgage rate sheet for July 16, 2007, also shows no yield-spread for a loan with no prepayment while allowing a 3% yield-spread for a loan with LBMC's standard prepayment penalty. (July 16, 2007). Decision One's July 25, 2007 rate sheet states that "YSP requires PP where allowed" and "State allowed maximum PP required for > 1.00 YSP." WMC's July 24, 2007 rate sheet limits the YSP to 0.50 if there is no prepayment penalty. (Rate sheets available from CRL.)

	Interest rate to borrower	Broker's Compensation
No prepayment penalty (+ 1% for PPP buy-out)	10.45%	No YSP
2 year prepayment penalty (+ 1.1% for 2 point YSP to broker)	10.55%	2 point YSP

Thus, the lender offers the broker the choice of providing the consumer with a loan with no prepayment penalty at a rate increase of 1%, or providing himself with 2 points ($4,000 on a $200,000 loan) at a cost to the consumer of a prepayment penalty (costing the borrower perhaps 3%, or $6,000 in equity) *plus* a 1.1% rate increase. Given this incentive structure, CRL's finding of ***higher*** interest rates on subprime purchase loans that had prepayment penalties, holding borrower characteristics constant,[40] is unsurprising.

The market failure, then, is that the subprime mortgage market gives the broker the incentive to sell to his client the loan that costs more at both ends – the higher rate on the front end and the prepayment penalty on the back.

In other words, we now know that borrowers with prepayment penalties are not only trapped, they are paying more for being put in the trap by a poorly functioning market. At best, prepayment penalties extract substantial equity from the home. With common formulations of 6 months' interest, or amounts of approximately 3% of the principal, the amount of equity lost is significant. For a $200,000 loan, a 3% prepayment penalty costs borrowers $6,000, eating almost entirely the median net worth for African American households.[41]

Yet more tragically, the prepayment penalty that traps the homeowners in an unaffordable loan increases the odds that the family will lose the home to foreclosure. In fact, as UNC researchers have shown, subprime loans with prepayment penalties are at 16% to 20% greater risk of foreclosure than those without prepayment penalties.[42] Clearly, the harm to consumers is substantial.

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[40] Christopher A. Richardson and Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (January 2005).

[41] Indeed, according to one study, it would exceed the median net worth in 2002 for African American households ($5,988). And it drains almost 7% of the median net worth for white households that year ($88,651). Rakesh Kochhar, *The Wealth of Hispanic Household: 1996-2002* p. 5, (Pew Center for Hispanic Studies), http://pewhispanic.org/files/reports/34.pdf

[42] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures:The Special Case of Prepayment Penalties and Balloon Payments*, (Center for Community Capitalism, University of North Carolina at Chapel Hill, January, 2005), p. 25. *See also* "Losing Ground" at 21.

(b) The harm is not outweighed by benefits to consumers or competition.

Prepayment penalties are often justified as a trade-off for discounted interest rates, but the evidence has not demonstrated any such benefit to borrowers in the subprime context. If one ignored all adjustment factors on a rate sheet except the prepayment penalty, it may appear to be the case. But this single pricing factor does not occur in isolation in the real world.

A CRL study found no statistically significant interest rate benefits from prepayment penalties in the subprime market, and in fact found a perverse relationship in the purchase money subprime market: prepayment penalties were associated with a 40 basis points upward bump in rate.[43] Though one paper discussed at a recent Federal Reserve System conference found some rate benefit, the results there, too, were not what they seemed at first blush. For the most common product in the subprime market – the hybrid ARM – the rate reduction the study reported was only 18% of the purported reduction commonly associated with a prepayment penalty on the rate sheets.[44] In other words, the possible consumer benefit of the prepayment penalty, as found by the Elliehausen paper, is less than 1/5th of its purported value. Still further evidence weighing the cost of the prepayment penalty against the gains shows there is no net benefit. Conservative analysis suggests that "borrowers will pay $2 in prepayment penalties for every $1 in interest rate benefits on hybrid ARMs."[45]

(c) The harm is unavoidable.

Consumers cannot reasonably avoid practices that result from systemic market imperfections. As the earlier analysis of our subprime borrower shows, the market is distorted by the perverse incentives in the intertwining of prepayment penalties and yield-spread premiums. Lenders condition the broker's ability to earn his full yield-spread on his ability to push the borrower into a loan with a prepayment penalty. Conversely, it limits the yield-spread if there is a shorter prepayment penalty or no prepayment penalty. Thus, although prepayment penalties increase the borrower's cost, this conflict encourages brokers to steer their clients to higher priced loans with prepayment penalties. Brokers, like other economic actors, respond to financial incentives. However, evidence is overwhelming that borrowers place significant weight in their brokers' recommendations, while brokers, for their part, deny they have any legal

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[43] Christopher A. Richardson and Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (January 2005),

[44] Michael D. Calhoun, Comments, p. 5 (discussant on Elliehausen, Staten, and Steinbuks, *The Effect of Prepayment Penalties n the Pricing of Subprime Mortgages*, (Sept. 2006), at session "Are Legislative Remedies to Limit Predatory Lending Really Remedies," The Federal Reserve System's Fifth Community Affairs Research Conference (March 29, 2007)). available at: http://www.responsiblelending.org/issues/mortgage/briefs/page.jsp?itemID=33436798

[45] *Id.*

duty to place the interests of their clients above their own.[46] For the borrower this is the worst of both worlds – a higher rate loan, and a significant barrier to escaping to a loan with a better rate. It is a classic example of a market imperfection demanding corrective action.

(d) Prepayment penalties in the subprime market are inherently deceptive.

Prepayment penalties as they are utilized in the subprime market are also inherently deceptive. As discussed above, they create an inherent conflict of interest between originators and their clients, perverting normal market forces. Experience has demonstrated that rules about written disclosures are inadequate to counter these strong economic incentives.[47] These dysfunctional market dynamics can only be reversed by declaring prepayment penalties in the subprime market to be a *per se* deceptive practice.

In sum, after nearly fifteen years since policymakers turned their attention to the higher-cost market, and now with even greater abuse of these penalties in the pricing of the loans, it is clear that prepayment penalties pervert the subprime market, without countervailing benefit, and should be prohibited on these loans.[48]

Should prepayment penalties be restricted?

For the reasons just stated, prepayment penalties should be banned, not merely restricted, for subprime loans.[49]

Should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited?

Permitting prepayment penalties that extend until the first rate adjustment would perpetuate the problem. Indeed, the current crisis has been caused by loans whose prepayment penalties remain in effect "only" until the first rate increase. Loans structured this way generally

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[46] For discussion of the broker-consumer relationship, *see, e.g.* Ren S. Essene and William Apgar. UNDERSTANDING MORTGAGE MARKET BEHANVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS. Harvard Joint. Center for Housing Studies, (April 25, 2007). For a discussion of the development of the common law and statutory law concerning loan broker duties, *see* generally National Consumer Law Center, *The Cost of Credit*, § § 11.5.4, 12.9.2. (3rd Ed. 2005 and supp.)

[47] While the problem is exacerbated in the broker-channel market, the structural incentives are also seemingly irresistibly strong in retail channels, as the abuses with respect to prepayment penalties in both Household and Ameriquest demonstrated. Without reform of the basic market incentives, disclosures only compound the problem. By purporting to inform consumers of a phantom price advantage, thereby contributing to the deception.

[48] More disclosure concerning prepayment penalties is not the solution to structural problems. *See* note 122, *infra*.

[49] Many other organizations, including the National Association of Attorneys General concur with the need to ban prepayment penalties from the subprime market. *See, e.g.,* National Association of Attorneys General, *Letter to Hon. Ben Bernanke, Re: Docket No. OP-1288,* p.5-6 (August 13, 2007).

force the borrower to choose between paying the increased rate and paying a prepayment penalty to refinance early. Both options are extremely costly. Even before the rate increase, subprime borrowers frequently struggle to meet their housing and other costs. Forcing these borrowers to sustain an increased rate even for a short period (in an effort to avoid the prepayment penalty costs) subjects them to the risk of default, or at least temporary delinquency, which, in turn, perpetuates the inability to move into the prime market. Thus, loans structured this way help trap borrowers in the subprime market.

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

Disclosures are insufficient to address the problem. Mortgage financing is complicated for most borrowers, and even those who are sophisticated and highly educated may rely on their lawyers or loan originators to explain loan terms. Subprime borrowers generally cannot afford to be represented by counsel and frequently rely on loan originators – typically mortgage brokers – to help them understand what the disclosures mean. For such transactions, disclosures are generally inadequate to address market abuses because originators frequently explain the written disclosures in a way that obscures their true significance.

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

Contrary to some industry claims, careful analysis of the effects of anti-predatory lending laws, including those with limitations on prepayment penalties, show that banning prepayment penalties and other predatory practices does not cause a restriction in access to credit.[50] Instead, it only causes a decrease in targeted abuses, and increased competition. In fact, in states that have limited prepayment penalties as part of their approach to curbing predatory lending, interest rates have stayed the same or even been lowered, compared with control states where such protections are absent.[51] In other words, thoughtful evidence is that, rather than reducing access

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[50] Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, 2-3, 13-17, Center for Responsible Lending (February 23, 2006).

[51] *Id.* Of particular interest are eleven states that met the study's criteria of targeted mortgage regulation only for their prepayment penalty protections: *Alaska,* Idaho, *Iowa,* Kansas, *Maine*, *Maryland*, *Michigan*, Missouri, Ohio, Wisconsin, and *Vermont*. (See p. 7, where the six italicized states scored highest for the scale of their prepayment penalty restrictions, p. 22-23). In these six states, the volume of subprime loans actually *increased* after the restrictions on prepayment penalties were implemented. Other states which restricted prepayment penalties saw *no change* in volume following the implementation of these restrictions. *Id* , Fig. 3, p.13. Moreover, the study demonstrates that prepayment penalties do not reduce interest rates. The interest rates on fixed rate mortgages in all eleven of those states were lower than interest rates in the control states that did not significantly restrict prepayment penalties. On ARMs, the six states with the most protective laws had interest rates that were lower than those prevalent in the control states, and there was no difference in the remainder. *Id* , Fig. 4, 5, p.16 *See also,* Michael D. Calhoun, *supra* note 44, at 8-10 and sources cited therein.

We also note that at least thirty-five states regulate prepayment penalties, including eleven states that have prepayment penalty bans on broad categories of mortgage loans. There is no evidence that consumers feel deprived of "choice" in those states. **Alabama** (unless approved mortgagee under National Housing Act or where creditor is to legitimate credit, prepayment penalty and other regulation targeted at subprime mortgage abuses has countered a market that has been governed by Gresham's Law – where bad loans tended to drive out good loans. Regulation, thus, is a boon to competition as well as consumers.

We note that as states address the current subprime crisis, the laws passed in 2006 and 2007 are trending towards significant restrictions and outright bans of prepayment penalties: Minnesota and North Carolina have banned prepayment penalties from the entire subprime market, Ohio bolstered its prepayment penalty laws by banning their use on loans in amounts less than $75,000, and Maine prohibits prepayment penalties on a broad range of loans (alternative mortgages including ARMs interest-only, negative amortization and balloon payment loans).[52]

Suggested Regulatory Language

It is an unfair and deceptive practice to make or approve a subprime mortgage loan that requires a consumer to pay a penalty for paying all or part of the principal before the date on which it is due, or to collect such a penalty imposed in violation of this paragraph.

2. The Board Should Ban Subprime Yield-Spread Premiums.

Like prepayment penalties, yield-spread premiums, as practiced in the subprime market, easily meet the test for unfairness and are inherently deceptive. While the preferable solution is an absolute prohibition of yield-spread premiums in connection with subprime loans, the Board at minimum could hold the lender responsible for the conduct of brokers where the lender has given a yield-spread premium.

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exempt from licensing, per ALA. CODE § 5-19-31) (ALA. CODE § 5-19-4(c)); **Alaska** (except federally insured loans requiring prepayment penalty) (ALASKA STAT. ANN. § 45.45.010(g)); **Indiana** (prepayment penalty banned for a consumer loan (key requirement: secured by an interest in land or by personal property that is the borrower's principal dwelling) that is not "*primarily* secured by an interest in land" (i.e., that is not a first lien mortgage) as well as for a refinancing or consolidation (junior lien)) (IND. CODE ANN. § 24-4.5-3-209 (limitation on penalty); § 24-4.5-3-104 (definition of "consumer loan"); § 24-4.5-3-105 (explanation of "primarily secured by land")); **Iowa** (purchase money or refinance of purchase money loan secured by 1- or 2-family dwelling or by agricultural land)(IOWA CODE ANN. § 535.9.2); (reverse annuity or graduated payment mortgage loans) (IOWA CODE ANN. § 528.4); **Minnesota** (prohibited in residential mortgages under Fannie Mae conforming limit) (Minn. Stat. §58.137(2)(c); **New Jersey** (for loans with interest rates exceeding 6%) (N.J. STAT. ANN. § 46:10B-1, B-2); **New Mexico** (N.M. STAT. ANN. § 56-8-30); **North Carolina** (banned on first mortgage loans below $150,000) (N.C. GEN. STAT. § 24-1.1A(b)(1)); **Ohio** (prohibited in residential mortgage under $75,000) (Ohio Rev. Code §1343.011(2)(a); **South Carolina** (banned on loans below $150,000) (S.C. CODE ANN. § 37-23-80, 37-10-103);**Vermont** (Vermont Stat. Ann. tit. 8 § 2232a, tit. 9 § 45).

[52] **Minnesota** Sec. 4. Minnesota Statutes 2006, section 58.137, subdivision 2; **North Carolina** NC House Bill 1817 (presented to the Governor 8/2/2007 and available at: http://www.ncleg.net/Sessions/2007/Bills/House/HTML/H1817v5.html); **Ohio** Ohio Rev. Code §1343.011(2)(a); **Maine** 9-A MRSA §2-509.

(a) There is substantial consumer injury.

The structural market problems associated with the role and compensation of mortgage brokers are hardly a tangential issue. Brokers play an important role in mortgage lending, and lenders use them to originate *the majority* of the loans they make. Their involvement in subprime and predatory loans is greater still.[53] According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 72 percent of subprime loans.[54]

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[55] Similarly, a report issued by Harvard University's Joint Center for Housing Studies stated, "Having no long-term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[56]

The compensation system that lenders in the subprime market have created for brokers assures that the injury that flows from it will be widespread. That compensation system creates a strong incentive for brokers to push borrowers into higher rate loans than those for which they qualify. Such payments distort competitive market forces by creating a reverse competition effect – the broker shops for his or her own best deal, not the best deal for the customer.[57] The rate sheet attached at Appendix F for example, shows that each yield-spread point to the broker adds 0.55 basis points to the borrower's interest rate. Thus, with a $200,000 subprime loan, for the broker to receive a 2% yield-spread premium, or $4,000, the borrower pays 1.1% more than

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[53] *See*, for example, testimony of Andrew Celli, Jr., NY Attorney General's Office, describing 10% broker fees and other abuses by brokers selling loans to Delta Funding before the House Banking Committee, May 24, 2000: http://www.house.gov/banking/52400cel.htm.

[54] *See* MBA "*Subprime Originations Survey Yearend 2006,*" (July, 2007) at 2; *See also* MBA Research Data Notes, *"Residential Mortgage Origination Channels,"* (September 2006).

[55] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[56] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[57] For extensive discussion of the history of yield-spread premium regulation and the "trilateral dilemma" of financial regulation of the premiums, *see* Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield-spread Premiums* (January 8, 2002), at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf Annual Review of Banking (forthcoming 2005).

she actually qualified for, or $8,800 in excess interest expense if he or she stays in the loan for four years. The broker maximizes his compensation by seeking the lender and the loan that allow for the maximum return to him.

Further, as we detailed above (Section II, note 39 and accompanying text), this system costs consumers more on both the front and the back ends, because it is common practice in the subprime market for lenders to allow their maximum yield-spreads only when the broker delivers a loan with the lender's maximum prepayment penalty.

(b) There are no countervailing benefits to consumers or competition

As with the prepayment penalties, the yield-spread premiums are typically justified as a way for consumers to reduce up-front costs by trading them for a higher rate. However, as with prepayment penalties, the empirical evidence does not support that finding.[58] That is particularly the case in the subprime market, where it is rare for a loan not to have upfront fees that could have paid for the broker's services.

There is also no benefit to competition. As with other practices leading to "reverse competition," there is a push to the lowest common denominator. Lenders who do not wish to pay yield-spread premiums are forced to do so, or the brokers take the loans to the lenders who will. Only regulation imposed on <u>all</u> lenders will solve this problem.

(c) The practice is not reasonably avoidable by consumers, as it is a system-wide market imperfection.

This perverse pricing incentive for the primary "gatekeepers" to the subprime market – mortgage brokers – is precisely the kind of structural flaw that serves as an obstacle to efficient and effective market operation. It is insidious, as yield-spread premiums generate a financial conflict of interest in a professional whose primary duty should be to his customer,[59] with the result that consumers pay an unnecessarily higher price for credit. In this, it is a quintessential example of a dysfunctional market, and thus the type of practice that is unavoidable by consumers and is "properly banned as an unfair practice."[60]

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[58] Theoretically, the yield-spread is paid, at the consumer's choosing, to lower closing costs. Empirically, that trade-off has not been found. *See, e.g.* Testimony of Howell E. Jackson, Senate Banking Committee Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield-spread Premiums" (January 8, 2002), available at http://banking.senate.gov/02_01hrg/010802/jackson.htm#N_1_ ("Homeowners who are short on cash could, theoretically, use yield-spread premiums to finance settlement costs. My study, however, offers compelling evidence that yield-spread premiums are not being used in this way."); *See also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing* 44 Harvard J. on Leg. 123, 139 note 94 and sources cited therein.

[59] *See* note 46, *supra.*

[60] *See AFSI v. FTC,* 767 F.2d at 986 (discussing FTC Policy Statement on Unfairness). *Available in* Greenfield, at p. 147, *supra* note 119.

This structural reverse competition may help explain why the mortgage brokers deny that they have an obligation whatsoever to provide the borrower with the advice that is in the borrower's best interest.[61] Banning yield-spread premiums on subprime loans would eliminate this conflict of interest that pushes brokers to take unfair advantage of their clients, and thus eliminate some of the unfairness associated with subprime lending.

(d) Yield-spread premiums in the subprime market are inherently deceptive.

For the same reason that prepayment penalties as utilized in the subprime market are inherently deceptive, so too are yield-spread premiums in that market segment. They are equally unsuited to regulation through disclosure.[62]

(e) At minimum, the Board should hold lenders liable for the conduct of brokers to whom they have given a yield-spread premium.

If the Board does not prohibit yield-spread premiums, at the very least the Board should prevent lenders from continuing to benefit from the conflict of interest they create between brokers and their clients. An alternative to prohibition would be to hold the lenders liable for the misconduct of brokers to whom the lender pays a yield-spread premium in subprime and nontraditional loans. This is within the scope of the Board's authority.

The Board has the authority to declare certain acts or practices "in connection with mortgage loans" to be unfair or deceptive or, in connection with refinancings to be "not in the interest of the borrower" under 15 U.S.C. § 1639*l*. We note that the authority extends to the making of the loans themselves: it is not limited to any particular category of player involved in the making of mortgage loans.[63]

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[61] The National Mortgage Brokers Association's Code of Ethics at one point recognized that their "obligation of absolute fidelity to the client's interest is primary," quoted in National Consumer Law Center *The Cost of Credit* §11.8.2 note 286 (1st ed. 1995). It disappeared from its Code of Ethics shortly thereafter, perhaps not coincidentally as legal challenges to the practice of yield-spread premiums began. The first reported decision challenging YSPs as illegal kickbacks under RESPA were in 1996. *See discussion* at National Consumer Law Center, *The Cost of Credit* § 12.2.1.5.2 (3rd Ed. 2003).

[62] It is foreseeable that disclosures would come either in the form of the meaningless disclosures often provided now: "we may receive compensation from the lender," or, as with some prepayment penalties, would be deceptively disclosed as a price trade-off that does not in fact exist, thereby again compounding the deception.

[63] Indeed, this would be a logical concomitant to the increasing assertion of federal preemption into banking activities engaged in through the use of third party agents. The first circuit recently held that New Hampshire's Consumer Protection Act, as applied against a third party agent used by a bank to market and sell its gift card, was preempted. The court stated that "the question here is not whom the New Hampshire statute regulates, but rather, against what activity it regulates." SPGGC, LLC v. Ayotte, 488 F.3d 525, 532 (1st Cir. 2007). See also OCC Preemption Determination, 66 Fed. Reg. 28593 (May 23, 2001)(Michigan law did not apply to car loan arranged by Michigan car dealer to Michigan customer at Michigan dealership, as dealership placed loan with Ohio national bank; business of banking includes use of third party agents.)

Indeed, the Department of the Treasury has previously suggested that the Board utilize this HOEPA authority to impose supervisory obligations on lenders for the conduct of brokers originating target loans.[64] In connection with a review of regulations governing high-cost loans, Treasury suggested that the Board "prohibit, as an unfair practice and a practice not in the interest of the borrower, a lender from funding a high-cost mortgage or refinancing arranged by a broker who violated an applicable state or federal law in the course of arranging the loan unless the lender had reasonably supervised the broker."[65] The proposal further offered suggestions of evidence that could establish "reasonable supervision," and noted that the "contours of the duty" could be established through private actions and state attorneys general actions, as well as FTC and regulatory enforcement actions.[66]

It has also been established in closely analogous circumstances that the practice of trying to insulate from liability lenders to whom originators bring borrowers is "unfair or deceptive" within the meaning of the FTC Act. The recommended rule would operate to impose derivative liability, in a fashion similar to the FTC Preservation of Claims and Defense Rule, 16 C.F.R. 433, which holds that it is an "unfair or deceptive practice within the meaning of Section 5 of [the FTC Act]" for a creditor to take the benefit of seller-arranged credit without accepting liability for the seller's conduct.[67] The yield-spread premium paid by the lender to the broker is a deeper and more direct tie between the lender and the originator would be deemed sufficient to impose lender liability for seller conduct under the FTC rule. A home improvement mortgage lender is liable for the conduct of a home improvement contractor who simply refers the consumer to the lender, 16 C.F.R. § 433.1(d), (g). This FTC rule has been in place for over 30 years without harm to the retail credit market.

Such a rule would reinforce statements that the federal banking agencies have already made. Noting that "institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans," the agencies have admonished lenders to "have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws."[68]

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[64] *See* Dept. of the Treasury, *Comments on Regulation Z, Docket No. R-1090,* p. 13-15 (January 19, 2001).

[65] Id.

[66] Id.

[67] We caution, however, that in promulgating such a rule, care should be taken not to implicitly interfere with existing law where the lender may have liability for broker conduct through such theories as agency, aiding and abetting, civil conspiracy, or similar bases.

[68] Nontraditional Mortgage Guidance at 15; s*ee also* Statement on Subprime Mortgage Lending (June 2007) at 15; *See also* Mark W. Olson, Governor of Federal Reserve Board, "*Before the Consumer Bankers Association 2005 Fair*

Further, federal policy has long recognized that kickbacks increase costs to consumers, and are prohibited. 24 U.S.C.2607. If a subprime yield-spread premium truly allowed for lower up-front fees, as is often claimed, it may not violate RESPA. However, as we have explained above, the empirical evidence is that this hypothesis is more rationalization than reality, leaving the yield-spread premium to pay for "simply delivering a loan with a higher interest rate." In any given individual case, this would be a violation of RESPA.[69] Yet we now know that the standard YSP compensation structure establishes incentives industry-wide that drive pricing to a similar result as that which federal policy has long decried. An industry-wide market practice such as subprime yield-spread premiums that moves pricing closer to, rather than farther from, crossing already illegal lines should not be countenanced, for it is both unfair, and intrinsically misleading as to its value. As such, it easily falls within the scope of the Board's UDAP authority to prohibit.

Whether the lender directly originates an abusive loan or funds an abusive loan originated by a broker, the borrower suffers injury, and the lender gets the asset. Moreover, lenders, who are mortgage professionals themselves, as well as repeat users of brokers' services, have the expertise, the leverage and the capacity to exercise oversight of the brokers with whom they do business. Consumers do not. Indeed, the agencies have acknowledged lenders must engage in just such oversight. The costs of their failure to do so should therefore be borne by lenders, not borrowers.

It is appropriate, therefore, to hold the lender responsible for abusive subprime loans, regardless of whether originated by the lender directly, or through the broker. Allowing lenders to obtain the benefit of broker misconduct without associated liability distorts the market and substantially undermines the effectiveness of any regulations. It also would leave borrowers without adequate remedies. Brokers are commonly thinly capitalized and transitory, leaving no assets for the borrower to recover against. Even more problematic are the hurdles that unclear lender liability creates as borrowers seek to defend foreclosures on the basis of origination improprieties. Though this is true of any brokered loan, it is particularly unfair to let lenders who have provided financial incentives that generate a conflict of interest between the broker and the borrower to deprive the borrower of the right to meaningful relief.

Lending Conference, Arlington, VA" (November 7, 2005), available at: http://www.federalreserve.gov/boarddocs/speeches/2005/20051107/default.htm (commenting on the need for "diligence and regular testing of its broker channels to verify that third parties are acting in accordance with your policies" and stating that originators that "use brokers and correspondents to monitor the quality of loans by origination source in order to uncover problems and take appropriate action--including terminating the relationship--against any third-party originators that do not produce quality loans").

[69] HUD Policy Statement Regarding Lender Payments to Mortgage Brokers, 66 F.R. 53052, 53055 (Oct. 18, 2001).

Suggested Regulatory Language

It is an unfair and deceptive practice to make or approve a subprime mortgage loan that includes a yield-spread premium, or to collect a yield-spread premium imposed in violation of this paragraph.

Alternative Regulatory Language (Liability for broker conduct where yield-spread is paid):

It is an unfair and deceptive practice for a creditor or "lender" as defined in 24 C.F.R. § 3500.2 (2007)[70] *to disclaim or otherwise refuse to accept liability for acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers a subprime or nontraditional mortgage loan to or for the benefit of a creditor or lender from which the broker received compensation.*[71]

An additional alternate formulation of the regulation:
A "lender" as defined in 24 C.F.R. §3500.2 (2007) for a subprime mortgage loan is liable for all acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers the subprime mortgage loan to or for the benefit of the lender.

III. Codify and Expand Essential Protections from the Guidance and Statement.

The recent Guidance is a welcome step in addressing key market failures that have marked the industry in recent years. But to ensure that they apply to all segments of the industry, they should be codified, and further clarified for both subprime and nontraditional loans. We offer these recommendations for the transition from Guidance to rule.

The Board's Questions:

The Board asked the following questions concerning underwriting and affordability:

- Should lenders be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments?
- Should there be a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income ratio exceeds 50 percent (at loan origination)?
- Are there specific consumer disclosures that would help address concerns about unaffordable loans?

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[70] *"Lender* means, generally, the secured creditor or creditors named in the debt obligation and document creating the lien. For loans originated by a mortgage broker that closes a federally related mortgage loan in its own name in a table funding transaction, the lender is the person to whom the obligation is initially assigned at or after settlement. A lender, in connection with dealer loans, is the lender to whom the loan is assigned, unless the dealer meets the definition of creditor as defined under ``federally related mortgage loan'' in this section. See also Sec. 3500.5(b)(7), secondary market transactions."

[71] In practice, this liability is more limited than the Treasury Department suggested in 2001, as it would only be triggered where there is a "lender-paid" yield-spread premium or similar charge, however denominated.

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

As detailed below, lenders should be required to establish the borrower's ability to pay the loan at the fully indexed rate, assuming a fully amortizing loan. The rebuttable presumption suggested by the Board would establish an important guideline for lenders. Disclosures are inadequate to address abuses generally, and are particularly ineffectual with respect to unaffordability. Such provisions would dramatically reduce the incidence of borrowers receiving loans that will result in the loss of their homes to foreclosure. The will have no negative affect on the cost and availability of responsible loans.

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

Yes. Federal regulators have repeatedly admonished lenders that responsible lending precludes making loans that a borrower is unlikely to be able to repay according to the loan's terms. The recent regulatory and legislative trends at the state level have focused a great deal on clarifying rules that ensure that originators properly analyze a borrower's ability to repay a loan.[72] A regulation applying that concept to the whole subprime market and putting clearer standards in place is necessary to enforce this fundamental principle of the lending business. We heartily agree with the National Association of Attorneys General that loan originators should be prohibited from making loans without evaluating a borrower's ability to repay a loan (including the all of the true costs such as taxes and insurance) and that "no responsible lender should oppose a uniform loan affordability standard."[73]

At least since 2001, the federal banking agencies have put lenders on notice that "loans to borrowers that do not have the capacity to service their loans generally will be classified substandard."[74] The agencies have similarly warned lenders against making loans based on the value of the collateral, rather than the borrower's ability to repay the loan without resort to the sale of collateral.[75]

Such collateral-based loans are "unfair" and "abusive" under the standards articulated above. Indeed, the agencies have specifically described predatory lending to include "[m]aking

[72] In 2006-2007 Ohio, Maine, Minnesota and North Carolina have all passed laws requiring that loan originators properly consider a borrower's ability to repay the loan. The scope of these provisions ranges from protections for all home loans to nontraditional mortgages and subprime loans. Other states are currently considering similar protections addressing ability to repay (and including proper income verification requirements).

[73] *See,* National Association of Attorneys General, *Letter to Hon. Ben Bernanke, Re: Docket No. OP-1288,* p.4 (August 13, 2007).

[74] Expanded Guidance for Subprime Lending Programs, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision (Jan. 31, 2001) ("2001 Expanded guidance") at 9, *available at* http://www.ots.treas.gov/docs/2/25137.pdf

[75] *Id.*

unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation."[76] In the recently issued Statement on Subprime Lending ("Statement"), the agencies further noted, "Qualifying consumers based on a low introductory payment does not provide a realistic assessment of a borrower's ability to repay the loan according to its terms."[77]

The agencies' declarations establish the "unfairness" of lending without determining the borrower's ability to repay, under both federal and state definitions of that term.

The practice of making unaffordable loans meets the current FTC unfairness standard:

(a) It causes substantial consumer injury.

A consumer in a loan she cannot afford will be forced to refinance or sell the home. Refinancing will cause a substantial injury through substantial loss of equity – approximately 8% of the loan amount (3% in upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $16,000 for a $200,000 loan. This amount is more than twice the average net worth for an African-American family in the United States today.[78] Even worse, many consumers are driven to foreclosure, especially where the loan amount exceeds the value of the home due to declining property values (or a fraudulent appraisal), and thus refinancing or sale of the house become impossible.

(b) These injuries overwhelm any theoretical benefit to few consumers.

The harm of receiving a loan that borrowers cannot afford to repay is so severe that it would take a substantial benefit to outweigh it. No such benefit exists. Further, compared with existing alternatives of fixed rate loans, exploding ARM loans offer little or no benefit even in a short-term rate reduction.[79] And if the borrower is currently in an exploding ARM, a loan modification would be a far preferable outcome to refinancing into another unaffordable loan at the expense of the loss of additional home equity.

(c) For a borrower in an unaffordable loan product, substantial injury is difficult and frequently impossible to avoid.

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[76] 2001 Expanded Guidance at 10.

[77] Interagency Statement on Subprime Mortgage Lending, Fed. Reserve. Sys. Docket No. OP-1278 (June 28, 2007) ("Statement") at 6.

[78] According to the 2000 Census, net worth for the median African-American family was $7,500.

[79] CRL surveyed rate sheets for seven subprime lenders for mid-July, 2007, and found that borrowers would pay only an extra 0.325 to 0.5 percent to get a 30-year fixed over an ARM, with a median differential of only 0.35 percent.

In today's market, originators, motivated to maximize volume, distort the market, leading to loans which are commonly often "sold, not bought."[80] The secondary market has functioned to separate the rewards of today's loan sales from the risk that they may collapse. They have strong incentives to close as many loans as possible, while they have little incentive to consider the long term viability of the loan, because much of the risk is passed on to other players in the market, who, in turn, price the risk and spread it widely. Thus, as with most of the practices we urge Board action on, this is the kind of structural market imperfection that demands corrective action.

Once in an unaffordable loan, it is difficult, if not impossible, for a subprime borrower to escape the loan without incurring substantial equity stripping through prepayment penalties, charges and fees. Alternatively, excessive costs or the lack of sufficient equity may put refinancing or sale of the property out of reach entirely.

(d) Extending credit without making a good faith determination of the borrower's ability to repay the debt as scheduled is *per se* deceptive.

Additionally, extending loans without establishing the borrower's ability to repay is inherently "deceptive" under both federal and state standards. Common public understanding of the mortgage system assumes that lenders underwrite loans and would not make loans to borrowers who do not have the ability to repay them. In the face of an increasingly complicated market and complex products, this reliance on the expertise of the originator and underwriter is not only understandable, it is important for the efficiency and credibility of the industry. This is the case whether the loan is originated by the lender or by a broker.

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

Yes. This will provide a clear guideline for lenders. Without a debt-to-income ratio presumption, lenders can simply increase their debt-to-income ratio lending standards commensurately to underwriting to the fully indexed rate, to a clearly unaffordable level, and then argue that they met the fully indexed standard.[81] To assist lenders in calculating debt-to-income ratios, the Board could include in its commentary to the rules excerpts from the Fannie Mae guidelines for calculating monthly housing expenses and other monthly obligations. The guidelines focus on "the total debt-to-income ratio (which consist of two components – monthly

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[80] Gene A. Marsh, *The Hard Sell in Consumer Credit: How the Folks in Marketing Can Put You in Court,"* 52 Cons. Law Qtrly Rep. 295, 298 (Summer, 1998). "Push-marketing" remains key to subprime volume, aided by data brokers who sell leads for subprime refinance prospects, *see, e.g. http://www.exactsalesleads.com/subprime-mortgage-leads.html.* A former broker recently explained to CRL staff that they were taught to look for refinance leads, as there were more homeowners at any given time than there were people looking to buy a home. And, they were taught to look for subprime leads, because they made more money with those loans.

[81] Conceivably a more appropriate benchmark is the 41% maximum debt-to-income ratio set by the Federal Housing Administration for FHA loans. *See* http://www.fha-home-loans.com/debt_ratios_fha_loans.htm.

housing expense and the total of other monthly obligations)" as the relevant baseline for the debt-to-income calculation.[82]

The ability to pay regulation should encompass these principles:

- Lenders must consider an applicant's ability to repay the loan according to its terms and based on a fully-amortizing repayment schedule.

- The debt-to-income ratio must include all debt payments, including total monthly housing-related payments such as principal, interest, taxes, and insurance. This must also include all mortgage debt, both first and subordinate liens.

- Factors to consider in determining whether the presumption is rebutted include whether there are other verified resources available to the consumer for making payments on the loan, the consumer's current expenses, and whether there are adequate resources available to cover family living expenses after deducting debt service requirements from monthly income. In underwriting its home loans, the Veterans Administration similarly uses a multi-factor approach.[83]

- The payment shock associated with adjustable rate or non-fully amortizing loans must be taken into account.

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

A borrower should not be put into an unaffordable loan under any circumstance – regardless of how fully the unaffordability may be disclosed. Borrowers generally assume that lenders will not extend a loan that the borrower could not repay, and extending the loan sends a strong message of affordability that negates the significance of any contrary disclosure. Moreover, borrower experience over the last several years demonstrates that the further problem of brokers explaining away such significance is particularly acute on issues of affordability, as many borrowers now facing foreclosure due to hybrid ARMs that became unaffordable after rate

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[82] Fannie Mae Selling Guide, Chapter 7, X, 703: Benchmark Ratios (Jan. 31, 2006), relevant excerpts of which are included in Appendix E of this Comment.

[83] "It should also be clearly understood from this information that no single factor is a final determinant in any applicant's qualification for a VA-guaranteed loan. Once the residual income has been established, other important factors must be examined. One such consideration is the amount being paid currently for rental or housing expenses. If the proposed shelter expense is materially in excess of what is currently being paid, the case may require closer scrutiny. In such cases, consideration should be given to the ability of the borrower and spouse to accumulate liquid assets, such as cash and bonds, and to the amount of debts incurred while paying a lesser amount for shelter. . . . [I]t is important to remember that the figures provided below for residual income are to be used as a guide and should be used in conjunction with the steps outlined in paragraphs (c) through (j) of this section." 38 CFR 36.4337.

reset had been assured by their broker at origination that the broker would refinance the loan before reset.

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

Such provisions would prevent borrowers from receiving subprime loans that they will have to refinance before rate reset in order to avoid losing the home. In some instances, lenders will offer lower-rate loans in order to meet affordability standards. In instances where even this cannot bring the payments within the range the borrower could afford, the borrower will avoid receiving a loan that would cost them their home, their equity and their credit rating. This would be good for consumers and the market. A current borrower stuck in an exploding ARM would be much better off with a refinance to an affordable product, or, if one is not available, a loan modification, than a refinance into an unaffordable product.

Contrary to the suggestion of some subprime lenders, making credit available at any cost, regardless of the consequences, is not always good for the consumer. In fact, this false suggestion is belied by the experience of the past nine years, during which, subprime lending has actually resulted in a net loss in home ownership.[84] Between 1998 and 2006, the number of subprime borrowers who have lost or are projected to lose their homes to foreclosure exceeded the number first time homebuyers who purchased a home with a subprime loan by almost one million families.[85] Precluding lenders from making unaffordable loans will reduce the number of homes lost to foreclosure and help make subprime lending a positive force in increasing homeownership.

Suggested Regulatory Language

It is an unfair and a deceptive practice to make or approve a subprime or nontraditional mortgage loan absent a good faith determination that the borrower has the capacity to repay the loan according to its terms and by its final maturity, assuming a fully-amortizing repayment schedule.

(A) There shall be a rebuttable presumption that the consumer does not have the capacity to repay if the ratio of total debt to gross income (DTI) exceeds 50%.

(B) In calculating the debt-to-income ratio,

1) all debt payments, including the total housing debt, including principal and interest payments on all first and subordinate liens, taxes and insurance, shall be included;

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[84] CRL Issue Paper No. 14, Subprime Lending: A Net Drain on Homeownership (Mar. 27, 2007) http://www.responsiblelending.org/page.jsp?itemID=32032031.

[85] *Id.* at 4.

2) for adjustable rate mortgages, the repayment capacity must be assessed at the fully indexed rate,[86] *assuming a fully amortizing repayment schedule.*

(C) Factors to be considered in determining whether the presumption of inability to repay has been rebutted shall include, but not be limited to:

1) the applicant's current or anticipated other expenses;

2) in the case of an adjustable rate loan, whether it is reasonably foreseeable that underwriting to a "fully-indexed" rate as defined herein understates the calculation of the debt obligation; and

3) whether there are adequate liquid resources available to cover family living expenses after deducting debt service requirements from monthly income.

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

Yes. Most borrowers could readily document their income using W-2s, 1099s or tax returns. For a small minority of borrowers, such documents may not accurately reflect their anticipated income, and such borrowers' income should be documented by reference to bank returns or other reasonable third party verification. Such documentation is fundamental to sound underwriting and should be required.

A necessary corollary to an effective rule regarding ability to pay is mandatory verification of income. Inadequate documentation compromises a lender's ability to assess the true affordability of a loan and makes any reported debt-to-income ratio meaningless. In order to give lenders the benefit of the above-described presumption of borrower ability to repay where the debt-to-income ratio is 50% or less, it is essential that the lender accurately document the borrower's income, so that it is possible to know what the debt-to-income ratio actually is. "No doc" loans have no legitimate purpose for any but the narrow category of borrowers whose income is not accurately reflected in tax returns or W-2s or 1099s, and even as to this category, some reasonable third-party verification is possible and essential.

Fitch noted in 2006 that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . . ."[87] A 2007 CRL review of 10 mortgage-backed securitizations revealed that, on average, 37% of these recently securitized

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[86] The fully indexed rate equals the index rate prevailing at origination plus the margin specified in the contract as applicable after the expiration of any introductory rate, without regard to any interest rate caps that limit how quickly the fully indexed rate may be reached.

[87] See *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 4.

subprime loans continue to be approved with stated income or reduced documentation standards for verifying the borrower's income.[88] Lenders have increasingly used these loans to obscure violations of sound underwriting practices. For example, a review of a sample of "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[89]

Many actors in the mortgage market have an incentive to inflate stated incomes in low-documentation loans: borrowers are able to qualify for bigger loans;[90] brokers receive higher yield-spread premiums for pushing the higher interest rates that comes with stated-income mortgages and by not having to do the work to verify incomes;[91] and lenders and brokers both collect hefty fees with each later refinancing of these unaffordable loans.[92] Or brokers and lenders do so for the simple reason that otherwise the loan would not be made at all, for lack of a qualifying applicant.

It is borrowers who have the most to lose[93] and who are the least knowledgeable about the dangers these loans present.[94] Brokers and lenders, however, while fully aware that the vast majority of stated incomes are inflated, continue to encourage – and often participate in – the

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[88] *See also* Appendix A in "Testimony of Michael D. Calhoun Before the U.S. Senate Committee on Banking, Housing and Urban Affairs - Subcommittee on Housing, Transportation, and Community Development" at http://www.responsiblelending.org/pdfs/senate-testimony-m-calhoun-june-26-2007.pdf

[89] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

[90] However, in many cases, borrowers are unaware that the broker or originator has inflated the income, often after the borrower provided the documentation, such as W-2 forms, according to attorneys and governmental investigators who have worked on such cases. The adjective in the frequently used term "liar's loans," then, should not be thought to apply just to the applicant.

[91] *See, e.g.,* Testimony of Ms. Delores King, Senate Banking Committee Hearing on "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures" (February 7, 2007), available at http://banking.senate.gov/_files/king.pdf.

[92]John C. Dugan, Comptroller of the Currency, "*Remarks Before the Neighborhood Housing Services of New York*," (May 23, 2007) at 4-5, available at: http://www.occ.treas.gov/ftp/release/2007-48a.pdf. [hereafter "Dugan"] Dugan at 4-5.

[93] *See* "Losing Ground" at 22.

[94] Ren S. Essene and William Apgar. UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS. Harvard Joint Center for Housing Studies, April 25, 2007, p. 11.

practice, pushing borrowers into loans they are unable to repay.[95] And investors, who also stand to lose, gladly accepted loans with unverified income in order to secure higher rates: investors understand the market is a gamble; homeowners do not understand their mortgages to be such.

The failure to document borrower income is highly deceptive under federal and state standards. Mortgages made without documentation of borrower's income are rife with deception. As the Comptroller of the Currency has described it, the practice "is at best misleading and, at worst, fraudulent."[96] The practice misleads consumers into mortgages they are unable to repay, or are unnecessarily expensive. Because lenders charge a higher rate for "no doc" loans, brokers and lenders often push borrowers into "no doc" loans even where the borrower provides or could provide documentation.[97]

Most subprime borrowers are salaried employees who could easily produce W-2 forms as documentation of income.[98] By encouraging these borrowers to take out low-documentation loans, or indeed by putting them into these loans without the borrower's awareness at all, brokers and lenders mislead consumers into paying interest rates up to 1.5 percent higher than they should. The deceptive nature of this aspect of low-documentation loans, even when borrowers are aware it is a no-doc loan, was summarized by the Comptroller of the Currency: "[I]n their zeal to get their loan applications approved quickly, borrowers may not fully understand how much more they are paying for the limited convenience of not producing their W-2s or providing any other form of income verification. That lack of understanding provides a tempting target for brokers who typically have a financial incentive to skip the verification process and get the loan approved at a higher interest rate."[99]

The failure to document borrower income also satisfies the federal and state standards of unfairness. Under the federal standard:

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[95] Dugan at 4. *See also,* for example, State of Iowa v. Ameriquest, EQCE-53090, petition, ¶ 16(F); (Dist Ct for Polk County, March 21, 2006).

[96] Dugan at 4.

[97] *See, e.g.,* Testimony of Ms. Delores King, Senate Banking Committee Hearing on "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures" (February 7, 2007), available at http://banking.senate.gov/_files/king.pdf. Traditional Rate Sheet effective 12/04/06 issued by New Century Mortgage Corporation, recently a major subprime lender, shows that a borrower with a 600 FICO score and 80% LTV loan would pay 7.5% for a fully-documented loan, and 9.0% for a "stated wage earner" loan.

[98] Dugan at 3.

[99] *Id.*

(a) It causes substantial injury to consumers.

Borrowers who are placed into no doc loans despite being capable of fully documenting their income, pay an increased rate without any corresponding benefit. A borrower who pays an extra one percent interest on a $200,000 loan that he or she stay in for four years needlessly loses $8,000. Borrowers who are placed into no doc loans to facilitate inflated income-applications are being placed into loans without establishing their ability to pay, and they lose substantial equity or in many cases, their home, as described in section II.B., above.

(b) This injury is not outweighed by benefits to consumers or competition.

Again, as described in section II.B. above, the severity of the harm is significant, while there appears to be little benefit from accepting a stated income loan.

While lenders should be able to accept reasonable third party documentation of income when W-2 or similar tax forms are unavailable or not truly reflective of the borrower's actual income, the justification of marginally lower lender origination costs is far outweighed by the negative consequences of not verifying income.

Moreover, the failure to document borrower income has perverted competition among lenders as they compete for the higher returns offered by investors for no doc loans. This was frankly acknowledged by the chief executive of Ownit Mortgage Solutions, William D. Dallas, who "acknowledges that [underwriting] standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other subprime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[100]

(c) The injury is not easily avoidable by consumers.

Those consumers who are placed into no doc loans without knowing that they are being charged higher interest rates for the privilege are not aware they are being injured and so cannot avoid the injury. Those consumers who are being placed into a loan that their incomes cannot support face an elevated risk of losing the home to foreclosure. This is a classic example of a "market imperfection" that the unfairness doctrine is intended to overcome. *See* I.B.1, above.

The failure to document borrower income is also "unfair" under state unfairness standards. The practice "offends public policy" as established by the 2007 Statement on Subprime Mortgage Lending.[101] Furthermore, in addition to being "immoral, unethical,

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[100] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.

[101] Statement at 6.

oppressive, or unscrupulous," the practice "causes substantial injury to consumers," as noted above.

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

Yes. Loans with high loan-to-value ratios should be more heavily scrutinized because of the risk layering involved. The debt-to-income ratio is an essential data point whose validity is entirely dependent upon the credible documentation of income. Accordingly, for all loans some form of appropriate documentation should be required.

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

Restricting stated income loans in the way we propose would significantly impact only those borrowers whose ability to obtain the offered loan depends on an inflated income statement. Such borrowers should not receive the loans they are offered. Most borrowers can readily verify their income by reference to W-2s, 1099s or tax returns. The minority of borrowers whose anticipated income is not accurately reflected in such documents, can document their income by providing bank statements or other reasonable third party verification. Such borrowers will not be affected by our proposed restriction. Those borrowers who are unknowingly placed into no doc loans, despite having submitted tax returns to their mortgage broker, for which they are charged a higher interest rate, will benefit from the lower rate available for fully documented loans.

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

Lenders should not be able to offer a subprime or nontraditional loan without documentation.

Suggested Regulatory Language

It is an unfair and deceptive practice to make or approve a subprime or nontraditional mortgage loan without verifying and documenting income by tax returns, payroll receipts, bank records, or other reasonable third-party means.

3. Should Escrows for taxes and insurance be required for subprime mortgage loans?

Yes.[102] Failing to escrow for taxes and insurance on a subprime loan is an unfair and deceptive practice that contributes to high rates of foreclosure.[103] Among the substantial differences between the prime and subprime markets is the handling of escrows for taxes and insurance. Requiring such escrows is the norm in the prime market[104] and is rare in subprime.[105] This has distorted the subprime market by making it difficult for responsible lenders to compete. By creating artificially low monthly payment figures, the failure to escrow deceives consumers about the actual cost of these mortgages relative to those offered by competitors that do escrow. Consumers are frequently lured into higher cost or unaffordable loans by misleading comparisons of lower PI payments to higher PITI payments.[106] Non-escrowing lenders have benefited financially from the deception.

The failure to escrow for taxes and insurance puts subprime borrowers – borrowers most in need of help with financial discipline – in the position of facing an unexpected tax bill. Brokers later target these borrowers for new high-cost refinancings, as homeowners who are facing tax problems are known to be more likely to accept a mortgage with high fees and unfavorable terms.[107]

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[102] Many other organizations, including the National Association of Attorneys General concur with the need to require escrows of taxes and insurance. *See, e.g.,* National Association of Attorneys General, *Letter to Hon. Ben Bernanke, Re: Docket No. OP-1288,* p.6 (August 13, 2007).

[103] *See* "Losing Ground," *supra* note 6, at 27.

[104] *See, e.g.,* Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance. . . . The lender may waive the escrow deposit account requirement for an individual first mortgage, as long as the standard escrow provision remains in the mortgage documents—however, we do not recommend waiving it for a borrower who has a blemished credit record because the borrower may find it difficult to maintain homeownership if faced with the need to make lump-sum payments for taxes and/or insurance and any other periodic payment items.")

[105] *See, e.g.*, "B&C Escrow Rate Called Low*," Mortgage Servicing News Bulletin* (February 23, 2005), *"*Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments."

[106] *See, e.g.* States' settlement agreement with Ameriquest, IV-B-5, http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_SETTLMNT_FINAL.pdf; State of Iowa v. Household International, *Consent Judgment* Para. 9(E)(1), *available at* http://www.state.ia.us/government/ag/latest_news/releases/dec_2002/hhconsent.pdf; Federal Trade Commission vs. Citigroup, et al. Civ. No 1:01-CV-00606 (E.D. Ga., filed), Complaint, Para. 18-19, http://www.ftc.gov/os/2001/03/citigroupcmp.pdf.

[107] Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 Md. L. Rev. 707 at 770, 808-09 (2006).

The failure to escrow also subjects borrowers to the cost of force-placed insurance, which is more costly and less helpful for borrowers,[108] but which generates significant fees for lenders. Fannie Mae has expressed concern over this practice, warning lenders who might "make a practice of rarely or never establishing escrows for blemished credit borrowers with the intent of understating the true cost of financing and generating fees out of activities like lender-placed insurance."[109]

For these reasons, the failure to escrow also meets the federal and state definitions of unfairness. Under the federal standard:

(a) It causes substantial injury to consumers.

Failure to escrow encourages repeated refinancings, as homeowners are forced to borrow additional funds to cover taxes. It further exposes homeowners to the risk of losing the home to foreclosure[110] or tax sale. It also places the borrower at risk of further financial loss in the servicing process through the imposition of force-placed insurance.

(b) This injury is not outweighed by benefits to consumers or competition.

To the contrary, failure to escrow in the context of subprime lending is anti-competitive, because it makes it difficult for responsible lenders to compete, as lenders that do not escrow appear to be offering lower monthly payments. Nor is there any serious argument that the practice is used to accommodate borrowers who lack the cash-flow to pay the escrows earlier in the year but anticipate receiving additional income exactly when tax or insurance bills are due; if it were, it would be used only exceptionally.

(c) The injury is not easily avoidable by consumers.

Borrowers who receive subprime loans are frequently not even aware that the payment quoted understates the real monthly costs. Once locked into the loan, if the borrower cannot afford to pay the taxes when they come due, the harm is unavoidable: the borrower has to refinance, at a high cost in lost equity and fees, or, where that option is unavailable, lose the home.

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[108] *Cf.* Federal Trade Commission "Facts for Consumers" available at http://www.ftc.gov/bcp/conline/pubs/homes/mortgserv.shtm ("It's important to maintain the required property insurance on your home. If you don't, your servicer can buy insurance on your behalf. This type of policy is known as force placed insurance; it usually is more expensive than typical insurance; and it provides less coverage.")

[109] Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05.

[110] *Losing Ground*, *supra* note 6, at 27.

For these reasons, the failure to escrow is likewise "unfair" under state unfairness standards. The practice "offends public policy" as established by the 2007 Statement on Subprime Mortgage Lending[111] and as practiced by Fannie Mae.[112] As noted above, failing to escrow "causes substantial injury to consumers" in addition to being "immoral, unethical, oppressive, or unscrupulous."

If escrows were to be required, should consumers be permitted to "opt out" of escrows?

No. The "opt-out" for subprime loans raises significant concerns. The potential for abuse by unscrupulous lenders and brokers and the magnitude of the risk argue against permitting an opt-out, which would likely be yet another disclosure form manipulated by the loan originator. In today's marketplace, loans are marketed by how low the payment amount is; if opting out is a possibility, a borrower could be unwittingly placed in a loan that *appears* to be cheaper but one that they cannot sustain once the taxes and insurance come due.

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

As mentioned above we suggest that escrows should be required for all subprime and nontraditional home loans.

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

Escrow requirements would benefit both consumers and lenders. Requiring escrows would increase the transparency of the mortgage transaction and make sure that the borrower is fully aware of the true costs associated with the mortgage. Requiring escrows would place all lenders on equal footing: responsible lenders that already escrow would not be unfairly undercut by more reckless lenders. Lenders could no longer use the absence of escrows to mask the true costs of the loan, and borrowers would be less vulnerable to the threat of having to refinance to cover unanticipated tax payments when they come due. Escrows would make it easier for borrowers to accurately compare the true monthly costs of the loans they are offered.

Suggested Regulatory Language

It is an unfair and deceptive practice to make or approve a subprime or nontraditional mortgage loan without requiring escrow of tax and insurance installments calculated in accordance with the requirements of 12 U.S.C. § 2609 and regulations promulgated pursuant thereto.

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[111] "Statement" at 23.

[112] *See* http://www.fanniemae.com/faq/faq6.jhtml?p=FAQ

IV. Definitions of Subprime and Nontraditional Mortgages.

A. Subprime loan definition

Our proposed definition of "subprime" uses two separate benchmarks, creating two safe-harbors for lenders. The two benchmarks are: (i) the rate for U.S. Treasury securities of comparable maturity (the benchmark used by HMDA), and (ii) the rate for 30-year fixed-rate mortgages as set out in the Federal Reserve Statistical Release H.15 ("H.15"). We suggest using the HMDA definition because lenders already have systems in place to identify loans that trigger HMDA obligations. We suggest providing a safe-harbor through the alternative of the H.15 rate to provide stability, and to avoid inadvertently capturing prime loans in circumstances where a "flight to quality" depresses the yield on U.S. Treasury securities, and in periods in which the yield curve is inverted. As can be seen in Appendix D, these two indexes track each other extremely well, except for periods when, due to market disruption, Treasury yields are bid down as against mortgage yields (as occurred in 2000-2001) or where 30-year Treasury rates, which are used for HMDA purposes, fall below 10-year Treasury rates, which are used in part to determine mortgage rates (as occurred in the past year).

Accordingly, we would propose defining "subprime" as those loans whose APR exceeds the greater of the following two benchmarks:

> *(1) If the loan is a closed-end loan, the difference between the annual percentage rate for the loan and the yield on U.S. Treasury securities having comparable periods of maturity is either equal to or greater than (i) 3 percentage points, if the loan is secured by a first lien mortgage or deed of trust, or (ii) 5 percentage points, if the loan is secured by a subordinate lien mortgage or deed of trust. If the loan is an open-end credit plan, the difference between the annual percentage rate for the loan and the yield on U.S. Treasury securities having comparable periods of maturity is equal to or greater than 5 percentage points, regardless of whether the open-end credit plan is secured by a first or subordinate lien mortgage or deed of trust. Without regard to whether the loan is subject to or reportable under the provisions of the federal Home Mortgage Disclosure Act (12 U.S.C. § 2801, et seq.) ("HMDA"), the difference between the annual percentage rate and the yield on Treasury securities having comparable periods of maturity shall be determined using the same procedures and calculation methods applicable to loans that are subject to the reporting requirements of HMDA (as such procedures and calculation methods are amended from time to time).*
>
> *(2) The difference between the annual percentage rate for the loan and the annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as published in statistical release H.15 or any publication that may supersede it, is either equal to or greater than (i) 1.75 percentage points (1.75%), if the loan is secured by a first lien mortgage or deed of trust, or (ii) 3.75 percentage points (3.75%), if the loan is secured by a subordinate lien mortgage or deed of trust.*

B.

Nontraditional mortgage definition

We recommend the following definition of nontraditional mortgage:

> *"Nontraditional loan means a loan that allows a borrower to defer payment of principal or interest."*[113]

V. Remedies for Violations.

We believe that rules as here proposed, if promulgated pursuant to the Board's authority under HOEPA, would be among the most material of requirements that flow from § 1639. Rescission has proven to be one of the most effective and vital tools to protect consumers from the loss of their home for loans that violate the most critical features of the law. Yet, because of the inherently limited exposure and the tender requirement in the extended rescission right, it does not expose the holder of the loan to either excessive or unwarranted litigation risk.[114]

Nothing is more fundamental to responsible lending than writing loans primed for success, not failure. As useful as TIL's monetary damages may be, in the context of today's mortgage market, they are very modest, and wholly inadequate to prevent to loss of the home to foreclosure when a lender violates one of these rules. Congress has repeatedly recognized the essential role that rescission plays, for example, in assuring that the remedy is available against assignees, 15 U.S.C. § 1641(c), and in reducing the tolerances for error to $35 when claims are raised in defense to a threatened foreclosure. 15 U.S.C.§ 1635(i)(2). To be effective, violations of these rules must trigger the right to rescind the loan. We therefore recommend that violations of the rules proposed herein be designated "material" violations in Reg. Z, §§ 226.15. n. 36 and 226.23 n. 48.

As to liability for violations of Truth in Lending itself, including violations of § 1639, assignees are subject to the rescission remedy. "Any consumer who has the right to rescind a transaction under section 1635 … may rescind the transaction as against any assignee of the obligation." 15 USC 1641(c). This provision recognized that rescission has no meaning if it

[113] This definition mirrors the definition used in the Nontraditional Mortgage Guidance, which states: "These mortgage products, herein referred to as nontraditional mortgage loans, include such products as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "payment option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization."

[114] The consumer's obligation to tender back the real value he or she received originally, coupled with the courts' right to equitably modify the process, provide ample systemic protection for the owners of the loans. *See* Reg. Z, §226.23(d). As a practical matter, what typically happens is that, once the tender amount is determined (the existing balance after payments and any monetary damages to which the consumer is entitled are credited is the " tender amount"), the consumer refinances the tender balance with another lender, or receives a loan modification from the existing lender. In a Chapter 13 bankruptcy, typically the tender amount is the allowed secured claim that the debtor must pay as part of the plan.

cannot be asserted against the holder of the obligation.[115] Should the Board adopt these rules and designate them "material," as we recommend, consumers could rescind the loans against assignees in the event the rules are violated. This is particularly critical given that the majority of subprime loans are sold – often repeatedly – on the secondary market. As a practical matter, the question of whether a loan was made without verified ability to repay most often arises only when the struggling homeowner is facing foreclosure at the hands of an assignee. Without this remedy available against the entity threatening foreclosure, the value of these rules to either the homeowners or to a better functioning market would be considerably diminished.

Assignee exposure to monetary damages is limited to that which is apparent on the face of the documents. 15 USC 1640(c), and 1641(e). The existence of a prepayment penalty would be apparent on the face of the documents, as it must be contracted for in the underlying note and mortgage or rider. However, because it must be visible, it is also easy for assignees to protect themselves. Liability for other violations of the recommended rules would depend upon the transparency of the violations.

<u>*Suggested Regulatory Language*</u>

A. Amend Reg. Z, § 226.15 n. 36 to read:

> *The term "material disclosures" means the information that must be provided to satisfy the requirements in § 226.6 with regard to the method of determining the finance charge and the balance upon which a finance charge will be imposed, the annual percentage rate, the amount or method of determining the amount of any membership or participation fee that may be imposed as part of the plan, ~~and~~ the payment information described in § 226.5b(d)(5)(i) and (ii) that is required under § 226.6(e)(2), <u>and the limitations and prohibitions of §§ 226.35A and .35B</u>.*

B. Amend Reg. Z, § 226.23 n. 48 to read:

The term "material disclosures" means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total payments, the payment schedule, ~~and~~ the disclosures and limitations referred to in § 226.32(c) and (d), <u>and the limitations and prohibitions of §§ 226.35A and .35B</u>.

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115 *See* National Consumer Law Center, *Truth in Lending*, § 6.9.2 note 815 (5^{th} Ed. 2003).

Conclusion

HOEPA is unequivocal: the Board must issue regulations banning practices that it finds are unfair and deceptive. To fulfill this mandate, the Board should protect consumers from the unfair or deceptive practices discussed above, by: (1) banning prepayment penalties and yield-spread premiums, two unfair or deceptive practices that were not prohibited by the recent Guidance and Statement; and (2) codifying and expanding the key protections discussed in the Guidance and Statement as they relate to affordability, underwriting, the necessity of documenting income and escrowing taxes and insurance. These two essential measures will help to curb the practices most responsible for the current crisis, and protect borrowers from the risk of losing their homes and their equity to unfair or deceptive mortgage lending practices.

Respectfully submitted,

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APPENDIX A

I. Definitions

A. Add new Reg. Z, § 226.2(a)(20), and renumber remainder accordingly:

Nontraditional mortgage loan means a loan secured by a dwelling that is or will be the consumer's principal dwelling and that allows a consumer to defer payment of principal or interest"

B. Add new Reg. Z § 226.2(a)(28), as renumbered:

Subprime mortgage loan means a loan secured by a dwelling that is or will be the consumer's principal dwelling and in which the APR exceeds the greater of the following two benchmarks:

> (1) "If the loan is a closed-end loan, the difference between the annual percentage rate for the loan and the yield on U.S. Treasury securities having comparable periods of maturity is either equal to or greater than (i) 3 percentage points, if the loan is secured by a first lien mortgage or deed of trust, or (ii) 5 percentage points, if the loan is secured by a subordinate lien mortgage or deed of trust. If the loan is an open-end credit plan, the difference between the annual percentage rate for the loan and the yield on U.S. Treasury securities having comparable periods of maturity is equal to or greater than 5 percentage points, regardless of whether the open-end credit plan is secured by a first or subordinate lien mortgage or deed of trust. Without regard to whether the loan is subject to or reportable under the provisions of the federal Home Mortgage Disclosure Act (12 U.S.C. § 2801, et seq.) ("HMDA"), the difference between the annual percentage rate and the yield on Treasury securities having comparable periods of maturity shall be determined using the same procedures and calculation methods applicable to loans that are subject to the reporting requirements of HMDA (as such procedures and calculation methods are amended from time to time); or
>
> (2) "The difference between the annual percentage rate for the loan and the annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as published in statistical release H.15 or any publication that may supersede it, is either equal to or greater than (i) 1.75 percentage points (1.75%), if the loan is secured by a first lien mortgage or deed of trust, or (ii) 3.75 percentage points (3.75%), if the loan is secured by a subordinate lien mortgage or deed of trust."

II. Unfair or Deceptive Acts and Practices Defined.

A. Add a new § 226.35A: Unfair or Deceptive Acts or Practices In Connection With Subprime Mortgage Loans.

(a) *Prepayment penalties:* It is an unfair and deceptive practice to make or approve a subprime mortgage loan that requires a consumer to pay a penalty for paying all or part of the principal before the date on which it is due, or to collect such a penalty imposed in violation of this paragraph.

(b) *Yield-spread premiums:*
(i) Alternative # 1: Ban on yield-spread premiums
Yield-spread Premiums: It is an unfair and deceptive practice to make or approve a subprime mortgage loan that includes a yield-spread premium, or to collect a yield-spread premium imposed in violation of this paragraph.

(ii) Alternative # 2: Lender liability for broker conduct where yield-spread premiums are paid
Liability for Broker Conduct: It is an unfair and deceptive practice for a creditor or "lender" as defined in 24 C.F.R. § 3500.2 (2007)[116] to disclaim or otherwise refuse to accept liability for acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers a subprime mortgage loan to or for the benefit of a creditor or lender from which the broker received compensation.

OR

Liability for Broker Conduct: A "lender" as defined in 24 C.F.R. §3500.2 (2007) for a subprime mortgage loan is liable for all acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers the subprime mortgage loan to or for or for the benefit of the lender.

(c) *Ability to repay:* It is an unfair and a deceptive practice to make or approve a subprime mortgage loan absent a good faith determination that the consumer has the capacity to repay the loan according to its terms and by its final maturity, assuming a fully-amortizing repayment schedule.

> (1) There shall be a rebuttable presumption that the consumer does not have the capacity to repay if the ratio of total debt to gross income (DTI) exceeds 50%.

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[116] "*Lender* means, generally, the secured creditor or creditors named in the debt obligation and document creating the lien. For loans originated by a mortgage broker that closes a federally related mortgage loan in its own name in a table funding transaction, the lender is the person to whom the obligation is initially assigned at or after settlement. A lender, in connection with dealer loans, is the lender to whom the loan is assigned, unless the dealer meets the definition of creditor as defined under ``federally related mortgage loan'' in this section. See also Sec. 3500.5(b)(7), secondary market transactions."

(2) In calculating the debt-to-income ratio,

(i) all debt payments, including the total housing debt, including principal and interest payments on all first and subordinate liens, taxes and insurance, shall be included;

(ii) for adjustable rate mortgages, the repayment capacity must be assessed at the fully indexed rate,[117] assuming a fully amortizing repayment schedule.

(3) Factors to be considered in determining whether the presumption of inability to repay has been rebutted shall include, but not be limited to:

(i) the consumer's current or anticipated other expenses;

(ii) in the case of an adjustable rate loan, whether it is reasonably foreseeable that underwriting to a "fully-indexed" rate as defined herein understates the calculation of the debt obligation; and

(iii) whether there are adequate liquid resources available to cover family living expenses after deducting debt service requirements from monthly income.

(d) *Verification of Income:* It is an unfair and deceptive practice to make or approve a subprime mortgage loan without verifying and documenting income by tax returns, payroll receipts, bank records, or other reasonable third-party means.

(e) *Escrow of Tax and Insurance Installments:* It is an unfair and deceptive practice to make or approve a subprime mortgage loan without requiring escrow of tax and insurance installments calculated in accordance with the requirements of 12 U.S.C. § 2609 and regulations promulgated pursuant thereto.

B Add a new § 226.35B: Unfair or Deceptive Acts or Practices In Connection With Nontraditional Mortgage Loans.

(a) Ability *to repay:* It is an unfair and a deceptive practice to make or approve a nontraditional mortgage loan absent a good faith determination that the consumer has the capacity to repay the loan according to its terms and by its final maturity, assuming a fully-amortizing repayment schedule.

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[117] The fully indexed rate equals the index rate prevailing at origination plus the margin specified in the contract as applicable after the expiration of any introductory rate, without regard to any interest rate caps that limit how quickly the fully indexed rate may be reached.

(1) There shall be a rebuttable presumption that the consumer has the capacity to repay if the ratio of total debt to gross income (DTI) does not exceed 50%.

(2) In calculating the debt-to-income ratio,

(i) all debt payments, including the total housing debt, including principal and interest payments on all first and subordinate liens, taxes and insurance, shall be included;

(ii) for adjustable rate mortgages, the repayment capacity must be assessed at the fully indexed rate,[118] assuming a fully amortizing repayment schedule.

(3) Factors to be considered in determining whether the presumption of ability to repay has been rebutted shall include, but not be limited to:

(i) the consumer's current or anticipated other expenses;

(ii) in the case of an adjustable rate loan, whether it is reasonably foreseeable that underwriting to a "fully-indexed" rate as defined herein understates the calculation of the debt obligation;

(iii) whether there are adequate liquid resources available to cover family living expenses after deducting debt service requirements from monthly income."

(b) *Verification of Income:* It is an unfair and deceptive practice to make or approve a nontraditional mortgage loan without verifying and documenting income by tax returns, payroll receipts, bank records, or other reasonable third-party means.

(c) *Escrow of Tax and Insurance Installments:* It is an unfair and deceptive practice to make or approve a nontraditional mortgage loan without requiring escrow of tax and insurance installments calculated in accordance with the requirements of 12 U.S.C. § 2609 and regulations promulgated pursuant thereto.

(d) *Liability for Broker Conduct:* It is an unfair and deceptive practice for a creditor or "lender" as defined in 24 C.F.R. § 3500.2 (2007)[119] to disclaim or otherwise refuse to accept liability

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[118] The fully indexed rate equals the index rate prevailing at origination plus the margin specified in the contract as applicable after the expiration of any introductory rate, without regard to any interest rate caps that limit how quickly the fully indexed rate may be reached.

[119] "*Lender* means, generally, the secured creditor or creditors named in the debt obligation and document creating the lien. For loans originated by a mortgage broker that closes a federally related mortgage loan in its own name in a table funding transaction, the lender is the person to whom the obligation is initially assigned at or after settlement. A lender, in connection with dealer loans, is the lender to whom the loan is assigned, unless the dealer meets the definition of creditor as defined under ``federally related mortgage loan'' in this section. See also Sec. 3500.5(b)(7), secondary market transactions."

for acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers a nontraditional mortgage loan to or for the benefit of a creditor or lender from which the broker received compensation.

[OR *Liability for Broker Conduct: A "lender" as defined in 24 C.F.R. §3500.2 (2007) for a subprime mortgage loan is liable for all acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers the subprime mortgage loan to or for or for the benefit of the lender.]*

3. Designate violations of these rules as "material" for purposes of rescission.

A. Amend Reg. Z, § 226.15 n. 36 to read:

> The term "material disclosures" means the information that must be provided to satisfy the requirements in § 226.6 with regard to the method of determining the finance charge and the balance upon which a finance charge will be imposed, the annual percentage rate, the amount or method of determining the amount of any membership or participation fee that may be imposed as part of the plan, ~~and~~ the payment information described in § 226.5b(d)(5)(i) and (ii) that is required under § 226.6(e)(2), and the limitations and prohibitions of §§ 226.35A and .35B.

B. Amend Reg. Z, § 226.23 n. 48 to read:

> The term "material disclosures" means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total payments, the payment schedule, ~~and~~ the disclosures and limitations referred to in § 226.32(c) and (d), and the limitations and prohibitions of §§ 226.35A and .35B.

APPENDIX B

A. The Board Must Prohibit Unfair or Deceptive Acts or Practices

The Board's duty to identify and prohibit unfair or deceptive acts and practices is mandatory, and stands in contrast to its discretionary authority to create certain exceptions to HOEPA's other restrictions: The Board "*may*" exempt specific mortgage products from any or all of HOEPA's substantive prohibitions and limitations if it is in the interest of the borrowing public and will facilitate homeownership, 15 USC 1639*l*(1),[120] but the Board "*shall* prohibit acts or practices in connection with" unfair or deceptive practices in mortgage loans, or abuses in refinancing loans. The word "shall" bespeaks a Congressional directive – it is "ordinarily the language of command." *Alabama v. Bozeman*, 533 US 146, 153 (2001); *Lexecon, Inc.* v. *Milberg Weiss Bershad Hines & Lerach,* 523 US 26, 35 (1998).

The legislative history of the provision similarly states:

> At the same time, the Board is *required* to prohibit acts and practices that it finds to be unfair, deceptive, or designed to evade the section and with regard to refinancings that it finds to be associated with abusive lending practices or otherwise not in the interest of the borrower.

House Conf. Report No. 103-652, at 161 (emphasis supplied).

The Board's duties under 1639*l* extend to loans beyond those that constitute high-cost loans as defined in 15 USC 1639*l*, ("HOEPA" loans), as the Board itself has recognized. 66 Fed. Reg. 65604, 65612 (December 20, 2001). It is also important to note that Congress instructed the Board to prohibit practices that are either unfair <u>or</u> deceptive, and did not require that the practices be both.

In light of the Board's obligation to regularly examine the effectiveness of existing legislation and regulation in protecting consumers, the obligatory nature of the Board's duty is not diminished by virtue of extending only to practices the Board "finds to be" unfair, deceptive, or abusive. Here, such a finding is compelled by the unequivocal evidence of a failure of the market, as revealed in daily news reports and through hearings held by the Board throughout the country, and by Congress throughout the year. Indeed, as we discuss in this Comment, the unfair, deceptive or abusive nature of these practices has long been recognized not only in the recent subprime statement, but in prior agency statements and reports: what the Board now must consider is the adequacy of the regulatory response.

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[120] The Board could exempt certain products from the limitations and prohibitions relating to prepayment penalties, post-default interest rates, balloon payments, negative amortization, prepaid payments, ability to pay, and the provisions relating to home improvement contracts. 15 USC 1639 (c) – (i).

In appointing the Board to monitor and correct evolving market abuses, Congress recognized the truth described by the Supreme Court in a case dealing with another agency: "There is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again. If Congress were to adopt the method of definition, it would undertake an endless task." *FTC v. Sperry and Hutchinson Co.*, 405 U.S. 233, 240 (1972) (internal citation omitted). Charging the relevant agency with the continuing responsibility for oversight and action is the better course than constantly evolving legislative definitions. *Id.*

B. Federal and State Standards for Unfair or Deceptive Acts or Practices

In implementing the HOEPA requirements, Congress directed the Board to utilize both state and federal precedent in identifying such practices. "In making any determination, the Board should look to the standards employed for interpreting *state unfair and deceptive trade practices acts and the Federal Unfair and Deceptive Practices Act* (15 U.S.C. S 45(a)(1))." House Conf. Rep. 103-652, at 161 (emphasis supplied). At the time HOEPA was enacted, both the federal government and all fifty states had existing laws prohibiting unfair or deceptive acts and practices ("UDAP") laws.[121]

1. Federal Standards for Unfairness and Deception

Unfairness: The current federal standard for "unfairness" is three-pronged. An unfair practice is one that:

- causes substantial consumer injury;
- is not outweighed by countervailing benefits to consumers or competition; and
- is not reasonably avoidable by consumers.

Congress elaborated on these standards when it codified them in 1994.[122] Consumer injury may be considered on a sliding scale: relatively small injury to a large number of consumers, or greater harm to a smaller number of consumers, may constitute "substantial injury."[123] The second prong of the standard, "countervailing benefit to consumer," requires careful evaluation, considering available evidence. It does not demand a quantified cost-benefit analysis – in some cases that "would be unnecessary; in other cases it may be impossible."[124]

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[121] For discussions of state and federal standards for unfairness and deception, *see generally* National Consumer Law Center, *Unfair and Deceptive Acts and Practices,* Chap. 4 (6th Ed. 2004 and supp.); Michael M. Greenfield, *Consumer Law: A Guide for Those Who Represent Sellers, Lenders and Consumers.* (1995). For cases discussing the application of state and federal UDAP laws as they relate to mortgage lending issues discussed herein, *see esp.* NCLC, *Unfair and Deceptive Acts and Practices* §§ 5.1.3, 5.1.4 – 5.1.8.

[122] This standard, adopted by the FTC in 1980, was codified in 1994, 15 U.S.C. 45(n).

[123] Sen. Rep. No. 130, 103d Cong. 2d Sess. 12 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1776, 1787-88.

[124] *Id.*

The third prong, that the consumer may not reasonably avoid the injury, derives from a recognition that

> "certain types of seller conduct or market imperfections may unjustifiably hinder consumers' free market decisions and prevent the forces of supply and demand from maximizing benefits and minimizing costs. In such instances of market failure, the [agency] may be required to take corrective action. Such corrective action by an agency is not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making.[125]

As the events of the last few months have made undeniably clear, it is "market imperfections" – structural market imperfections – that now characterize the subprime market with respect to the issues we address in this Comment. When these imperfections dominate the market, it is the duty of the Board to intervene. Unfairness jurisprudence recognizes that corrective action is necessary, because normal market tools, such as disclosure, have proven inadequate to overcome pervasive, structural market flaws.[126]

Deception: Deception includes misrepresentations, as well as failure to disclose material facts, or telling half-truths to leave misleading impressions.[127] Of particular importance in credit transactions, misleading sales representations that obscure proper written disclosures can be deceptive.[128] The infamous "Monster Track" sales presentation developed by First Alliance Mortgage Company was a classic example of this. Turning Truth in Lending (TIL) on its head,

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[125] *Amer. Fin. Serv. Ass'n v. FTC*, 767 F.2d 957, 976 (D.C. Cir. 1985) (internal citations omitted) (case upholding FTC credit practices rule).

[126] Indeed, the FRB recognized nearly ten years ago that disclosure was inadequate to the task. Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July, 1998), at 51, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

As the market has become even more complex since then, the chances that disclosure will suffice are even more remote now than they were then. *See, e.g.* Patricia A. McCoy, *Rethinking Disclosure in A World of Risk-Based Pricing*, 44 Harv. J. on Leg. 123 (2007); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 Maryland L. Rev. 707 (2006). *See also* William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy*, at 23-27 (noting conflicts of interest and increased complexity as obstacles to financial literacy. Paper presented at conference "Consequences of the Consumer Lending Revolution," St. Louis U. School of Law and Federal Reserve Bank of St. Louis, December 8, 2004).

[127] F.T.C. Policy Statement on Deception, *6 (October 14, 1983) (Appended to Cliffdale Associates, Inc., 103 F.T.C. 110, 174 (1984)).

[128] *See*, e.g. *FTC v. Cyberspace.com*, 453 F.3d 1196 (9th Cir. 2006): *FTC v. Direct Marketing Concepts*, 2004 WL 1399185 (D. Mass. June 23, 2004); *FTC v. Horizon Corp.*, 97 F.T.C. 464 (1981).

the company's accurate TIL disclosures were integrated into a sales presentation that effectively obscured the fact that the loans financed as much as 20 points.[129]

2. State Standards for Unfairness and Deception

The Board is not limited to the federal UDAP standards in determining what is "unfair" or "deceptive," but rather should consider state standards as well.[130] Though there are many similarities, common state standards for unfairness are broader than the current federal definition.[131]

Unfairness: One common standard, used by courts in at least a dozen states, was formerly used by the FTC and noted with approval by the Supreme Court in *FTC v. The Sperry and Hutchinson Co.,* 405 U.S. 233 (1972).[132] The "S&H" standard considers whether a practice:

- "without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise – whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness;"
- "is immoral, unethical, oppressive, or unscrupulous;" and
- "causes substantial injury to consumers (or competitors or other businessmen)."[133]

Thus, if a practice is "exploitive or inequitable" and, in addition, is "seriously detrimental" to consumers or others, it is unfair.[134]

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[129] *See, e.g. Federal Trade Commission v. First Alliance Mortgage Co.*, No. SACV00-064, *complaint Para.* 18-21.

[130] *See B, above .*

[131] The 1994 codification of the 1980 FTC unfairness standard was not intended to affect state laws on unfair or deceptive practices. "Sound principles of federalism limit the impact of this section to the FTC only." Sen. Rep. No 130, 103d Cong. 2d Sess. 13 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1788. In this Comment, we discuss our individual recommendations only under the current federal standard, though they would even more readily pass muster under these broader state standards.

[132] Courts in Alaska, California, Connecticut, Florida, Hawaii, Illinois, Louisiana, Massachusetts, Minnesota, New Hampshire, North Carolina, Rhode Island, South Carolina and Washington have used the S&H standard in interpreting their state UDAP laws. *See* cases collected in National Consumer Law Center, *Unfair and Deceptive Acts and Practices,* Sec. 4.3.3.4 note 567 (6th Ed. 2004 and 2006 supp.) and Michael M. Greenfield, *Unfairness Under Section 5 of the FTC Act and Its Impact on State Law,* 46 Wayne L. Rev. 1869, 1914-23 (Winter 2000).

[133] 405 U.S. at 244, citing *Statement of Basis and Purpose of Trade Regulation Rule 408, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking*, 29 Fed. Reg. 8355 (1964).

[134] *Id.*

<u>Deception</u>: State deception standards generally are similar to federal standards: literal truths and half-truths that mislead or conceal as to material facts are deceptive, as are omissions of material facts in some cases.[135]

[135] State deception standards and case law are also discussed in the treatises cited in note 17, above.

APPENDIX C

A. TILA and HOEPA monetary damages are limited.

TILA applies limited monetary damages for violations of the Truth in Lending Act sections, as well as enhanced damages for violations of the specific provisions of 15 USC 1639, the HOEPA substantive protections. Claims can be brought within one year from the date of the occurrence of the violation.[136] 15 USC § 1640 (e). The modest standard monetary remedies available under the general provisions of Truth in Lending apply to violations of requirements imposed under 15 USC §1639, meaning that the borrower may be able to collect both sets of damages for violations of HOEPA rules.

Standard TILA monetary damages include actual damages[137] and a statutory damages award of twice the finance charges in connection with the transaction, capped at a maximum of $1,000 for open-end mortgage loans or $2,000 for closed-end transactions secured by real property or a dwelling. 15 USC 1640 (a)(1) and (2).

In addition to damages available under TILA's general provisions, violations of HOEPA protections trigger special monetary damages in addition to the general awards discussed above. These, however, are limited to "an amount equal to the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the violation is not material." 15 USC 1640(a)(4).[138]

Thus, even the maximum monetary damages exposure for a violation of 15 USC 1639 are limited in an individual case. For a $200,000 loan at 8.73%,[139] with 3% financed fees, the maximum exposure, under the broadest reading of the statute, for an affirmative claim would be approximately $25,000: $2,000 statutory damages, $6,000 financed fees and $17,460 in interest paid during the one year before the statute of limitations was tolled ($25,460). Some courts have read that section even more restrictively, requiring a return only of fees and interest actually

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[136] Where state law permits, claims for monetary damages may be asserted defensively past the one-year statute of limitations by way of recoupment or set-off. 15 U.S.C. § 1640(e). State attorneys general may bring actions for violations of HOEPA within 3 years of the occurrence of a violation. *Id.*

[137] Court rulings in four circuits have borrowed common law fraud principles to make it more difficult to obtain an award of actual damages. *See generally*, National Consumer Law Center, *Truth in Lending* § 8.5.4.1 (5th Ed. 2003 and supp.). Whether such cases reflect an accurate reading of TIL or not, the precedent means that this aspect of TIL's remedial scheme will not expose creditors to unwarranted liability. And, of course, it should not be a priority for the Board to protect creditors from *warranted* liability.

[138] For purposes of this provision, "material" refers to a common law standard of materiality, not to "material" disclosures as defined by 15 USC 1602(u), Reg. Z, 226.23 n. 48. See H.R. Conf. Rep. No. 652, 1103d Cong. 2d Sess. 147, 162. Cases interpreting the HOEPA damage provision may be found at National Consumer Law Center, *Truth in Lending* §9.6.1 (5th Ed. 2003 and supp.)

[139] Current Freddie Mac survey rate plus 2%

paid, which in this case would reduce the exposure by $6,000 (the amount of the financed fees), and the interest refund, under this reading, would be reduced in the event the borrower was delinquent, as less interest would have been "paid."[140]

B. Class actions will be rare and damages are limited.

While class actions will be rare, in those cases where they arise, the damages are extremely limited. Class action exposure is limited by a class action cap of ***the lesser of*** $500,000 or 1% of the creditor's net worth. 15 USC § 1640(a)(2)(B). The same one-year statute of limitations applies. 15 USC §1640(e).

In general, because of the individualized nature of claims brought under an ability to repay or income verification rule based on unfairness principles, it will be difficult to bring a class action for violations of these proposed rules. In widespread cases of failure to escrow or inclusion of illegal and abusive prepayment penalties or yield-spread premiums, while class actions may be feasible, they will still be capped at a maximum amount of $500,000. For small lenders with net worth below $50 million, the cap will be even lower—1% of the creditor's net worth.[141]

C. The right of rescission should also apply to violations of the proposed rules.

Under the Truth in Lending Act, a consumer has a three-day right of rescission in consumer credit transactions in which a non-purchase lien or security interest is or will be placed on the consumer's principal dwelling.[142] Rescission may be extended for up to three years from the date of consummation if a creditor fails to properly provide notice of right to rescind or fails to deliver "material disclosures" as defined in the statute and regulation.[143]

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[140] *See, e.g.* In re Williams, 291 B.R. 636, 664 (Bankr. E.D. Pa. 2003).

[141] It is possible that class damages for §1639 damages would be determined by the court's examination of traditional factors, such as "the frequency and persistence of failures of compliance, the resources of the creditor, the number of persons adversely affected, and the extent to which the creditor's failure of compliance was intentional," rather than the formula spelled out in 15 USC §1640(a)(2)(B). See 15 USC § 1640(a), language following 1640(a)(4).

[142] 15 U.S.C. § 1635(a). *See also*, 12 C.F.R. 226.15(f) *and* 12 C.F.R. 226.23(f) (exempting residential mortgage transactions from rescission procedures). Rescission essentially unwinds the original transaction and puts both parties in the position they were in before the loan was made. The process for rescission is described in 15 U.S.C. § 1635(b), Reg. Z, § 226.15, 226.23. A consumer who exercises the right to rescind, is not liable for any finance or other charges and any security interest becomes void. The creditor returns money or property that was given by the consumer, while the consumer must tender back the money originally provided by the creditor. Additionally, a court order may modify the tendering process.

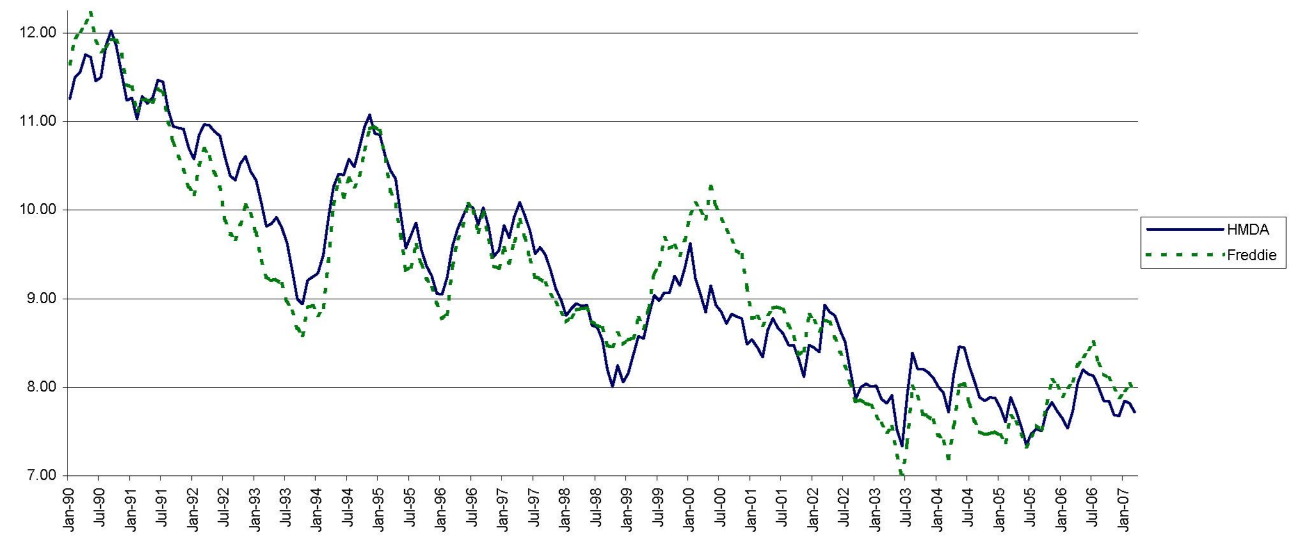
[143] 15 U.S.C. § 1635(f). The Supreme Court has held that the Truth in Lending Act does not permit the extended rescission right to be raised by way of recoupment after three years. *Beach v. Ocwen Fed. Bank*, 523 U.S. 410 (1998). There may be limited circumstances in which state law may extend it, though in the nearly decade since *Beach*, that has been little used, except in Massachusetts, which has an exemption from federal TIL and parallel state

Failure to make disclosures required by § 1639 or including provisions prohibited by §1639 constitute a failure to deliver material disclosures for the purposes of rescission, 15 U.S.C. §§ 1602(u), 1639(j). Current Board rules, however, place some limits on which violations of § 1639 trigger the extended three year rescission right. Reg. Z, § 226.23 n. 48 (omitting violations of § 226.34 from the definition of "material" violations for purposes of rescission.).

TIL with rescission. *See generally*, National Consumer Law Center, *Truth in Lending* § 6.3.3.2 (5th Ed. 2003 and supp.)

APPENDIX D

Comparison of HMDA (TREASURY + 3.00) and Freddie Mac + 1.75
January 1990 - March 2007



APPENDIX E

Fannie Mae Selling Guide

X, Chapter 7: Liabilities and Debt-to-Income Ratios (01/31/06)

A borrower may have several types of liabilities—some involving debts that need to be paid off at (or prior to) loan closing, some that are contingent on the occurrence (or non-occurrence) of a particular event or action, and others that represent either short-term or long-term recurring monthly obligations. Once a borrower's liabilities have been appropriately categorized and his or her stable monthly income has been determined, the lender should develop ratios that compares the borrower's anticipated monthly housing expense and total monthly obligations to his or her stable monthly gross income. Those ratios may be used as a benchmark to determine whether the borrower will be able to meet the expenses involved in homeownership.

X, 701: Monthly Housing Expense (01/31/06)

Monthly housing expense is the sum of the monthly principal and interest installment for the mortgage that is secured by the borrower's principal residence; escrow deposits for the hazard, flood, and mortgage insurance premiums (as applicable), real estate taxes, ground rent, or special assessments; any owners' association dues (including utility charges that are attributable to the common areas, but excluding any master utility charges that apply to the individual unit); any monthly cooperative corporation fee (less the *pro rata* share of the master utility charges for servicing individual units that is attributable to the borrower's unit); and any payments actually required to be made for subordinate financing. When the mortgage that is being delivered to us is secured by a second home or an investment property, the monthly principal and interest installment for the mortgage is not considered part of the borrower's monthly housing expense; rather, it is considered one of the borrower's monthly debt obligations.

Generally, when the mortgage that is being delivered to us is secured by the borrower's principal residence, the lender should use the monthly principal and interest installment for the mortgage (which is based on the actual mortgage interest rate) in determining the borrower's monthly housing expense. However, the actual payment for a biweekly mortgage must be multiplied by two to convert it to a monthly payment.

. . .

X, 702: Monthly Debt Obligations (01/31/06)

Monthly debt obligations are the other key component in developing the underwriting ratios. Some types of debts do not have to be considered in developing the qualifying ratio, either because they are required to be paid off at (or prior to) closing or because they represent a contingent liability. Other verified liabilities that represent long-term debt (and some that represent significant short-term debt) must be taken into consideration in developing a borrower's qualifying ratio.

…

X, 702.03: All Other Liabilities (11/25/03)

The borrower's other liabilities include all revolving charge accounts; installment debt; lease payments; real estate loans; home equity lines of credit; nonreimbursed employee expenses; alimony, child support, or maintenance payments; and all other debts of a recurring nature. For each liability, the lender must determine the unpaid balance, terms, and the borrower's payment history. Generally, this information can be obtained from any of the types of credit reports we accept. However, the lender also must verify any other liability that is not shown on a credit report.

A. **Revolving charge accounts.** When the borrower's credit report includes any revolving charge account with an outstanding balance that suggests that more than ten payments remain to be paid, the lender always must consider the payment on the account as part of the borrower's recurring monthly debt obligations, even if the loan application indicates that the debt will be paid off at (or prior to) loan closing. Revolving debt with ten or fewer monthly payments remaining also may be considered as a recurring debt obligation if it significantly affects the borrower's ability to meet his or her credit obligations. If the credit report does not show a required minimum payment amount, the lender should use an amount equal to five percent of the outstanding balance.

B. **Installment debt.** Generally, all installment debt that is not secured by a financial asset—including student loans, automobile loans, and home equity loans—should be considered as part of the borrower's recurring monthly debt obligations only if there are more than ten monthly payments remaining to be paid on the account. However, an installment debt with ten or fewer monthly payments remaining also should be considered as a recurring monthly debt obligation if it significantly affects the borrower's ability to meet his or her credit obligations.

Deferred installment debt—such as student loans and loans in forbearance—must also be included as part of the borrower's recurring monthly debt obligations. If the borrower's credit report does not indicate the monthly payment that will be payable at the end of the deferment period, the lender should request a copy of the borrower's payment letter or forbearance agreement so that it can determine what payment amount to use in calculating the borrower's total monthly obligations.

C. **Lease payments.** Because the expiration of a lease agreement for rental housing or an automobile typically leads to either a new lease agreement, the buyout of the existing lease, or the purchase of a new vehicle or house, we require that lease payments always be considered a recurring monthly debt obligation, regardless of the number of months remaining on the lease.

D. **Payments on real estate mortgages.** When the borrower owns mortgaged real estate (other than investment properties), the full mortgage payment (principal, interest, taxes, and insurance) that the borrower is obligated to pay is considered as part of the borrower's recurring monthly debt obligations. There is no need to add the full mortgage payment for an investment property to the borrower's monthly obligations since it is already factored into the net monthly rental income (or loss) amount (as discussed in *Section 402.24*).

E. **Home equity lines of credit.** When the mortgage that is being delivered to us also has a home equity line of credit that provides for a monthly payment of principal and interest or interest only, the payment on the home equity line of credit must be considered as part of the borrower's recurring monthly debt obligations. If the home equity line of credit does not require a payment, there is no recurring monthly debt obligation so the lender does not need to develop an equivalent payment amount.

F. **Nonreimbursed employee expenses.** When a borrower has nonreimbursed business expenses such as classroom supplies, uniforms, meals, gasoline, automobile insurance and/or automobile taxes, the lender must determine the borrower's recurring monthly debt obligation for such expenses by developing a 24-month average of the expenses, using information from the borrower's *U. S. Income Tax Return* (IRS Form 1040) including all schedules (Schedule A (Itemized Deductions) and IRS Form 2106 (Employee Business Expenses)) and net out any automobile depreciation claimed on IRS Form 2106. Consequently, when calculating the total debt-to-income ratio, the 24-month average for nonreimbursed expenses should be subtracted from the borrower's stable monthly income, unless such expenses are automobile lease payments or automobile loan payments, in which case they are to be considered part of the borrower's recurring monthly debt obligations. If there is not a 24-month history of such expenses, the lender should develop an annualized monthly average for the expenses and add this calculated amount to the borrower's monthly debt obligations.

G. **Alimony, child support, or maintenance payments.** When the borrower is required to pay alimony, child support, or maintenance payments under a divorce decree, separation agreement, or any other written legal agreement—and those payments must continue to be made for more than ten months—the lender must consider the payments as part of the borrower's recurring monthly debt obligations. However, voluntary payments do not need to be taken into consideration.

H. **Business debt in borrower's name.** When a self-employed borrower claims that a monthly obligation that appears on his or her personal credit report is being paid by the borrower's business, the lender needs to confirm that it verified that the obligation was actually paid out of company funds and that this was considered in its cash flow analysis of the borrower's business.

- When the account in question does not have a history of delinquency, the business provides acceptable evidence that the obligation was paid out of company funds (such as 12 months of canceled company checks), and the lender's cash flow analysis of the business took payment of the obligation into consideration, the lender does not need to consider the account payment as part of the borrower's individual recurring monthly debt obligations.

- If the business does not provide sufficient evidence that the obligation was paid out of company funds, the lender must consider the account payment as part of the borrower's individual recurring monthly debt obligations.
- If the business provides acceptable evidence of its payment of the obligation, but the lender's cash flow analysis of the business does not reflect any business expense related to the obligation (such as an interest expense—and taxes and insurance, if applicable—equal to or greater than the amount of interest that one would reasonably expect to see given the amount of financing shown on the credit report and the age of the loan), it is reasonable to assume that the obligation has not been accounted for in the cash flow analysis. When that is the case, the lender must consider the account payment as part of the borrower's individual recurring monthly debt obligations.
- When the account in question has a history of delinquency, the lender must consider the full monthly obligation as part of the borrower's individual recurring monthly debt obligations. (To ensure that the obligation is counted only once, the lender should adjust the net income of the business by the amount of interest, taxes, or insurance expense, if any, that relates to the account in question.)

X, 703: Benchmark Ratios (01/31/06)

Historically, a lender has used two different ratios—a monthly housing expense-to-income ratio and a total monthly obligations-to-income ratio—to assess whether a borrower is able to meet the expenses involved in homeownership. Because our research has not demonstrated that there is a significant relationship between the incidence of mortgage default and the borrower's monthly housing expense-to-income ratio, our emphasis is on the total debt-to-income ratio (which consists of two components—monthly housing expense and the total of other monthly obligations).Although we have established a benchmark qualifying debt-to-income ratio, we recognize that often there are legitimate reasons for exceeding this guideline. Therefore, a lender may use a ratio that is higher than our benchmark guideline, as long as its assessment of the comprehensive risk for the mortgage identifies and documents factors that justify the higher ratio.

A borrower's debt-to-income ratio is a comparison of the borrower's total monthly obligations to the borrower's stable monthly income. Total monthly obligations are the sum of

- the monthly housing expense (as described in *Section 701* above);

- monthly payments on installment debts, revolving debts, and other mortgage debts that extend beyond ten months;
- monthly payments on installment debts, revolving debts, and other mortgage debts that extend ten months or less—if the payments significantly affect the borrower's ability to meet credit obligations;
- monthly payments on lease agreements, regardless of the expiration date of the lease;
- monthly alimony, child support, or maintenance payments that extend beyond ten months;
- monthly payments for other recurring monthly obligations (as discussed in *Section 702* above); and
- any net loss from a rental property (as discussed in *Section 402.24*).

Our benchmark debt-to-income ratio is 36 percent of the borrower's stable monthly income. However, we may occasionally specify a maximum allowable debt-to-income ratio for a particular mortgage product—for example, we limit the debt-to-income ratio for a Streamlined Purchase Money Mortgage Option 2 to 50 percent. In addition, when the income from more than one borrower is used to qualify for a mortgage (and not all of the borrowers will occupy the property), we require the owner-occupant borrower(s) to satisfy an additional debt-to-income ratio—even if the combined incomes and debts of all of the borrowers result in a debt-to-income ratio of 36 percent or less. In this case, the owner-occupant borrower(s) should have a debt-to-income ratio of 43 percent or less, after excluding the income(s) and debt(s) for the non-occupying borrower(s).

OPTION ONE MORTGAGE — Option One Mortgage Rate Sheet — Latitude Advantage

East Area Rate Sheet - 3 Year Fixed -2 Year Prepay / Par (DC, MA, MD, NJ, NY, CT, DE, FL, ME, NH, PA, RI, VT, VA)

GRADE	SCORE	Full Doc						Stated Income/Lite*					
12 Mo Mtg.	LTV	65%	70%	75%	80%	85%	90%	65%	70%	75%	80%	85%	90%
AA+	700+	7.850	8.000	8.150	8.250	8.850	9.250	9.000	9.150	9.300	9.400	10.050	10.850
	680	7.950	8.100	8.250	8.300	8.900	9.400	9.100	9.250	9.400	9.450	10.200	11.000
0X30	660	8.000	8.150	8.200	8.350	9.000	9.400	9.150	9.300	9.350	9.500	10.300	11.100
dotted box = I/O min	640	8.150	8.350	8.400	8.650	9.300	9.700	9.300	9.500	9.650	9.750	10.550	11.350
Margin = 6.00	620	8.200	8.400	8.450	8.700	9.350	9.750	9.500	9.800	9.850	9.950	10.850	11.650
	600	8.350	8.600	8.800	9.100	9.650	10.000	9.500	9.800	10.100	10.250	11.150	12.000
Stated Wage Earner:	580	8.650	8.900	9.150	9.500	10.100	10.500	9.950	10.200	10.550	10.850		
Max 80% min 560 score	560	8.900	9.200	9.400	9.850	10.500	10.950	10.300	10.600	11.000	11.300		
Max 85% min 600 score	540	9.600	9.900	10.250	10.750	11.400							
Max 90% min 620 score													
AA	700+	8.200	8.350	8.500	8.600	9.100	9.500	9.300	9.450	9.600	9.700	10.400	11.200
	680	8.300	8.450	8.600	8.650	9.250	9.650	9.400	9.550	9.700	9.750	10.550	11.350
1X30	660	8.350	8.500	8.550	8.700	9.250	9.650	9.450	9.600	9.650	9.800	10.650	11.450
dotted box = I/O min	640	8.500	8.700	8.750	8.850	9.400	9.800	9.600	9.800	9.850	10.050	10.800	11.600
Margin = 6.20	620	8.550	8.750	8.800	8.900	9.450	9.850	9.800	10.100	10.150	10.250	11.100	11.900
	600	8.600	8.850	9.050	9.200	9.750	10.150	9.950	10.200	10.500	10.650	11.500	12.300
Stated Wage Earner:	580	8.900	9.150	9.400	9.600	10.200	10.600	10.250	10.500	10.850	11.150		
Max 80% min 560 score	560	9.150	9.450	9.650	9.950	10.600	11.050	10.600	10.900	11.200	11.500		
Max 85% min 600 score	540	9.850	10.150	10.500	10.850	11.500							
Max 90% min 620 score													
A	700+	8.300	8.400	8.600	8.700	9.200	9.600	9.400	9.550	9.700	9.800	10.500	11.400
	680	8.400	8.550	8.700	8.750	9.350	9.750	9.500	9.650	9.800	9.850	10.650	11.550
2X30	660	8.450	8.600	8.650	8.800	9.350	9.750	9.550	9.700	9.750	9.900	10.750	11.550
	640	8.600	8.800	8.850	8.950	9.500	9.900	9.750	9.950	10.000	10.100	10.950	11.750
Margin = 6.40	620	8.650	8.850	8.900	9.000	9.550	9.950	10.000	10.200	10.250	10.450	11.200	12.000
	600	8.700	8.950	9.150	9.300	9.850	10.250	10.150	10.400	10.600	10.750	11.600	12.400
Stated Wage Earner:	580	9.000	9.250	9.500	9.700	10.300	10.700	10.550	10.800	11.050	11.250		
Max 80% min 560 score	560	9.250	9.550	9.750	10.050	10.700	11.150	10.800	11.100	11.350	11.650		
Max 85% min 600 score	540	9.950	10.250	10.600	10.950								
Max 90% min 620 score													
B	700+	8.700	8.900	9.100	9.250	9.750	10.150	9.800	10.000	10.200	10.350	11.050	11.950
	680	8.900	9.100	9.300	9.400	10.150	10.600	9.950	10.150	10.350	10.450	11.400	12.350
4X30	660	8.950	9.150	9.300	9.450	10.350	10.850	10.150	10.350	10.550	10.700	11.900	12.800
or	640	9.150	9.400	9.550	9.600	10.650	11.150	10.350	10.600	10.750	10.800	12.150	13.050
2X30,1X60	620	9.250	9.550	9.700	9.750	11.000	11.500	10.600	10.900	11.050	11.150	12.650	13.550
	600	9.350	9.650	9.900	9.950	11.350	11.850	10.800	11.100	11.250	11.400	13.100	
Margin = 6.65	580	9.700	9.850	10.300	10.450	11.850	12.400	11.250	11.500	11.850	12.000		
	560	10.000	10.250	10.550	10.850			11.600	11.800	12.150	12.450		
	540	10.700	10.900	11.450	11.800								
C	700+	9.050	9.250	9.450	9.600	10.100	10.550	10.150	10.350	10.550	10.700	11.400	12.350
	680	9.200	9.400	9.600	9.700	10.450	11.000	10.300	10.500	10.550	10.750	11.750	12.800
6X30,1X60,1X90	660	9.300	9.500	9.650	9.850	10.700	11.350	10.350	10.550	10.700	10.800	11.900	12.950
or	640	9.500	9.750	9.900	9.950	11.000	11.700	10.600	10.950	11.100	11.150	12.500	13.600
6X30,2X60,0x90	620	9.600	9.900	10.050	10.100	11.350	12.100	10.850	11.100	11.250	11.400	12.850	14.000
	600	9.700	10.000	10.250	10.350	11.700	12.500	11.150	11.450	11.700	11.800	13.450	
Margin = 7.25	580	10.150	10.400	10.750	10.950	12.400		11.750	12.000	12.350	12.550		
	560	10.350	10.550	10.900	11.250			11.950	12.150	12.500	12.850		
Stated Doc N/A	540	11.050	11.250	11.800									
Lite Doc Only*													
CC	700+	11.050						12.250					
	680	11.050						12.300					
MTG = OTHER	660	11.100						12.500					
	640	11.350						12.700					
Margin = 7.40	620	11.500						13.150					
	600	11.600						13.350					
Stated Doc N/A	580	12.000						13.850					
Lite Doc Only*	560	12.450						14.300					
	540	13.400											

Minimum Rates
3/27 @ 5.85, 5/25 @ 6.25, Fixed (15,20,30) @ 6.65

Pricing Adjustments

Loan Size	DC, MA, MD, NJ, NY	Rate Adj		Loan Size	CT, DE, FL, ME, NH, PA, RI, VT, VA	Rate Adj
$750,000 +		(0.500)	(Max 1 YSP >$650,00+)	$750,000 +		(0.500)
$300,000 -	$749,999	(1.000)		$250,000 -	$749,999	(0.750)
$250,000 -	$299,999	(0.750)		$200,000 -	$249,999	(0.625)
$200,000 -	$249,999	(0.625)		$175,000 -	$199,999	(0.500)
$125,000 -	$199,999	(0.250)		$125,000 -	$174,999	(0.350)
$100,000 -	$124,999	0.000		$100,000 -	$124,999	0.000
$75,000 -	$99,999	1.000		$75,000 -	$99,999	1.000
<$74,999		2.000		<$74,999		2.000

Products	Rate Adj
Fixed	0.400
Fixed (Fannie Mae Conforming Limits - AU Submissions only)	0.250
5-year ARM	0.150
40-Year or 50-Year (Min Fico is State Specific)	0.150
Interest-Only - FICO >= 620 (Risk grades AA+, AA only)	0.250
Interest-Only - FICO < 620 (Risk grades AA+, AA only)	0.400

Documentation	Rate Adj
Business Bank Statements (add-on to Full Doc)	0.250
No-Doc (Add on to Stated Rate, AA+ only)	0.600
Score Advantage: Qualify with Co-Borrower Score	0.500
Stated Wage Earner	0.250

Other Adjustments	Rate Adj
Disposable Income >= $2500 (Full Doc & Lite Doc)	(0.100)
Cash Reserves > 6 Months Principal & Interest	(0.100)
First Time Home Buyer (FTHB)	0.250
Manual Submission	0.250
Customer Assisted Processing Fee (National Clients)	0.300
10% Down Payment (Purchase Transaction only)	(0.100)
Verification of Rents (FTHB only)	(0.100)

Buyups/Buydowns (Max buy down 2 pts)	Points		Rate Adj
3-Year Fixed	1.000	=	0.550
5-Year Fixed	1.000	=	0.550
Fixed	1.000	=	0.550

Prepay Charges (3/27, 5/25 = 2yrs & Fixed = 3yrs) Max 1 YSP where PP Prohibited (State Specific)	Points		Rate Adj
Partial Prepay State (reference state matrix)			0.200
Non-PrePay State			0.400
1-year prepay (Max 1 YSP)	1.250	or	0.750
2-year prepay (Fixed)	1.000	or	0.500

Prepay Buyout (3/27, 5/25 = 2yrs & Fixed = 3yrs) Max 1 YSP where PP Prohibited (State Specific)	Points		Rate Adj
Prepay Buyout (Where Standard PPP allowed)(YSP not Permitted)	1.500	or	1.000
Prepay Buyout (Where Partial PP allowed) (YSP not Permitted)	1.250	or	0.800

Property Type (Adjustments based upon CLTV) Occupancy	<=70%	70.01 - 80.00%	>80%
2-4 units (Adjustments for 2 unit properties do not apply in NY, CT, RI, MA, NH, VT, ME, NJ)	0.400	0.400	0.400
Condo	0.125	0.250	0.400
2nd Home	0.125	0.250	0.375
Non-Owner Occupancy (Minimum FICO 600)	1.100	1.350	1.600

Secondary Financing (CLTV > LTV)	Rate Adj
Credit Score (CLTV > LTV) - FICO >= 660	0.900
Credit Score (CLTV > LTV) - FICO < 660	1.550

UW Fees	UW Fee		UW Buyout
$300,000 +	$850	or	0.200
$125,000 - $299,000	$850	or	0.300
<$125,000	$695	or	0.500

LTV Max Eligibility Adjustments		AA+	AA	A	B	C	CC
Non-Owner, Full Doc		-10	-10	-10	-10	N/A	N/A
Non-Owner, Stated	(Max 80%, no C or CC)	-10	-10	-10	-10	N/A	N/A
3-4 Units, Full Doc	(Max 90%)	-5	-5	-5	-5	-5	-5
3-4 Units, Stated	(max 90%)	-5	-5	-5	-5	-5	N/A
Second Home > 80% *, Full Doc		-5	-5	-5	-5	-5	N/A
Second Home > 80%, Stated	(Max 90%)	-5	-5	-5	-5	-5	N/A
No Doc Maximum LTVs		660 - 80%, 680 - 80%, 700 - 90% FTHB - 680 - 80%, primary residence purchases only					
Stated Wage Earner		Max 80% for 560-599, 85% for 600-619, 90% for 620-679					

If you do not wish to receive further documents call 866 800 3697 to be removed from our database.
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