Opening Statement of
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at Public Hearing on the
Home Ownership and Equity Protection Act of 1994
before Board of Governors of the Federal Reserve System
Washington, DC
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Good afternoon Governor Kroszner and members of the staff of the Board of Governors of the Federal Reserve. My name is Mark Pearce, and I am Deputy Commissioner of Banks for the State of North Carolina. The Office of the Commissioner of Banks licenses and supervises over 1,600 mortgage lenders and brokers and over 17,000 individual loan officers. Thank you for permitting me the opportunity to testify before you today on possible regulations issued under the Home Ownership and Equity Protection Act (HOEPA), the national predatory lending law.

I do not envy your task. The mortgage market in this country is innovative and highly competitive. The evolution of the mortgage market has led to an efficient means of enabling capital to reach people that once had great difficulty in obtaining homeownership opportunities. Much of this system developed outside of depository institutions and was the result of market forces, not regulatory requirements.

On the other hand, these market forces have outpaced regulatory control and even the expectations of market experts. The same tools used to expand options for homeownership have mutated and been marketed in a manner that undermines sustainable homeownership. The laws, regulations, and systems designed to monitor the practices and the purveyors have not been up to the task of preventing abuses.

And so, the Board of Governors has an awesome responsibility – it must weigh the pressing need to reduce abusive lending with the recognition that market innovation has benefited the vast majority of homebuyers in this country through increased choice and lower costs.

In my comments today, I wish to offer you North Carolina's experience with these issues, and my views on today's marketplace. Despite the challenges, I believe HOEPA can be updated to inoculate against some of the ills we are seeing in the marketplace, without having a negative impact on innovation or market access.

The North Carolina Experience

In 1999, my home state of North Carolina enacted the first state-level supplement to HOEPA in order to reduce the incidence of predatory lending. At that time, the major abuses affecting North Carolina borrowers were financed single premium credit insurance, equity stripping through high fees and prepayment penalty charges, and the "flipping" of home loans, the practice of refinancing a home loan without a reasonable, net tangible benefit. This law passed with almost unanimous support – lenders and advocates, Republicans and Democrats. Despite this broad support, there were lenders that pulled out of the state – with great fanfare – only to return quietly a year or two later, once it became clear that other market participants were more than willing to serve the North Carolina market.

Over the past eight years, there have been a number of studies that have sought to assess the impact of North Carolina's law on predatory lending and on lending in the market. While this argument is interesting and worth study, it is nearly irrelevant to the current debate about subprime hybrid ARMS, nontraditional mortgage products, and mortgage fraud. In short, while researchers built models and policymakers debated, market participants adapted to abide by the law without missing a beat, and unscrupulous lenders developed new tools and techniques to take advantage of our most vulnerable homeowners. Many of these tools were a perversion of innovative products designed to serve higher-income and more knowledgeable homeowners.

In 2001, North Carolina enacted a comprehensive licensing and supervision scheme for mortgage brokers, mortgage lenders, and individual loan officers. In the course of just five years, the Office of the Commissioner of Banks developed a state-of-the-art computer system to implement the licensing system, licensed thousands of companies, and tens of thousands of individual loan officers. Our office has conducted over 250 hearings on mortgage licensing matters. As we have implemented the system, we have continued to refine it, amending our licensing statute in each of the last five legislative sessions. Maybe we just didn't get it right the first time, but I believe this frequent revision reflects a work in progress to find the right infrastructure to support the evolving mortgage delivery system.

Let me give you an example: A mortgage broker has its headquarters in Florida. The mortgage broker has a branch office in Ohio. The Ohio branch office has a loan officer that is licensed to do loans in multiple states. The mortgage broker works with a variety of multi-state lenders, some that are state-chartered non-depositories, some that are depositories or subsidiaries, some that are affiliates of depositories, and some that are joint ventures of different stripes from any of the above. Now, when a North Carolina homeowner receives a mortgage loan, the loan ultimately funded may touch three or four licensed entities. And this does not even consider many lead generators on the front end and correspondent lenders, and securitizers, on the back-end. And all of this gets us through origination of the loan and does not include entities that may service (or sub-service) the loan after origination.

This example illustrates two additional points. First, given the multi-state and dispersed method of originating loans, is it any wonder that the states, through the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, have banded together to develop a national licensing system to track these moving pieces more efficiently and cooperatively? The national licensing system will go on-line on January 1, 2008 and is the result of three long years of cooperative development. North Carolina will join the system next year, and will do so even though we have designed and implemented our own system just in the past five years.

Second, the fact that HOEPA regulations can apply to all participants in the mortgage market make them an extremely useful tool in correcting abuses in the marketplace. While state laws and regulations provide important laboratories for experimentation, we need federal support to be optimally effective in rooting out abusive lending.

In addition to licensing standards, the North Carolina mortgage licensing statute sets out duties expected of mortgage originators. Mortgage brokers have a duty to make reasonable efforts to secure a loan reasonably advantageous to the borrower and a duty to act with reasonable skill and care. All mortgage originators must act in good faith and fair dealing in connection with the brokering or making of a mortgage loan. These principles-based standards provide us with the ability to address many abuses in the marketplace, but reliance on principles-based rules alone will not provide the specificity to channel origination activity consistently away from abusive loan terms.

By now, it is old news that liquidity in the global capital markets with an appetite for mortgage securities coupled with excess capacity in the commission-driven origination sector led to a deterioration of underwriting quality and to mortgage fraud. In North Carolina, our examinations and observations in the last couple of years have noted:

1. sales and marketing practices that focus on initial monthly payment of the loan, often at the exclusion of meaningful information about future payment shock;
2. loan products with payment shock built in, leading the homebuyer to face a big jump in monthly mortgage payment regardless of changes in interest rates;
3. subprime loans originated with stated income; and
4. loans with indications of some level of material misstatement in the loan process.

What has been the impact of these practices? Frankly, it is hard to say. In 2007, North Carolina's foreclosure filings are up about 10% from 2006 levels. For the three years between 2003 and 2006, North Carolina's foreclosure filing rate was essentially flat. This is significantly below many other states in the country. I believe North Carolina's foreclosure numbers are less stark than some other states due to a combination of a relatively affordable homeownership environment with moderate price appreciation and wage growth, lower proportion of subprime lending and adjustable rate lending than national average, and impact of predatory lending law and licensing enforcement to reduce incidence of loans with high fees and prepayment penalties. I'll leave it to the economists to figure out how these factors played together, but I think they all played a part.

That is not to say that North Carolina has been a complete success story. In the three years after the predatory lending law, the rate of foreclosure filings more than doubled. In particular, foreclosure rates in newer-built subdivisions in metro areas increased dramatically. I believe payment shock and fraud are baked into many of these loans. Our continued moderate economic and home price growth may simply mask problems witnessed by my colleagues in other states, such as Michigan and Massachusetts.

As a result of this experience, we have increased our investigation and examination staff to address mortgage fraud. We have sponsored legislation to make mortgage fraud easier to prosecute as a felony, building on the success of a similar law in Georgia. We have sponsored legislation to make it easier to identify the loan originators active at the neighborhood level to help us see patterns of poor lending. We are developing better analytics to assess changes in origination activity faster to prevent our examination process from being a forensic exercise. We are looking at affiliated relationships between builders and lenders. We are aggressively enforcing our laws against brokers that have failed to uphold appropriate standards and lenders that have made loans without consideration of a borrower's ability to repay the loan. We have adopted the nontraditional mortgage guidance, and continue to work closely with other states to develop collaborative approaches to examination and enforcement. We are in the process of updating our requirements for financial responsibility of lenders, brokers, and loan officers to make sure participants have the wherewithal to keep promises made to North Carolina consumers. I do not think any of these steps is a silver bullet, but they all work together to establish fair standards in the marketplace.

Suggestions for the Board of Governors and Regulations Under HOEPA

The Federal Reserve has the opportunity to increase North Carolina's ability to police the mortgage market in a way that promotes wealth building homeownership. Updating the HOEPA regulation with a relatively small number of clear prohibitions and changes can remove much of the abusive lending we have witnessed in North Carolina.

<u>Regulations under HOEPA</u>

1. *Regulate prepayment penalties.* North Carolina law addresses prepayment penalties in three ways. First, North Carolina's predatory lending law includes prepayment penalties in points and fees (excluding one point if prepayment penalty length is less than 30 months). Second, North Carolina makes high prepayment penalties a separate threshold for high-cost home loan protections (any loan with a prepayment penalty longer than 30 months or more than 2% of the loan amount). Finally, North Carolina prohibits prepayment penalties for loans of under $150,000, which protects lower-income homeowners from getting locked into a loan. I recommend that the Board use its authority to prohibit unfair or deceptive practices to prohibit prepayment penalties in subprime loans. Given estimates by Freddie Mac and Fannie Mae of the number of borrowers with

subprime loans that would qualify for prime loans, we should remove barriers to these families to transition to less expensive loan products. In the alternative, the Board could revisit the HOEPA definition of points and fees to include all prepayment penalties in this calculation.

2. *Ban stated income loans in the subprime market, unless borrowers have irregular income.* Stated income loans are a major avenue for commission of mortgage fraud. We routinely find significant and material overestimation of income in subprime loans and are expending significant resources to address this fraud. In North Carolina, many subprime loans are hybrid ARMs with a stated income feature; however, these borrowers could have received a fixed rate loan at a comparable rate if they had provided full documentation of their income. While there are legitimate reasons for stated income loans, almost all borrowers in the subprime market have readily-verifiable and steady sources of income.

3. *Establish requirement that lender consider a borrower's ability to repay the loan at fully-indexed rate based on a fully-amortized payment schedule.* While this requirement is in the Agencies' nontraditional mortgage guidance (which North Carolina has adopted) and the proposed statement on subprime lending, many states may feel constrained about enforcing standards based on guidance directed at depository institutions. North Carolina has general authority under its requirement of good faith and fair dealing to enforce failure to use prudent underwriting in the mortgage origination process, but a regulation will eliminate any uncertainty in other states.

4. *Require escrows for taxes and insurance for subprime loans.* This requirement helps lenders and borrowers avoid unnecessary foreclosures caused by failure to budget for tax or insurance bills, and eliminates deceptive comparisons between loans with escrows and those without escrows. Since most subprime loans are sold on the basis of the monthly mortgage payment, we have observed instances where borrowers were sold a new loan thinking they were lowering their payment, when in reality they were only paying principal and interest on the loan. When the tax bill or insurance bill came later, they were forced to refinance the loan. Thus, failure to include escrows not only leads to deceptive marketing, but to flipping.

Improvements to Disclosures

In addition to improvements to existing HOEPA regulations, I would encourage the Federal Reserve to work closely with other federal agencies to revise the disclosures provided in the mortgage process. Having spoken with borrowers and lenders alike, I have never heard someone tell me that our current set of disclosures are effective in helping borrowers shop for the best loan for them. In fact, today's disclosures have the effect of enabling unscrupulous lenders to hide abusive terms in an incomprehensive mountain of paperwork, only to then assert that deceived borrowers should have been aware of these terms because they were disclosed in the thick stack of documents signed at a closing. At the same time, reputable lenders have burdensome costs of producing complex disclosures that are read or used by their customers.

On behalf of CSBS, I am pleased to offer a suggested disclosure form for your consideration. Although this is by no means a final or perfect product, we believe it is critically important to improve our disclosure system. This form sets forth information that would benefit many consumers as they shop for mortgage loans, while recognizing that no disclosure system will prevent abusive loans and will not in any way obviate the need for substantive regulation that I described earlier. I would encourage the Federal Reserve to once again use focus groups to develop new disclosures, as not everyone can decipher the literary style of lawyers and financial service regulators.

Conclusion

Today's dynamic mortgage market requires industry participants, regulators, policymakers, and advocates to work together to develop fair rules. The recent problems in the subprime market have exposed both the strengths and weaknesses of reliance on markets to promote responsible lending practices. Lenders, and investors in loans made by those lenders, have paid a price for irresponsible lending practices. The mortgage market itself has rapidly adapted to this "market correction" and yesterday's financial crisis has become today's market opportunity for other participants in the market.

At the same time, the irresponsible practices have had a devastating impact on some families and their communities. Market forces alone will not protect our most vulnerable homeowners. State and federal government must use the right tools at the right times to keep pace with changes in the marketplace. HOEPA did not solve predatory lending in 1994, and the North Carolina predatory lending law in 1999 did not either. The joint federal and state regulatory efforts on nontraditional mortgage guidelines and the statement on subprime lending are positive efforts, but still insufficient. I respectfully encourage the Board of Governors to update HOEPA to address practices that have caused harm, while recognizing that this is a continual work in progress.

Thank you for the opportunity to testify today. I look forward to your questions.

CSBS RESIDENTIAL MORTGAGE EARLY DISCLOSURE FORM

READ THIS FORM CAREFULLY IN ITS ENTIRETY – THERE ARE TWO PAGES TO THIS FORM

PROPOSED TERMS AND COSTS OF YOUR MORTGAGE LOAN

This disclosure is provided in addition to specific disclosures that may be required under federal and state law. The intent of this disclosure is to provide you with a simple, clear explanation of your proposed loan terms and costs. Additionally, by following the steps outlined at the bottom of this document, you may compare the proposed terms to the final terms at closing.

Loan Amount	Loan Type	Rate	Payment	APR
$100,000.00 .	30 yr Adjustable	7% See notice 1 below	$925.30 See notice 2 below	9.28%

THE FOLLOWING COSTS ARE PROPOSED ON THIS LOAN

Total Estimated Fees To Loan Origination Company	$ 2,500.00	
Total Estimated Fees To Lender Making or Funding Loan	$ 1,300.00	
Total Estimated Fees To All Other Service Providers	$ 1,800.00	
Total Fees We Estimate You Will Incur		**$ 5,600.00**

THE FOLLOWING TERMS APPLY TO YOUR LOAN

1. The rate shown above ☐ may change prior to closing or ☐ will not change for _____ days from the date of this disclosure. If this box is checked ☐, you are signing a loan that DOES NOT have a FIXED RATE OF INTEREST. This means that your interest rate is subject to change, either upward or downward, more likely upward. Your rate may adjust upwards by 1.0 % every 12 month(s) until it reaches 13.0 %. This rate adjustment may occur regardless of any other factors.

2. The payment above includes $ 260.00 of ☒ Taxes ☒ Property insurance ☐ Mortgage insurance ☐ Other. These amounts, known as monthly reserves, are subject to change on a periodic basis. Your loan payment plus the monthly reserves equals the amount you are responsible to pay. The highest your payment plus today's monthly reserves can reach is $ 1,339.71, and the earliest it can reach this is June 1, 2013. Refer to the back of this disclosure for more information on monthly payments and your loan.

3. Your home is at risk. If you do not make the required payments on this loan you could lose your home.

4. $ 5,000.00 of the above costs are included in your loan amount.
   $ 600.00 of the above costs will be paid by you at closing.

5. Prepayment Penalty. Your loan ☐ does ☐ does not contain an additional penalty charge you must pay the lender if you pay your loan off early. The terms of this penalty are written in your note. This penalty may be significant and must be paid by you in the event you refinance the loan or make significant additional payments to principal prior to June 30, 2010. Refer to the back of this disclosure for important information on prepayment penalty.

PROPOSED TERMS VERSUS FINAL TERMS

The terms provided to you in this disclosure are estimates. However, if any of these estimates increase for any reason prior to the signing of closing papers, the below named company will provide you with revised proposed terms that match your closing terms at least three days before the date of signing closing papers.

This disclosure was provided for the borrower's review by _____________________________ (Representative) of _________________________(Company), on ________________________(Date). License number ___________.

There are two pages to this form. You should receive this form within 3 days of the date of your application for a mortgage loan. However, for your own protection do not date this form any other dates than the date actually received by you. Do not leave the date section blank. Do not sign unless you have read and understand both sides of this form.

____. ____.

Borrower Date Borrower Date

CSBS RESIDENTIAL MORTGAGE EARLY DISCLOSURE FORM

IMPORTANT ADDITIONAL INFORMATION ABOUT YOUR LOAN
READ CAREFULLY

How to compare loan terms: The Loan Amount, Loan Type, Rate, Rate Adjustment, and Note Payment should be compared to the Note you sign at closing. The costs identified on page 1 of this form are derived from a disclosure known as a Good Faith Estimate. You should compare the costs on this form to the Good Faith Estimate before signing either disclosure. You should compare the costs on this disclosure, or a revised version of this disclosure, to the HUD Settlement Statement you will receive at closing. **You are not obligated to take this loan.**

Comparing Monthly Payments for Refinances: If you are refinancing your existing loan your monthly payments will change as follows:

Current principal and interest:	$ 705.93	Proposed principal and interest:	$ 665.30
Current monthly reserves:	260.00	Proposed monthly reserves:	260.00
Current total:	$ 965.93	Proposed total:	$ 925.30

Monthly Payments and Amortization (loan balance reduction): Your loan does ☐ does not ☐ contain payment features or options that may result in no reduction in your principal balance owed over time or possibly an increase in the amount you must repay over time. In certain cases, the payment choice you make early in the life of the loan may result in an effect known as "payment shock." Payment shock results when you choose to make a payment that is insufficient to retire or "amortize" the loan balance over the life of the loan. In such situations, the loan will "reprice" or "recast" to a new payment amount, which may be substantially higher than you are accustomed to paying. Your loan representative should explain these features to you carefully, including realistic examples of how the choices you make can affect the amount of money you owe.

Prepayment Penalty: Applicable to your loan ☐ Not applicable to your loan ☐
A prepayment penalty means that if you attempt to pay-off or refinance the loan early, you will pay a penalty in **ADDITION** to the interest and principal due under the loan.

If you refinance or pay this loan off early, you will pay these additional fees (penalties):
$__,____ if you pay more than $______ in the first year after you get this loan
$__,____ if you pay more than $______ in the second year after you get this loan
$__,____ if you pay more than $______ in the third year after you get this loan
$__,____ if you pay more than $______ in the fourth year after you get this loan
$__,____ if you pay more than $______ in the fifth year after you get this loan

Balloon Payment: Applicable to your loan ☐ Not applicable to your loan ☐
A balloon payment is a final lump sum payment due at the end of your loan. If you do not have the funds to pay off the balloon payment when due, you may have to obtain a new loan to make the balloon payment. If you do not have the money to make the balloon payment, you may lose your property and all of your equity in your home through foreclosure. Before deciding to take this loan, consider your ability to pay the balloon payment. The balloon payment on this loan is due 5 years from the date your loan begins.

Demand Payment Applicable to your loan ☐ Not applicable to your loan ☐
A demand payment provision means that the holder of your loan can demand payment in full if certain conditions are met. Before deciding on this loan, ask your broker or lender what circumstances allow the holder of the loan to demand payment in full.

Reduced Documentation Applicable to your loan ☐ Not applicable to your loan ☐
Your loan is being underwritten and approved without full documentation of your employment, income, or financial situation. Regardless, all statements made by you or your loan representative must be accurate and true. Inaccurate or untruthful statements are a serious violation of law and may result in criminal penalties. Your loan representative should explain to you any additional cost associated with a reduced documentation loan.

CSBS RESIDENTIAL MORTGAGE MODEL DISCLOSURE
EXPLANATORY STATEMENT
June 13, 2007

The attached Model Disclosure is an initial discussion draft. Its purpose is to initiate discussion and expose alternatives to the traditional required disclosure forms, primarily the Truth in Lending Act (TIL) disclosure and the Good Faith Estimate (GFE) disclosure. Some problems with existing early federal disclosures are:

- *Complexity and lack of clarity*. Often the disclosures are even confusing for the trained professional, much less the average consumer.
- *Too little information*. Some of the most important information a borrower requires in order to make an informed decision is not required in the existing disclosures. For example, there is no requirement to show the borrower the loan amount, the interest rate or the full amount of their monthly obligations in any of the early federal disclosures.
- *Too much information*. In some areas there is simply too much complicated information for the borrower to understand. For example, the TIL boldly expresses annual percentage rate (APR), Finance Charge, Amount Financed and Total of Payments, none of which the borrower finds very useful in understanding the offered loan.
- *No requirement for actual provision*. Federal regulation requires that the TIL and GFE simply be placed in the mail without any proof of having done so. Neither form requires a borrower's signature or acknowledgement of receipt. With no required acknowledgement, many investigations have found that essential disclosures were never provided to borrowers, although produced for the regulator as file documentation.

Format

The guiding intent of the CSBS model disclosure format is twofold:

1. To provide the borrower with a single, double sided, 8.5x11 inch disclosure form that gives the borrower enough clear information to make an informed decision, and
2. To limit a loan originator's ability to misrepresent the transaction and to commit the company to a straightforward and realistic expression of the loan offered.

The disclosure form initially advises the borrower that the document should be read in its entirety and that there are two pages of information to the disclosure (to prevent a single side delivery). The form explains to the borrower that the terms offered are initial estimates and that if the estimates change, re-disclosure will be made.[1] Finally, the bottom of page 1 requires specific acknowledgement of provision by the originator or company representative and acknowledgement of receipt by the borrower. Page 2 of the form tells borrowers how to compare loan terms and existing payments to offered payments.

[1] It is strongly recommended that an originator's ability to change terms be restricted to certain limits to avoid the practice of bait and switch (see Washington law RCW 19.146.030(4) for example of limits).

Key elements of front side of the CSBS Disclosure:

- Loan Amount: Actual dollars to be borrowed, versus Amount Financed on TIL.
- Loan Type (e.g., 30 year fixed rate): Not required by existing disclosures.
- Rate: The note rate from which the actual monthly payments are derived.
- Payment: Monthly payment, including taxes, insurance and other monthly amounts.[2]
- Loan Costs: Rather than a litany of costs with vague descriptions (current GFE), this early form shows total fees to be paid to each of the originator (e.g. mortgage broker), the lender, and all other parties. A borrower's early decision is not dependent on knowing each and every cost item, but rather, how much the loan will cost. A lengthy list of possible costs confuses and hides potential overcharges and makes comparison between originators very difficult.
- Simple additional information about the terms of the loan: Potential rate change prior to closing; Rate Adjustments; Highest Rate possible; Inclusion/Exclusion of reserves for taxes, insurance, and other; Details of the Payment; Highest Payment possible; Earliest Date of Highest Payment; the fact that the borrower's home is at risk; Dollar Amount of Costs Financed and Dollar Amount of Costs Paid Out of Pocket; Inclusion of Prepayment Penalty and Expiration Date of Penalty.

Reverse side of the CSBS Disclosure

The reverse side of the disclosure provides additional important information to the consumer that is not available in the federal forms:

- A short guide to comparing loan terms and a simple comparison of the borrower's existing monthly obligation to the proposed obligation in a refinance. This key comparison eliminates one of the prime deceptions used by predatory lenders to convince borrowers to refinance their loan.
- Information about nontraditional features such as negative amortization, loan re-pricing and the effects of borrower "payment shock" with these features.
- A prepayment penalty table that shows the actual dollar amount of penalty to be paid by the borrower at each early payment period throughout the penalty term.
- Balloon Payment information and what the borrower should expect.
- Demand Payment information and what the borrower should ask.
- Reduced Documentation disclosure that informs the borrower of reduced documentation underwriting and the risks associated with this feature.

[2] While this disclosure form requires the originator to clearly disclose the inclusion or exclusion of monthly reserves in a dollar amount, it has been suggested that originators be required to disclose the actual dollar amount of excluded reserves in an "effective" monthly payment so that borrowers are reminded of the full obligation owed.