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April 8, 2008

VIA EMAIL

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Regulation Z; Docket No. R-1305

Dear Secretary Johnson:

Attached please find the comments prepared on behalf of my clients, four Florida-based non-bank lenders and home finance professionals. We comment upon the Proposed Rule issued under the Truth in Lending Act to amend Regulation Z and define the term "higher-price loans."

Commenters urge the Board to target the rule to ending genuinely predatory lending practices, and take better care to preserve the beneficial affects of responsible subprime lending. We believe this can be achieved by narrowing the overly broad definition of "higher-price loans" by first basing it on a tracking of prime mortgage rates themselves, and then granting a wider differential between the prime mortgage rate and the "higher-price loan" rate than the spread provided in the Proposed Rule.

Commenters then propose that the Board create an exemption to remove loans with 80 percent or lower loan-to-value ratios, since an analysis of foreclosure and delinquency data shows this to be a clear demarcation point between risky loans and those performing as anticipated.

We then proposed that for loans that then truly meet the intent and definition of "higher-price loans," that the Board give better guidance of its intentions in order to limit litigation risks in the Final Rule's enforcement. Further, we believe the Final Rule should provide an exemption from the Rule's income verification and ability to pay requirements for borrowers with familial emergencies. Commenters also believe prepayment penalties should barred only for "teaser rate" loans that proved to be so problematic in the marketplace.

Finally, as small businesses ourselves, Commenters argue that the Board risks violating the Regulatory Flexibility Act and the Board's own stated policy principles, if the Final Rule does not better consider the unnecessarily broad and burdensome affects of the proposed definition of "higher-price loan" on small non-bank mortgage companies.

Sincerely yours,

Kyle Mulhall
Of Counsel

Attachment

Comments of Lansdowne Mortgage, Home Equity Mortgage, Northstar Mortgage, and Raymond Reyes on the Board of Governors of the Federal Reserve System's Notice of Proposed Rulemaking amending Regulation Z (73 FR 1672, Jan. 9, 2008)

Lansdowne Mortgage, Home Equity Mortgage, Northstar Mortgage, and Raymond Reyes ("Commenters") are Florida-based non-bank lenders and home loan professionals who strongly support the Board of Governors of the Federal Reserve System's ("Board") efforts to bring stability to the mortgage market and enhance consumer protections. Commenters believe that effective rules can be put into place that fairly balance the need to protect consumers from ill-advised borrowing while also maintaining financial policies that promote access to credit.

Commenters are responding to the Board's request for comments on the proposed rule for "higher-priced mortgage loans." Commenters believe that portions of the proposed definition and related rule, section 226.35(a), (b)(1-3), as currently drafted will have a chilling affect on the availability of credit, confuse consumers, lack effective and consistent enforcement, and will have an unreasonably disproportionate impact on small businesses. Commenters also argue that the Proposed Rule fails to meet the Board's goal that "the rule identifying higher-priced loans should be as simple as reasonably possible."

Our goal, as mortgage businesses and professionals, is to avoid the legal and reputational risks created by the Proposed Rule, and therefore to avoid lending that could be defined as "higher-priced."

INTRODUCTION

- ***The Borrower & the Subprime Market***

Commenters are small businesses with extensive experience and expertise in providing real estate financial services, including retail loan origination, originating through mortgage brokers, loan funding, providing cash out, servicing and collecting on loans in the subprime market. As non-bank lenders, loan originators and servicers, Commenters have assisted thousands of consumers in navigating the complexities of mortgage origination. Commenters regularly apply their expertise to guide consumers from loan application, through credit and financial calculations, to finalizing a real estate purchase or refinance at closing. We have in fact been providing these services long before the recent growth and contraction in the subprime lending market. We are career professionals in the lending industry with well established businesses, including family-originated professions passed down over decades of time.

Our experience leads Commenters to believe that a vast majority of borrowers do understand the loans they acquire and do budget appropriately for loan payments. Some unscrupulous lenders may have misled or tried to hide loan terms, but that characterization does not apply to Commenters or the majority of lenders. We try at every stage to protect our customers by making certain they understand the terms of their loans and that they are prepared to manage their loan payments. We do believe, however, that some borrowers enter the market without a broad grasp of the financial options and decisions, and legal rights and obligations they have when seeking to finance a home. This fact argues for better consumer protection, and also for protections that are clear and as unambiguous as possible. The Federal Trade Commission ("FTC") has opined that consumers would be better protected if mortgage terms were clearly presented in a uniform and simple format. In its 2008 annual letter to the Board, the FTC summarized its "key findings" that "both prime and subprime borrowers misunderstood key loan terms" and that the result was consumers too often choose loans that actually cost more money.[i] Commenters experience and the FTC's findings indicate that consumers will not be well served by making the regulatory framework for mortgage origination more complex or uncertain.

The borrower will also be harmed if small loan non-bank lender and originators, such as Commenters, are forced out of the competitive market by the very proposed rules that were intended to benefit the consumer. Commenters believe that the Proposed Rule goes too far in shifting the inherent risk in lending onto the lending industry. As a result we will not be able to absorb the risk at a reasonable price. In addition, as small businesses, Commenters will naturally have a far more difficult time managing this additional risk than our larger bank competitors. Borrowers could loose the choice of using a non-bank or non-bank-affiliated lender and the unique services that we offer.

Non-bank lenders traditionally offer consumers a range of financing choices that are not available at banks or traditional mortgage companies. From this position in the market place, Commenters give consumers a competitive option for getting a mortgage that fits the consumer's financial needs and resources. Recent academic studies of mortgage data bases have shown because of the increased competition we offer, non-bank lenders lower costs for borrowers when compared to bank originated mortgages. Commenters therefore believe a final rule that disproportionately impacts smaller non-banking originators, lenders and loan servicers will actually harm consumers.

We further believe that adding further risks onto the financing industry will inherently raise the cost of borrowing itself. Commonsense dictates that this will make homeownership less affordable as lenders raise the cost of borrowing to cover the additional risk. Our businesses are built on the understanding that the mortgage marketplace functions effectively. We succeed when we can regularly attract borrowers based upon our ability to offer competitively valued loans, and have a reasonable expectation that customers will repay the loans upon which we generally continue to service and collect. Commenters do not make loans where there is no reasonable expectation of reliable loan performance, or with the expectation of ultimately foreclosing on property. We are not in the property acquisition business, in fact we loose money when foreclosures and delinquencies occur.

Commenters' businesses cannot prosper by operating with a pattern and practice of uncompetitively expensive loans, or of originating loans that are so high risk that they regularly fail. In fact, having witnessed a contraction of available credit and increased concerns about delinquency, we have tightened our own underwriting guidelines. The overall market itself has done the same, and now effectively ended the origination of high-risk, subprime mortgages. The market corrected itself without imposing new risks and liabilities on responsible lending. Commenters fear the Proposed Rule oversteps the mark, and unnecessarily adds risks and costs to lending without equaling advancing consumer protection.

Since the start of 2007, and the end of the period of rapidly increasing home values, underwriting standards began to tighten. That trend crystallized by the end of 2007, with a dramatically altered mortgage origination landscape. By the first quarter of 2008, high foreclosure and delinquency rates, and large write-offs by investors and lenders, have compelled much tougher underwriting standards and greater scrutiny prior to loan approvals. While losses from past loans continue to threaten our economy, the tremendous drop in available mortgage credit and its impact on construction and real estate is now a major cause of our economic recession. Commenters ask the Board to consider that the market itself has stopped the proliferation of high-risk subprime loans, but it has not had an affect on businesses such as Commenters involved in responsible lending. The Board should target prospective remedies to avoid overly broad regulations that are not targeted to provide meaningful consumer protection and which could significantly acerbate the current credit crisis.

- ***The Benefits of Open Credit***

The press has widely reported on the current subprime crisis and its harmful effects on our economy and on many individual subprime borrowers. One policy organization advocating for consumers, has estimated that as many as 19 percent of the subprime mortgages originated in 2005 and 2006 will end in foreclosure.[ii] If the CRL statistics are accurate, that is an unacceptable and unsustainable delinquency level. That said, Commenters point out that these same statistics also show that 80 percent of subprime mortgages are not at risk of failure.

The expansion of credit in the past decade has in fact had a decidedly net positive affect, regardless of how one chooses to quantify the social or economic benefits. Driven by the success of the "originate to distribute" model, new funds flowed into mortgage financing as the mortgages themselves were sold after origination to investors. As funds flowed into the subprime market, the increased availability of credit lowered relative borrowing costs and increased competition to the benefit of consumers and our economy. As Board Chairman Bernanke recently remarked:

> *…the emergence of a large secondary market, among other factors, have significantly increased access to mortgage credit. From 1994 to 2006, subprime lending increased from an estimated $35 billion, or 4.5 percent of all one-to-four family mortgage originations, to $600 billion, or 20 percent of originations. Responsible subprime lending expanded credit to borrowers with imperfect or limited credit histories. More renters became homeowners than would have otherwise. Though few subprime mortgages are being written today, I believe responsible subprime lending has been helpful, and at some point will be again, in fostering sustainable homeownership.*[iii]

While the majority of subprime loans were pooled together and then divided into tranches which were sold as securities, Commenters are among the non-bank lenders who generally did not securitize their loans. We in fact maintain contact with our customers from the loan origination until the loan's final payout. While all responsible subprime lenders have an interest in preserving a healthy market by originating quality loans, Commenters have a financial interest in loan quality because we fund and service most of our loans ourselves. The Proposed Rule, however, adds additional risk onto us as if we did not already have a direct interest in promoting loan performance.

Despite our business model of servicing our loans, we recognize that by mid-2006, mortgage-backed securities were the largest segment of the United States bond market. As investors sought to maximize investment returns by purchasing subprime mortgages on the secondary mortgage market – as either mortgaged-backed securities or collateralized debt obligations – additional funds were made available to finance home purchases and refinance existing debt.

As a result, by 2000 home ownership rates began slowly to climb in the United States for the first time in nearly 20 years. By the end of 2004, the United States Census Bureau was reporting the highest ownership rates in our Nation's history at approximately 69 percent – an increase from 64 percent reported in 1994. This increase equates to a growth of approximately 12 million new owner occupied homes in that ten year period, and was broadly and evenly felt across nearly all demographic and geographic lines. As of the last quarter of 2007, the Census Bureau just reported the level of home ownership to be 67.8 percent – essentially 2002 levels.[iv]

Commenters believe that the subprime loans that are failing are those with high loan-to-value (LTV) ratios, and that also include excessive "risk layering" of other factors with each new factor statistically adding to the elevated risk of loan delinquency or foreclosure. Commenters did not build their businesses on providing high LTV loans and purchase money mortgages. As discussed below, LTV has been studied as a factor in the subprime crisis, but Commenters suggest that further study should by done by the Board of the affects of separate loan and risk characteristics in order to eradicate unsuccessful loan products.

Clearly the final rule needs to recognize the success achieved by the market through expanded available credit, and reflect Chairman Bernanke's view that responsible subprime lending should be preserved. Commenters believe that this argues against an "inclusive" final regulation that intentionally covers classes of mortgages that data indicate are not at a significant risk of foreclosure. We believe that inclusive definitions will without a doubt have a chilling affect on restoring responsible subprime market. It would unquestionably increase loan costs to consumers and lenders as well.

- ***The Board's Policy Goals***

The Board has provided four "general principles" to guide the formulation of the final rule on "higher-priced mortgages." Commenters agree with principles two through four and find them particularly clear and concise. These principles provide that a Final Rule should be based on loan characteristics, be as simple as possible, and be so clear that lenders could be reasonably certain of the new legal requirements.

Commenters essentially agree with the intent of the first principle – the Board needs to act to protect consumers from predatory lending. We note, however, that the description of the first principle is ambiguous, and we believe this ambiguity has unfortunately found its way into the Proposed Rule itself. This first principle is inherently a balancing test; an attempt to weigh the benefits of the consumer protections against the harm to consumers from compromising the market. On one hand, the principle notes that relief should be provided "broadly," but also notes that it should be targeted based on "evidence that consumers have actually been injured." The principle announces an intention to cover real and speculative threats to consumers, but then suggests the Final Rule should not be so broad as to impose "unintended consequences" on the market.

Board Governor Randall Kroszner described the intent of the higher-price mortgage rule more succinctly: the Board's goal is "to protect borrowers from practices that are unfair or deceptive, but to do so without unintentionally causing responsible lending to shrink or unduly limiting consumer choice." Commenters argue that the Board has failed to meet the clear intentions articulated by Governor Kroszner.[v]

Despite the Board's stated first principle as well, the Proposed Rule does not attempt to target subprime products with high failure rates, but instead the Rule intentionally covers all subprime and Alt-A, and unintentionally most prime mortgage products, regardless of how they are performing. The expanded coverage of the Rule means a tremendous legal risk is being shifted onto originators, which will undoubtedly have a chilling affect on mortgage markets.

It is our view that the first principle should be that the Final Rule give consumers' targeted protections that end lending practices that evidence shows are clear factors in subprime mortgage failure, and do so while preserving responsible subprime lending. Commenters argue below that we believe this can be done consistently with the Board's remaining general principles, thereby basing the rule on loan characteristics, and doing so simply and with little uncertainty.

COMMENTS ON SECTION 226.35

Commenters begin by proposing a narrower and more realistic definition of "higher-priced loan," than the one provide in the Proposed Rule. Most critically, we then offer a bright-line exemption to that definition that would better focus the protections provided under subsection 226.35(b). Finally, we propose that the Final Rule change to verification requirements that better reflect market realities.

226.35(a) – Higher-priced mortgage loans.

The Proposed Rule defines "higher-priced mortgage loans" as a loan secured by the borrower's primary residence, and for which the APR exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate lien loans. The Proposed Rule in effect attempts to equate the term "higher-priced mortgage" with subprime mortgage. The Board's policy goal is to exclude the prime market from this definition, but inclusively define "higher-priced" to include all subprime mortgages and much of the so-called Alt-A market. The Proposed Rule covers home purchase, refinancing, and home equity loans.

Commenters believe that subprime loans should be more clearly defined so that effective regulations can be targeted to end abuse and protect consumers. Unfortunately, the definition of "high-priced" in the Proposed Rule relies upon treasury securities and rate spreads that fail to reflect market realities.

- ***Use of Treasury Securities is Impractical***

Commenters argue that the use of Treasury securities to define "high-priced loan" violates the Board's goal of promulgating clear standards that are not unnecessarily confusing. Treasury securities are not an effective basis for defining "high-priced loans" for six reasons:

First, Treasury securities are not traditionally used in mortgage origination. Commenters, for example, obtain funding from banks, non-bank lenders, creditors and private individuals. These sources do not use Treasury securities as a factor in pricing the credit they provide. Making Treasury securities a critical component of the regulatory framework for originations interjects an entirely new component into the already complex world of real estate financing.

Second, Treasury securities also have their own, entirely separate policy goals and considerations, and tying them to mortgage standards may only confuse both mortgage lending and federal securities policy. Mortgage market considerations will likely be subordinate to Treasury needs, so significant decisions could be made to alter the nature or mix of treasury products without any consideration given to the impact on real estate financing.

Third, many mortgage products have no Treasury security equivalent, making that loan indefinable or defined based on a rough approximation of equivalence. While this is acknowledged as a difficulty in the Preamble, Commenters real life experience leads us to urge the Board not to minimize the confusion and difficulties this disparity will cause. That is hardly a framework that will be clear and certain.

Fourth, many Treasury securities are issued based upon the needs of the public weal, so they are not consistently available for use in mortgage calculations. The 30 year treasury security is rarely issued, yet the most common loan products are 30 mortgages. The Preamble also notes that fact, but then attempts an additional approximation to compensate that adds into the equation a further area for error and confusion. The Proposed Rule attempts to match loan products to treasuries based not on their face values, but on an extremely simplified averaging of the life of broad categories of loan products. Virtually no effort is made to rationalize this vague assignment of equivalents.

Fifth, Treasury securities are not tied to the same economic and market forces that affect mortgage financing. Treasury securities therefore do not traditionally move in parallel to mortgage rates, and quite often in fact move in the opposite direction. In the current market, for example, the average differential between mortgages and Treasury securities is nearly twice the average historic spread.

And sixth, basing the rate spread calculation on similarly defined Treasury security fails to consider the fact that Treasury securities are not expected to be redeemed early. Mortgage rates are always formulated with that actuarial assumption. Even equating mortgages to shorter term Treasuries, as is attempted in the Proposed Rule, fails to appreciate that this exercise is still a comparison of "apples and oranges." If a prime market 30 year fix-rate, fixed-payment mortgage is priced based on a likely lifespan less than its face term, it does not mean that the interest rate calculation was made in the same manner as the Treasury security that is closest to the anticipated lifespan of that prime loan.

- ***Use of Independent Mortgage Rate Tracking***

Commenters urge the Board to define "higher-priced loan" based on an accurate measure of prime mortgage rates themselves. It seems only rational to define a term for high-priced loans by comparing them to the average of the rate for the loan they are “higher” than – that is the prime mortgage rate. The definition in the Proposed Rule ignores readily available means for directly calculating and for tracking the prime rate. The Board itself notes in the Preamble the availability of non-government created prime trackers, but understandably seems reluctant to rely on a measure that is maintained for the profit motives of a private entity. Commenters believe it is critical for the Board to not keep the Treasury securities basis for “higher-price loans” in the Final Rule.

The Board has not considered the ease with which a federal agency could establish a government-sponsored, prime rate tracking system, modeled on those widely available from commercial vendors and government sponsored enterprises. By definition a prime rate tracker would give a more realistic definition of subprime since it would be based on the underlying measure of the prime itself. It would inherently better reflect the mortgage market and its realities, and would be simpler for lenders and consumers to use. Basing “higher-priced loans” on the prime mortgage rate would more directly tie it to real loan characteristics, while also avoiding many of the unintended impacts on the market that will be caused by basing the definition on Treasury securities.

- ***A 3 first-lien and 5 subordinate-lean spread is too inclusive***

Commenters believe the proposed rate spreads in the Rule will sweep all of the Alt-A market and the majority of all prime lending into the definition that is essentially "subprime." Commenters believe that the Board cannot have a rational basis for such a comprehensive definition of "higher-priced loan" that it would include the vast majority of all mortgages being originated in the United States. Clearly, the rate spread proposed violates the Board's goal not to have unintended impacts on the mortgage market. Defining that vast majority of all mortgage loans as essentially subprime, placing new responsibilities and liabilities on lenders will certainly have a consequential impact on the market.

As previously noted, current market conditions are creating significant rate spreads between subprime rates and Treasury securities. The spreads have widened to the point that nearly all first-lien loans originated – subprime and prime – would be defined as “higher-priced” by the Proposed Rule. In fact, in March 2008, the rate spreads that would affect 30-year fixed-rate mortgages reached an average of over 2.9 percent. At the current time, relative prices compared to the prime market continue to rise due to secondary market price increases in the form of Government Sponsored Enterprises delivery fees and additional rate increases in mortgage guarantee insurance premiums. These two factors are further exacerbating the relative rise in home mortgage costs versus Treasury rates.

If the Final Rule contains the narrower rate spread, costs associated with the loans that are labeled as "higher-cost" will continue to rise and certain lenders will no longer make "higher-price loans." Commenters' costs as well will continue to rise and we too will essentially be priced out of making loans that fall under the new definition of "higher-price loan."

Commenters urge the Board to increase the rate spread as is discussed in the Preamble. Commenters believe a four percent spread on first-lien mortgage loans, and six percent spread on subordinate lien loans over a prime loan rate would much better serve the Board's policy goals. We believe this wider spread is justified based upon the arguments we just presented against the narrower spread provided in the Proposed Rule. The wider spread will better target consumer protections, and better avoid negative impacts on responsible lending. And the four-percent, six- percent spread will much better accommodate market fluctuations.

226.35(b)(1) – Pattern and Practice

Commenters find the Proposed Rule's pattern and practice provisions to be perhaps the most problematic. We argue that this section fails to effectively advance any of the Board's four stated general principles that were to drive the formulation of the "high price loan" rule; first, it does not avoid unintended impacts on responsible lending; second, it is not clearly based on loan characteristics; third, it is unnecessarily complex, and; fourth, it creates tremendous uncertainty for lenders.

The proposed regulatory language itself is simple; as explained in the Preamble, it prohibits creditors "from engaging in a pattern or practice or making higher-priced mortgage loans based on the collateral without regard to repayment ability." The Proposed Rule critically fails, however, to define "pattern or practice." As a result, the ambiguity creates a concern that legitimate mortgage lending will be scrutinized, and that lenders will have to carry a large and uncertain legal risk as the ambiguous term is later defined and redefined in litigation.

Borrowers do at times assume mortgage debt that is beyond their verifiable ability to repay, absent ultimately reselling the property securing that mortgage. Borrowers themselves may have elected for their own legitimate financial reasons to acquire the debt. In addition, borrowers often are compelled to make financial decisions based on personal and familial reasons. Surely the Proposed Rule is not intended to limit the ability of consumers to make knowing financial decisions based upon their own individual circumstances.

The "pattern and practice" provision will put originators in the position of second guessing the decisions of consumers. Commenters agree that consumers need to be better informed of the mortgage options they have, and the consequences of each choice. The Proposed Rule goes further by broadly placing a legal risk onto lenders for a majority of all loans originated in the United States if any evidence suggests that loans were made, more often than once, to borrowers making unwise investment decisions.

In addition, by shifting legal liabilities the Board is potentially exposing loan originators and lenders to liability not just for predatory lending or the ill-advised but knowing decisions of a consumer, but also for fraudulent borrowing. One commentator recently noted:

> *As much as 70 percent of recent early payment defaults had fraudulent misrepresentations on their original loan applications, according to one recent study….the study looked at more than three million loans from 1997 to 2006, with a majority from 2005 to 2006. Applications with misrepresentations were also five times as likely to go into default….borrowers who were asked to state their incomes just lied, sometimes reporting five times actual income; other borrowers falsified income documents by using computers.*[vi]

Given the uncertainty about the meaning of "pattern and practice," lenders will almost certainly be exposed to litigation over the liability related to intentionally fraudulent actions by consumers. As the Preamble acknowledges: "The rule is also broad in another respect: It imposes a blanket verification requirement on creditors even though consumers, themselves, may inflate their stated incomes without creditor's knowledge. Such consumers might in some instances seek to enforce the proposed rule through civil action."

Small businesses, such as Commenters', are not built on a business model that allows for absorbing the risk and costs of spurious lawsuits. Our founders and owners will not accept this unquantifiable risk and absent clarification by the Board in the Final Rule, we will be forced to discontinue operations.

- ***Uncertain Meaning and Enforcement***

While the Federal Reserve and the FTC have authority to enforce regulations under the Truth in Lending Act (TILA), the fact is no auditing and oversight force exists to enforce the Proposed Rule on non-bank lenders.

The Preamble notes that in all likelihood enforcement will be through civil litigation. Inherently, however, since a violation cannot be proven unless a "pattern and practice" is found, the litigation the Proposed Rule will ignite will likely be class action in nature. And while the Board may believe that "creditors, regulators, and courts would find it relatively easy to determine compliance with the proposed rule" on an individual incident basis, the Preamble gives no such guidance or reassurances about recognizing what constitutes "pattern and practice." In addition, given the creativity of the plaintiffs' bar, it is not inconceivable that the Board's confidence about the standard for individual violations may eventually prove to have been misplaced.

Class action suits are almost by definition complex and expensive. They also on average take five to ten years to resolve, delaying consumer relief and inserting risk and uncertainty into the mortgage market. The ultimate definition of what constitutes a "pattern and practice" may largely be driven by the factual conclusions reached by juries. In addition, TILA itself requires the courts to construe TILA protections in favor of the consumer "with creditors who fail to comply with TILA in any respect becoming liable to consumer regardless of the nature of the violation or creditors' intent." TILA actions may be brought in any state or federal court, and the law allows for recovery of actual damages, attorneys' fees, and statutory damages.

Once again Commenters must emphasize, our owners and investors will not accept unquantifiable litigation risk.

- ***A Concise Exemption***

Commenters are pleased that the Board expressly acknowledges many of the concerns previously noted about the Proposed Rule's broad affects on the market and potential to spawn litigation. In the Preamble, the Board invites alternatives on a key component of income verification asking for "suggestions of narrower alternatives that would impose fewer costs on creditors and consumers while providing sufficient protection to consumers." Commenters propose an alternative, beginning with narrowing the definition of "high-priced loan" by using a real prime rate tracker and a wider, more realistic rate spread as above discussed.

Commenters then believe the Board should identify which types of loans, based upon loan characteristics, are actually at high risk of failing. A review of loan performance data reveals that the prime and Alt-A loan markets are not experiencing failures at a crisis or even unexpected level, given other current economic factors. The same can also be said of a clear majority of subprime mortgage loans.

Within subprime, however, there are alarming foreclosure and delinquency rates for some loan types. The question is whether there is a bright line that can be drawn between those loan types that succeed and those that fail.

A recent study of the subprime crisis that analyzed loan performance by borrower and loan characteristics, relying on data from the American Loan Performance database concluded: "In fact, the increases in the adjusted delinquency and foreclosure rates are almost exclusively caused by the worsening performance of loans with a combined LTV of 80 percent of more."[vii]

The threshold of 20 percent or more of equity – without risk layering or an additional loan – in real estate has long been recognized as critical one in mortgage financing and loan insuring. It is a simple concept that is readily understood by all consumers and lenders. And just as loan insurers have traditionally calculated that passing the 20 percent point in equity tipped the balance against the need to insure a loan, this threshold holds relevance in the current subprime crisis.

Commenters argue that a significant segment of the responsible subprime lending market would be preserved if loans with loan-to-value percentages of 80 or less that do not have additional secondary financing, were given a blanket exemption for subsection 226.35(b) of the Proposed Rule. We believe this bright line divide would meet all of the Board's general principles:

First, it still provides relief to consumers in the areas of the marketplace where they are facing unacceptable risks of loan failure. It better targets that relief based on evidence of real injury to consumers. And it avoids unjustified impacts on a broader range of the mortgage origination market.

Second, the exemption would be based on a loan characteristic – the loan-to-value percentage. An LTV calculation is done for all loans and is a standard mortgage measure.

Third, an LTV exemption is without a doubt a simple one to grasp for consumers and lenders. LTV is not a difficult concept and is one that the reasonable consumer already comprehends.

And fourth, LTV has an unmatched certainty. LTV calculations have a clear and standard meaning within the mortgage loan industry and are not conceptually complex or difficult to make.

Commenters note that "risk layering" does increase the likelihood of loan foreclosure and delinquency, as additional risk factors are added onto a loan transaction. However, borrowers with low-LTV mortgages are still more likely to maintain their loan performance, regardless of the other risks layered into the loan transaction, than high-LTV loan holders with fewer layered risks. The recent study of the American Loan Performance database concluded that:

> *The decline in loan quality has been monotonic, but not equally spread among different types of borrowers. Over time, high-LTV borrowers became increasingly risky (their adjusted performance worsened more) compared to low-LTV borrowers.*[viii]

We recommend that all subprime loans that are made without secondary financing and with a LTV of 80 percent or less should be exempt from all of the requirements of the “higher-price loan” regulation.

226.35(b)(1) – Repayment Ability

In addition to exempting all "high-priced loans" with LTV percentages of 80 or less under this requirement as well, Commenters believe further changes should be made to the repayment ability provisions to provide better protections for responsible lenders operating in good faith.

In most circumstances, ability to pay in a fully-documented loan application is established by payroll and tax records. Proving the ability to repay is a particularly difficult problem, however, when the consumer is, for example an independent contractor, self or seasonably employed, compensated by bonus or commission, or beneficiary of trust or gift income. The Preamble discusses such situations, but does not attempt to provide comprehensive examples of what documentation would constitute "repayment ability." Commenters propose that the Board provide substantially more illustrations that better capture these problematic situations in proving repayment ability. The Final Rule should also make clear the examples provided are not exclusive and that their meaning should be interpreted in an expansive manner to assure consistent enforcement of the rule.

Truth-in-lending laws provide that consumers have a right of rescission within three days of mortgage origination. This three day right to rescission can be extended to three years if the loan originator fails to adequately disclose the rescission right or makes other "material" misrepresentations as to the terms of the loan. Commenters believe the Board should clearly provide that the Proposed Rule does not expand upon this right of rescission, and the requirements to document ability to repay are not "material" for rescission purposes.

Commenters also suggest that the Board consider creating a provision that if a consumer can document a family emergency, that the consumer may then waive the verification of repayment ability by the lender. The consumer would then absorb the responsibility and liability related to proving ability to repay that would have fallen on lender under the Proposed Rule. Commenters believe the Board should look at the family hardship waiver for rescission under Regulation Z. The same justification for providing consumers that waiver option surely applies under ability to pay requirements of the Proposed Rule. Just as TILA contemplates financial emergencies and exigencies that will require a more flexible regulatory response, the Final Rule should also recognize this concept that we cannot effectively anticipate every circumstance facing an individual consumer. Incorporating an exemption methodology seems warranted.

Finally, Commenters argue that even in stances of full-documentation, it is unreasonable to limit the safe harbor protections for lenders to certifications of ability pay over seven years in the future. There are simply too many circumstances that can change income or asset valuation in less than seven years time. Until the safe harbor timeline is reached, lenders will be liable for rough estimations of ability to pay that extend unreasonably into the future. Commenters believe that the rule should only require a determination of ability to repay at the time of loan origination.

226.35(b)(2) – Verification of Income

The Proposed Rule requires loan originators to verify the income and assets of borrowers when making a higher-priced loan. Commenters support this requirement, especially if it is applied to subprime loans with high foreclosure and delinquency rates due to high-LTV and risk layering. Once again, Commenters object to broadly applied requirements that are not based upon empirical evidence of consumer benefit.

We again note, as we did previously under evidencing ability to pay, that income is often hard to document, especially for the self-employed, or those depended on bonus or tip income. Just as it is important for the Board to better illustrate what constitutes ability-to-pay; verifying income can lead to many subjective decisions. This is another area where Commenters will be exposed to potential liability under TILA, where presumptions are to be drawn against our favor. Responsible lenders will once again be forced out of the market.

Commenters, as independent mortgage companies and professionals, note that income verification is one of many good tenants of good underwriting, along with a high credit score and a low-LTV. The Board should not look at income verification in isolation without consideration of other reliable factors of loan performance. The market today, in fact, has made income verification a near absolute requirement for obtaining mortgage financing. Yet even in today's market, some consumers have a preference for low or no documentation loans. The Proposed Rule may in effect eliminate that option by placing responsibility and liability for income verification so squarely onto the lender. The result will be lenders will have to increase prices to consumers. Commenters do not believe that the Board's goal is simply to cause prices rise without also achieving meaningful consumer protections.

Commenters also believe that many borrowers fail to understand the benefit they receive from providing the best possible documentation of their qualifications as borrowers. The Congress has requested that the Board and the FTC address this problem by jointly issuing a risk-based pricing notice to alert consumers to the fact that better loan options may exist. Commenters urge the Board to consider implementing such a notice as soon as possible so that consumers are better informed of the nature of risk layering in mortgage finance, the benefits of full-documentation, and the availability of more affordable loan products.

Commenters support requiring income verification for high-priced loans with LTV of higher than 80 percent, but we believe it is unnecessary for loans that are low-LTV and have no secondary financing. Commenters find this particularly necessary when transacting loans with high LTV ratios and other layers of risk added, such variable rates on the mortgage. The data shows that borrowers with low equity who choose variable rate loans are a credit risk when the rates adjust.

Mortgage performance data also indicates that fixed-rate, fixed-payment loans are less likely to fall into delinquency and default. By definition of the loan they are obtaining, they also know the monthly payment due on their mortgage from the point of origination. Only if property taxes are included in the monthly payment, does the amount of the payment increase, and then almost exclusively in times of real estate appreciation. Commenters urge the Board to consider further study of whether fixed-rate, fixed-payment loans should be largely excluded from the Final Rule.

Section 226.35(b)(3) – Prepayment Penalties

Commenters oppose the Board's restrictions on prepayment penalties on "high-priced loans." We propose that prepayment penalty regulations should only be restricted for loans that carry low initial rates, often called "teaser rates."

As small, non-bank lenders, in the recent market it has often been difficult to originate loans. The costs of finding the loans, by our own retail efforts or through a mortgage broker, are comparatively high. The reality of the market is that the credit reporting agencies publicly report about each loan that we fund. Therefore, the fact that we have made a loan is widely known, increasing the possibility that our loans will be paid off faster than expected. Commenters argue that it is reasonable that we be compensated for such an early pre-payment risk.

Commenters do believe reasonable limitations can be placed on teaser rate loans. These loan products offer a consumer an initially lower interest rate as an enticement to borrow. These loans are far too often selected by borrowers who cannot afford the post-teaser rate incorporated into the loan. Placing a penalty on exiting from this often abused product model would hurt consumers.

Once again, Commenters urge the Board to avoid sweeping application of the higher-price loan rules that would affect even responsible subprime lenders. We urge that the Final Rule target documented areas of abuse in the prepayment penalty area, and not simply shift risks and stifling costs onto small businesses like ours.

REGULATORY FLEXIBILITY ACT

The Preamble acknowledges the applicability of the Regulatory Flexibility Act to the Proposed Rules because of its impact on small businesses, such as Commenters. The Act requires that the Board consider the impact the Proposed Rule will have on small businesses, and, when the regulatory impact is "significant", affecting a "substantial number" of these small businesses, the Board must seek less burdensome alternatives.

As Commenters have argued, though the Board announces in the Preamble its intentions of not adversely impacting the responsible lending market, the rule language incongruously was drafted broadly to include large areas of just that marketplace. The Board has already noted that the Proposed Rule's sweeping affect will be "significant" on a "substantial number" of small businesses. Unfortunately, after reaching this conclusion, the Board does not seem to have adjusted its rule to be any less burdensome. The Proposed Rule is intended to prevent a repetition of the poor lending practices that have hurt many consumers and led to the subprime mortgage crisis. The Rule language, however, applies a solution that goes well beyond protecting consumers from those specific problematic practices. There seems little justification for the Board to be issuing onerous new regulations that will cover substantial portions of the mortgage market that are functioning without problems – especially during the time of recession driven by a real estate downturn. A justification for such rulemaking seems to be particularly lacking when the Regulatory Flexibility Act is triggered by this sweeping regulatory coverage.

Commenters urge the Board to consider our proposed alternatives to target the rule to prevent areas of demonstrated abuse, and preserve the benefits of responsible subprime lending for consumers and small businesses. Failure to make substantial changes to the rule on "high-price loans" will likely put us out of business, while providing no meaningful consumer protections.

[i] Letter from Donald S. Clark, Secretary, Federal Trade Commission to Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System. January 24, 2008.

[ii] "Losing Ground: Foreclosures in Subprime and Their Cost to Homeowners," Ellen Schloemer, Wei Li, Keith Ersnt and Kathleen Keest. Center for Responsible Lending. December, 2006.

[iii] "Bernanke Remarks on Mortgage Crisis," Chairman Ben Bernanke, Federal Reserve Board of Governors. *Congressional Quarterly Transcripts*. March 14, 2008.

[iv] "Census Bureau Reports on Residential Vacancies and Homeownership," U.S. Census Bureau, U.S. Department of Commerce. January 29, 2008.

[v] "Statement of Governor Randall S. Krozner," Board of Governors of the Federal Reserve System. December 18, 2007.

[vi] "So We Thought," *New York Times*, Tyler Cowen, George Mason University. January 13, 2008.

[vii] "Understanding the Subprime Mortgage Crisis," Yuliya Demyanyk, Federal Reserve Board Bank of St. Louis; Otto Van Hemert, New York University. Draft of February 29, 2008.

[viii] Id.