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Name:	Jack M Guttentag
Affiliation:	Wharton School, University of Pennsylvania
Category of Affiliation:	Educational
Address:	1 Fern Woods Lane PO Box 574
City:	Valley Forge
State:	PA
Country:	UNITED STATES
Zip:	19481
PostalCode:	

Comments:

Comments by Jack Guttentag These comments pertain to the Board's proposals to curb lax underwriting rules, unfair practices by mortgage brokers, and abusive practices by loan servicing agents. Proposals to Regulate Underwriting Rules Are Too Late, and Would Regulate the Wrong Things During 2000-2006, house price appreciation was extraordinarily large, and underwriting requirements were relaxed to a degree never seen before. In the sub-prime market, loans with no down payment were made to borrowers with poor credit who couldn't fully document their income. If the Board in 2002 had intervened by requiring a minimum down payment of 10% on sub-prime loans, the crisis that erupted in 2007 never would have happened. Even if the Board didn't take action until 2004, the very worst batch of loans, those made in 2005-2006, would have been markedly reduced. The down payment is the appropriate tool for early regulatory intervention because it is easy to define and enforce, and has a marked effect on borrower demand and loan quality. But Board actions won't come until later in 2008, which is terrible timing. The mortgage market has already done a 180% reversal in underwriting requirements. The price sheets I get from the remaining sub-prime lenders show down payment requirements of 15%. And I now hear complaints from prime borrowers that lenders are examining

documents with a microscope, and asking for more and more verifications. Santa Claus has become Scrooge. In this kind of market, regulatory tightening of underwriting requirements is "piling on". Further, with one exception, the Board proposes that it intervene in the most complex and judgmental parts of underwriting. The proposed rules would prohibit lenders from making loans that borrowers cannot afford, and require lenders to verify income and assets. (The rules would apply to "higher-price loans", which include sub-prime loans). In my view, regulators should steer clear of these areas because rules that are very difficult to define are also difficult to enforce. The Board's lengthy explanations of how they intend to enforce the new rules indicate very clearly what a quagmire such enforcement is going to be. For example, the rule against making unaffordable loans would only be enforced in connection with a "pattern or practice" of making such loans, and would take account of "the totality of circumstances in the particular case." Similarly, the requirement that lenders verify income and assets only applies to the income and assets the lender "relies upon" in approving the loan, and would not apply if failure to verify "would not have altered the decision to extend credit". The Board does not have the army of highly-trained and sophisticated examiners that would be needed to enforce rules like these. Implicitly, enforcement will be delegated to community groups and class action lawyers, who like murky rules because they provide additional grounds for suing lenders. That may help a few individual borrowers, but it won't make the market work better. The one defensible underwriting rule proposed by the Board would require that all "higher-priced" loans carry escrow accounts for the payment of taxes and insurance. In contrast to the rules regarding affordability and income verification, this rule is unambiguous and easy to enforce – a loan either has an escrow or it doesn't. Further, the cost is small because borrowers can opt out after one year. But it raises an interesting question: why should an escrow opt-out be limited to borrowers with higher-priced loans? How about prime borrowers who have had their insurance cancelled and tax liens placed on their homes because the servicer failed to pay the insurance and taxes? The Board Would Curtail Broker Abuses, But Not in the Least Cost Way, and Would Not Touch Abuses by Other Retail Loan Providers In contrast to rules tightening underwriting requirements, which are too late to do any good, timeliness is not an issue in connection with mortgage abuse. However, doing it right is an issue. Mortgage brokers abuse borrowers when they collect a rebate from the lender for delivering a high interest-rate loan, without the knowledge of the borrower. I developed the Upfront Mortgage Broker program largely to deal with this problem.Upfront Mortgage Brokers (UMBs) agree in writing with borrowers to a specified total fee, which includes any payment received by the broker from the lender. The borrower elects how to pay the fee, either in cash at closing or in a rate high enough that the lender will pay a rebate to the broker. Under the Board's proposal, lenders would be prohibited from making a payment to a broker unless the borrower and broker had agreed in advance on the broker's total compensation. The obligation imposed on the

broker by this rule is thus identical to that imposed on a UMB. However, the UMB program is voluntary whereas the Board would impose the obligation on all brokers, most of whom don't want it. This makes enforcement a challenge. The Board would impose enforcement responsibility on wholesale lenders. Before paying a rebate to a broker, the lender would have to check the agreement between the broker and the borrower, as well as the HUD1 closing statement, to make sure that the total amount received by the broker does not exceed the amount agreed upon. But there is a better way to prevent brokers from getting paid by lenders behind the borrower's back that has no compliance burden. Lenders would simply be required to credit all rebates to borrowers. Lenders would inform their settlement agents that this is now the rule, and that would be it. There would be no need for case-by-case investigation because there would be nothing to investigate. This approach would also be more effective. Under the Board's proposal, glib brokers will still be able to get trusting borrowers to sign off on rebates. This will be much more difficult if rebates are credited to borrowers, because then borrowers must be persuaded to sign over what they already have. The rule should be applied not only to brokers but also to "correspondent lenders", who operate in the same way as brokers except that they close loans in their own name. Correspondent lenders receive rebates just like brokers, and should be subject to the same rules. If they are not, brokers who don't want to comply will become employees of correspondent lenders, who will allow them to function much as they had as brokers. The Board's proposal, however, only applies to brokers, reflecting its failure to recognize that while correspondent lenders may be lenders under the law, operationally they more closely resemble brokers. Like brokers, they receive rebates from wholesale lenders on higher-rate loans, and are similarly positioned to abuse borrowers. Lenders who originate loans at their own risk raise a different issue. Such lenders don't receive rebates, but its loan officer employees can abuse borrowers just as easily as brokers. Where opportunistic pricing by brokers usually involves pocketing rebates, opportunistic pricing by retail loan officers takes the form of overages – prices above the retail prices posted by the firm. A loan officer who can induce a borrower to accept a rate above the rate posted by the firm will typically share the value of the overage. To maintain a level playing field between brokers and loan officers, rebates on loans delivered by brokers and correspondent lenders should be credited to borrowers, and overages on loans delivered by loan officers at other lending firms should be prohibited. The Board Would Curb Some, But Not the Most Important Servicing Abuses Where underwriting requirements and broker abuses are long-standing areas of Board concern, servicing abuses seem to have been discovered by the Board only recently. The proposals are weak, but they are a good first step. Proposal one would require that servicers credit payments on the day a payment is received. Proposal two would require servicers to provide accurate payoff statements within a reasonable time to borrowers who intend to pay off their loan. Both are fair, clear and not onerous for the lender. Proposal three would prohibit servicers from

imposing late fees or delinquency charges when the scheduled payment is received on time but does not include prior late charges. This rule would eliminate the practice of "pyramiding late fees", where the servicer continues to charge late fees until all prior late fees have been paid. But this proposal does not cover an even worse type of pyramiding. When the scheduled payment is received on time but the escrow payment is short, the practice is to place the entire payment in a suspense account, to charge the borrower a late fee, and to send a delinquency notice to the credit bureaus. If the servicer does not send out monthly statements (which many do not, see below), the borrower will be in the dark. The next month's regular mortgage payment will also be deposited into the suspense account, and the borrower incurs a second late charge and a second 30-day delinquency report. At this point, the account may go to collections, and the borrower will suddenly find himself dunned for a laundry list of fees, with failure to pay possibly resulting in foreclosure. The Board's proposed rule against pyramiding late fees should be broadened to require that monthly payments received on time be credited when only the escrow portion is deficient. The Board's fourth proposal "would require a servicer to provide to a consumer upon request a schedule of all specific fees and charges that may be imposed in connection with the servicing of the consumer's account…and an explanation of each…" The fees and charges covered include those of third parties that are passed on to consumers. Since servicing does not involve third party fees until a loan goes into collection, this proposal is relevant mainly to borrowers who get behind in their payments and are referred to the servicer's collections department. At that point the borrower will be billed for, e.g., a broker's price opinion, property inspection, legal services, and more. Borrowers in trouble do need protection, but requiring that the servicer provide them with a list of charges, when there is no standard that such charges must meet, is not going to help. What could help is mandatory disclosure combined with a rule that servicers cannot mark up the prices charged by third parties, or profit from them in any other way. Conspicuous by omission from this proposal is the provision of information to all borrowers, so they can keep themselves out of trouble. The single most important step that the Board could take to curb servicing abuses is to mandate the provision of monthly statements that show everything that has transpired during the month – and that is comprehensible as well as comprehensive. Reference was made above to borrowers whose monthly payments are not credited because the escrow portion of the payment is deficient. If the borrower does not receive a monthly statement that shows this, the problem can snowball until the borrower finds himself in collections. Consider as well the Board's proposal to require that servicers credit payments on the day a payment is received. Who is going to monitor the roughly 50 million home mortgage payments that are made every month to assure compliance? The only ones who possibly can are the 50 million borrowers, who know when their payments were made and have a financial interest in receiving timely credit. But without access to monthly statements, borrowers are severely handicapped. The Board also ignores other important

abuses: Some servicers cripple the ability of borrowers to refinance profitably by not reporting good payment records to the credit bureaus. Servicers should be required to report payment histories on all their accounts. Some servicers purchase servicing contracts and convert the mortgages to simple interest if the note does not explicitly prevent it. If a borrower did not negotiate a simple interest mortgage at origination, a later conversion to simple interest is unconscionable. Such conversions should be prohibited. Some servicers cover up abusive practices by selling the servicing to another firm without forwarding evidence of the abuses – the prior servicing record. When servicing is transferred, the purchasing firm should be required to obtain and hold the complete file. The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at http://www.mtgprofessor.com.