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August 2, 2007

Via Email and U.S. Mail

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Regs.comments@federalreserve.gov

RE: Docket No. OP-1288

Dear Ms. Johnson:

We write to urge the Federal Reserve Board (FRB) to use its authority under the Home Ownership and Equity Protection Act to prevent abuses in the mortgage market that have led to the current crisis of lost homes, lost equity, and destabilized neighborhoods. How much more evidence does the FRB need to see that current loan practices and products are unsafe and in desperate need of substantial reform? Any changes will be too late for thousands of consumers who have lost their homes to foreclosure, deeds in lieu, short sales, and foreclosure rescue scams. Yet decisive and immediate action by the FRB can save borrowers in the future.

The undersigned nonprofit groups, private firms and public agencies write in response to the Federal Reserve Board's (FRB) request for comments on the Home Equity Lending Market.
Collectively, we are counseling agencies, community development corporations, legal service providers, advocacy organizations, housing providers, local government, private firms, research establishments, neighborhood community development initiatives and policy think tanks, all of whom are witnessing the devastating impacts of abusive lending practices on families, seniors, people of color, immigrants, low and moderate income households, and the communities in which they live.

California registered the nation's second highest state foreclosure rate in June of 2007, one foreclosure filing for every 315 households — 2.2 times the national average, according to Realtytrac. The state reported 38,801 foreclosure filings during the month, the most of any state for the sixth month in a row and more than three

This comment letter will track the FRB's request for comment as published in the Federal Register:

A. Prepayment penalties.

- *Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited?*

Prohibit prepays as unfair and deceptive. The FRB should prohibit prepayment penalties on subprime loans as inherently unfair and deceptive. Prepayment penalties trap borrowers into higher priced and unsuitable loan products.

Prepays are complex, confusing, and counterintuitive. Most consumers do not understand these penalties, which are counterintuitive and harmful for subprime borrowers who hope to graduate to prime products and for distressed homeowners who need to escape from unsuitable loans. Borrowers are not bargaining for lower rates in accepting prepayment penalties, as industry groups assert time and time again. Consumer choice cannot explain the large difference in the prevalence of prepayment penalties in the subprime and prime home loan markets. Prepayment penalties are in most subprime loans because investors want them there. The reality is that prepayment penalties provide no benefit to consumers,[4] yet increase the likelihood of foreclosure.[5]

Don't permit prepays after rate reset. Especially onerous are loans where the rates will rise or reset before the expiration of the prepayment penalty period. Borrowers are left with the harrowing choice of paying higher rates with their existing loan, or refinancing to a better loan and losing valuable equity in their home, typically thousands of dollars in California.[6] If the FRB is unwilling to prohibit prepayment penalties, it must, as a minimum, ban such penalties that extend beyond the loan's initial interest rate period and find this practice unfair and deceptive. Much of the industry has already moved to this position and is limiting the prepayment penalty period to that of the initial interest rate of the loan.

Create a 90 day window for refinances. Beyond merely tying the prepayment penalty period to the initial interest rate of the loan, the FRB should allow for a 90 day period prior to the first interest rate adjustment during which time the consumer is able to refinance without penalty.

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[4]Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits From Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending, January 2005.

[5] Michael A. Stegman, Roberto Quercia, 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 (UNC), January 25, 2005. The study found that loans with prepayment penalties with terms of three years or longer were 20% more likely to enter foreclosure than loans without these terms.

[6]Kevin Stein, Margaret Libby, *Stolen Wealth: Inequities in California's HomeLoan Market*, California Reinvestment Coalition, 2001. (In this study of over 100 subprime borrowers and their loan documents, several loans contained prepayment penalty provisions that extended beyond the initial interest rate of the loan. This dynamic was never explained to, and never understood by, the borrowers).

This is consistent with the recently released Statement on Subprime Lending which includes limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty.

Add prepays to HOEPA calculation. In addition to banning prepayment penalties or, in the alternative, restricting their duration, the FRB should include prepayment penalties in the points and fees calculation under HOEPA. This would extend HOEPA's protections to more consumers.

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

Disclosures are not enough. Enhanced disclosures would be unlikely to address our concerns about abuses. Adding one more disclosure to the large pile of documents given to borrowers will not guarantee understanding. To the extent borrowers are misled about their loan terms, they are doubly victimized by prepayment penalties which effectively prevent them from refinancing out of bad loans. A common practice of loan sellers is to tell apprehensive borrowers not to worry because they can always refinance if there are problems, thereby guaranteeing that a few thousand dollars in prepayment penalties will be incurred. Most borrowers do not understand this dynamic at all. However, coupling added disclosure with home loan counseling would probably result in borrowers better understanding their prepayment penalty provisions and more informed decision making.

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

Regulation would serve consumers' interests. Prohibiting, or in the alternative, restricting, prepayment penalty provisions would likely have little affect on the availability of credit, but will greatly increase consumer flexibility and ability to preserve and utilize, not lose, home equity. Prime borrowers are generally not forced to accept prepayment penalties in their loans, yet have reasonable access to credit. So, too, in those states that have prohibited or severely restricted prepayment penalties, there has been no drying up of credit.[7]

<u>B. Escrow for taxes and insurance on subprime loans.</u>

- *Should escrows for taxes and insurance be required for subprime mortgage loans?*

Yes. Many borrowers' decisions about whether or not they are able to afford a particular loan are based on their understanding of the monthly obligations under that loan. By failing to include the prorated monthly costs of taxes and insurance in that calculation, borrowers

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[7] Roberto Quercia, Michael Stegman, *The Impact of North Carolina's Anti Predatory Lending Law*, UNC Center for Community Capitalism, June 25, 2003. The authors noted, "Overall, we conclude that after the North Carolina predatory lending law was fully implemented, the subprime market behaved essentially as the law intended: There was a reduction in predatory loans but no change in the cost of subprime credit or reduction in access to credit for high-risk borrowers."

overestimate their own ability to repay the loan. Additionally, we see countless instances where the exclusion of escrow is used as a tool of deceit by unscrupulous mortgage brokers. Consumers are often exposed to "bait and switch" tactics by brokers who tell them that taxes and insurance will be included in their monthly payments but who ultimately arrange for a loan lacking escrows. In other instances, consumers are denied basic information and advice on the potential ramifications of forgoing an escrow. Consumers who are already carrying a debt load that stretches their financial resources can be pushed over the edge by the unexpected addition of thousands of dollars in additional annual costs for property taxes and insurance.

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

Opt out in limited circumstances. Consumers should be permitted to opt out either at loan closing or during the term of the loan only with written proof of participation in a publicly subsidized property tax and/or insurance. The State of California, for example, provides a property tax postponement program to qualifying senior citizens and to blind and disabled citizens.[8] If consumers could "opt out" of tax and insurance escrows without providing proof of their participation in an alternative program, there would be a substantial risk that they would either "opt out" of escrow unknowingly—by initialing yet another form among dozens received at closing, without explanation or comprehension – or would be induced to do so by their broker or lender.

- *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?*

Disclosure reform is inadequate. Since we assert that escrow should be required in all subprime loans except those where the consumer provides proof of participation in an alternative tax and/or insurance payment program, additional disclosure requirements related to escrow accounts under this regulatory regime would not be necessary.

Disclosure requirements are better than nothing, but often fail in their primary purpose—which is to guarantee that the consumer knows of potential risks and can therefore make an informed decision about whether or not to accept those risks. From our experience in counseling consumers in mortgage loan transactions, it has become apparent that the many disclosures required in these transactions are often misunderstood by subprime borrowers with limited financial literacy, and obfuscated by brokers and lenders who have either failed to explain key loan terms and disclosures to borrowers or have actively misrepresented or concealed these terms.

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

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[8] Information on California's Property Tax Postponement program, an example of a publicly subsidized property tax program, can be found on the website of the California State Controller's Office at http://www.sco.ca.gov/col/taxinfo/ptp/faq/index.shtml

Escrow serves consumers' interest. Escrow requirements such as the ones suggested above would have no deleterious effect on consumers or on the type of and terms of credit offered. Tax and insurance escrows are common practice for many subprime lenders, and are the industry norm for prime lenders. A lack of regulation in this particular area primarily benefits those borrowers and brokers who would attempt to secure loans unsuited to the borrowers' income.

C. "Stated income" or "low doc" loans.

- *Should stated income or low doc loans be prohibited for certain loans?*

Yes, prohibit stated income or low doc for certain loans. Stated income applications should be prohibited in conjunction with any "exotic" loan products, including but not limited to: Interest-only loans, Piggy back loans, Option ARMs, and Hybrid ARMs. We question whether the marginal utility of extending credit to consumers with widely fluctuating and/or speculative income outweighs the enormous and well-documented risks involved with literally betting the house on the representations written in small print on the latter pages of a loan application—often completed by mortgage brokers with a vested interest in insuring the borrower's loan qualification, regardless of their actual ability to repay. We strongly recommend that, where stated income loans are permitted, they should be subject to HOEPA provisions, without consideration of the traditional fee and APR triggers that bring a loan within HOEPA's protections. This would help to insure that what was ostensibly designed to be a loan marketed to a limited and highly particularized customer base is no longer a widely used tool of predatory lenders and brokers. The widespread availability of "stated income" loans in conjunction with high-risk products from subprime lenders over the last several years is one of the driving forces behind the recent and well-documented foreclosure spike in our communities. The stated-income feature has allowed brokers to inflate borrowers' incomes in a manner designed to increase broker fees and to make a deal work, even if the borrower's actual income is woefully inadequate to support a loan of the given size. Meanwhile, the artificially low initial payments conceal the true cost of the loan from the consumer. It is not until the payments reset and begin to adjust upwards that many consumers realize that their financial position is untenable. At that point, consumers have few options. They cannot legitimately refinance, since to do so would require an even larger loan than the one they should not have been qualified for in the first place. They cannot afford to stay, and, increasingly, in a homeowner market that has flatlined or declined (particularly in higher-cost areas), consumers are unable even to sell their homes, since the home is indebted for more than its value.

Stated income loans have also afforded predatory lenders and brokers the ability to gouge consumers for massive closing costs and fees without triggering HOEPA's protections. Since HOEPA's points and fees trigger is set as a percentage, brokers and lenders can simply inflate the total loan value to collect the same undeserved fees at a lower overall percentage. This loophole creates a perverse incentive for brokers and lenders to inflate total loan amounts and can be easily closed by extending HOEPA protections to all stated income loans.

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

Yes, prohibit stated income and low doc loans for higher-risk loans. As discussed above, stated income loans should be prohibited in conjunction with other high-risk loan products such as interest only and piggy back loans, option ARMs, and hybrid ARMs. To the extent that stated income loans remain available, they should be governed by HOEPA. Suitability standards applied to lenders in all loan transactions would offer further protections.

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

Restrictions on stated income and low doc loans would serve consumers' interests. Above all, restricting stated income loans would have the effect of preventing brokers and lenders from putting consumers into loans of amounts that are far beyond what they can afford. Because stated income loan products have been so heavily marketed by subprime lenders in the recent past, and because a shockingly large amount of these unsuitable loans have been given to borrowers whose incomes were deliberately misstated by brokers or lenders, or less often by the borrower herself, restrictions on stated income loans will impact the ability of these affected borrowers to get another loan. In effect, abuse of the stated income loans has created a class of borrowers for whom no legitimate loan is obtainable. However, the alternative—to use this misused product as a means to create even more untenable debt and to strip out even more of our communities' equity—is even worse.

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

Disclosures are of limited value. The effectiveness of written disclosures is one of diminishing returns. The more disclosures there are, the less useful any particular one of them is. The FRB would do better to meaningfully restrict stated income and low doc loans, but disclosure may be better than no disclosure.

D. Unaffordable loans

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

Yes, underwrite to the fully indexed rate. By so doing, regulators will help ensure that lenders issue mortgage loans appropriately, based on the fullest possible picture of the true cost of the loan to the consumer. Such a practice would benefit the lender, the borrower, and the mortgage industry as a whole, including investors.

The types of loans to which this should apply are 2/28s, 3/27s, and any other type of loan for which there is currently no requirement that underwriting be based on the fully-indexed rate (including 2/38s, the new frontier of loans conducive to payment shock and disaster). In the current environment, without this requirement, we have seen the highest-priced loans marketed to people with low to moderate incomes who have few if any assets to fall back on. The theory behind these loans is that the borrowers who get these loans are riskier and will be able to: (1) use the introductory, fixed time period of the loan, to improve their credit score, and (2) refinance out of this hybrid loan into a completely fixed rate loan before the hybrid loan adjusts upward.

The obvious danger of these types of loans is the fact that the borrower may not be able to refinance into a better loan (because of credit problems, or changes in the mortgage market) and may not be able to keep up with the new, rising payments. The Federal Home Loan Mortgage Corporation (Freddie Mac) has already declared that, beginning September 1, 2007, it will no longer purchase such hybrids unless underwritten at the fully-indexed, fully-amortizing rate.[9]

Underwriting all loans at a fully-indexed rate, showing fully amortizing payments, would also remove one of the ways in which brokers and lenders lure borrowers into loans that they cannot afford. For example, a lender or broker could no longer lawfully send offer letters to homeowners to refinance into a "fixed" rate loan, advertising a monthly payment amount that is actually only a time-limited, fixed introductory rate. Ads would have to reveal the fully indexed payment level instead.

At this point in time, most borrowers who have taken out hybrid ARMs do not fully understand the terms of the loans, including the true cost of the loan at the time of issuance or as it adjusts upward. Our experience is reflective of the findings of several recent studies. The FRB found in a 2006 study that 35% of ARM borrowers did not know the value of the reset interest rate cap and more than 44% did not know how to calculate the lifetime interest rate cap.[10]

It does not benefit the borrower for hybrid loans, such as 2/28s and 3/27s to be underwritten at anything less than the fully-indexed rate with fully amortizing payments. Much of the demand for such exotic and higher-cost home loan products has come from investors, not borrowers.[11] A recent NY Times article quoted William Dallas, the owner of the now defunct Ownit Mortgage Solutions, as placing the blame for Ownit's demise on investors and Wall Street saying they encouraged Ownit and other subprime lenders to make riskier loans. "The market is paying me to do a no-income verification loan more than it is paying me to do the full documentation loans. What would you do?"[12] The agencies must impose an obligation on Wall Street firms not to fund or securitize predatory loans so as to turn off the spigot of predatory finance. Recent indications that Wall Street's enthusiasm for unaffordable loans is souring is no substitute for appropriate regulation.

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

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[9] *See, FREDDIE MAC Announces Tougher Subprime Lending Standards To Help Reduce The Risk Of Future Borrower Default,* Freddie Mac Press Release, February 27, 2007, *available at* http://www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html.

[10] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.

[11] *Inside B&C Lending*, "Diversification, Branding, Key to Ameriquest Strategy," remarks of Ketan Parekh, Vice President for Capital Markets, Volume 9, Issue 22, p. 6)

[12] CITE???

Yes, implement an ability to pay standard. An exception should be crafted for specially developed rescue loan products, administered by a non-profit or government agency, and designed to assist homeowners in distress. Under the housing affordability standards of the federal Department of Housing and Urban Development, a household paying 50 percent or more of their income towards housing costs is in danger of becoming homeless. Notably, California's Covered Loan Law, includes a rebuttable presumption that a consumer is unable to pay the monthly mortgage if the consumer's total monthly debts, including amounts owed under the loan, exceed 55 percent of the consumer's gross monthly income. In light of this, it is distressing that "[o]ver half (52%) of [California] state residents who purchased a home within the last two years spend more than 30 percent of their total income on housing – a percentage that exceeds the top threshold recommended by the U.S. Department of Housing and Urban Development. Even more startling, 20 percent of these recent homebuyers spend more than half their income on housing."[13]

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

Disclosures must be accessible. Consumers need disclosures that show the true cost of their mortgage loan over the life of that loan. Such disclosures need to be in a language and format that are consumer friendly- in large print, with little to no technical language, and/or with clear explanations of technical language such that borrowers even with limited reading skills can understand them. They also need to be multilingual to account for our diverse society that has been fueling the housing boom with their hard-earned dollars. In California, in recognition of our state's diversity, the legislature enacted a law in 1976 that requires translation into Spanish of contracts and/or other key documents in consumer transactions (Civil Code, Section 1632). A couple of years ago, the legislature expanded the number of required languages to include Korean, Tagalog, Vietnamese, and Chinese. The law covers brokered mortgage loans, and there is an effort afoot in the legislature to extend its coverage to a broader range of mortgage loans.

Disclosures can be effective as a tool in preventing certain types of practices, the Homeownership and Equity Protection Act (HOEPA) stands out as an example of how a disclosure can have some positive effect on consumer finance to the extent that it reduced the prevalence of certain higher cost loans. (See below.) However, regardless of the quality of the disclosures, there is no substitute for high-quality counseling through a HUD-certified housing counseling agency to make sure the consumer truly understands the cost and terms of the loan.

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

Given the prevalence of hybrid ARMS, the positive impact in terms of consumer protection could be substantial in scope. "The share of adjustable rate and hybrid loans among all loans and buyers increased dramatically from 11 percent in 2003 to 43 percent in 2005, while the share

[13] Hans P. Johnson and Amanda Bailey, "California's Newest Homeowners Pushing the Envelope – Affording the Unaffordable," Public Policy Institute of California publication *California Counts: Population Trends and Profiles – Vol. 7, No. 1, Aug. 2005, pp. 11 – 13;* see website at: http://www.ppic.org/content/pubs/cacounts/CC_805HJCC.pdf

of fixed rate loans plummeted from 89 percent in 2003 to 57 percent in 2005. The share of adjustable rate loans last exceeded 40 percent in 1994."[14] "Adjustable Rate Mortgage (ARM) loans (including Interest Only ARM Loans) comprised 75 percent of subprime originations in the second half of 2006, versus an ARM share of 67 percent of subprime originations in the first half of 2006...".[15]

Of course, to seriously address deficiencies in today's home loan market, the FRB will need to go beyond the recommendations outlined above. We urge the FRB to further:

E. Expand the Homeownership and Equity Protection Act (HOEPA)

The FRB should expand HOEPA so that it covers more loans, in the following ways :

- Extend coverage of HOEPA to home purchase loans;
- Lower the points and fees threshold to 5% of the total loan amount (2% in high-cost areas of the country, such as California, New York and Florida);
- Lower the rate threshold to 6% above comparable Treasuries (3% in high-cost areas of the country, such as California, New York and Florida); and
- Expand the definition of points and fees to include Yield Spread Premiums and prepayment penalty provisions.

If HOEPA's protections are expanded and updated to reflect current realities and needs, we expect the updated HOEPA to be as effective as the original version. Despite its limitations, HOEPA has proven to be effective in reducing the number of certain types of risky loans issued to borrowers; in California in 2004, less than 1% of all loans fell within HOEPA's parameters (2,029/2,453,492[16]). Unfortunately, many higher-cost loans that are susceptible to abuse are not subject to HOEPA's protections.[17] The Federal Reserve has estimated that HOEPA loans accounted for only 0.0003 percent of all of the originations of home-secured refinance or home improvement loans reported for 2004.[18] The limitations in the HOEPA regulations are a reflection of how today's market and today's abuses have outpaced the current regulatory scheme. If its limitations are addressed, it will be an effective tool for stemming further abuses in the mortgage market related to affordability.

F. Improve underwriting consistent with suitability. The FRB should develop meaningful suitability standards that protect all borrowers from being pushed into loans that are not suitable

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[14] *State of the Housing Market 2005 – 2006 Real Estate Research Report: 2006-1*, California Association of Realtors, February 23, 2006, p. 4 *available at* http://www.car.org/library/media/papers/pdf/StateofMarket2005-2006SurveyParticipant.pdf

[15] Subprime Mortgage Originations Survey, *Percentage of Subprime Loans Used by First-Time Home Buyers Up During the Second Half of 2006*, Mortgage Bankers Association of America, *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/55453.htm

[16] Analysis is based on loans originated on single-family properties (1-4 units) in the state, using PCI's CRA Wiz software, 2006.

[17] For this section of our letter only, when we refer to "higher cost," we mean all loans that meet the HOEPA triggers but are not covered by HOEPA because they are not refinance loans.

[18] Robert B. Avery and Glenn B. Canner, "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin*, Summer 2005, p. 372.

for them. The FRB should seek Congressional authorization to accomplish this goal if that is deemed necessary. Such protections for borrowers are critical, since consumers often have little practical recourse against their supposed fiduciary, mortgage brokers, and since subprime lenders in particular are increasingly absent from any direct oversight.

The FRB should require improved underwriting standards and due diligence requirements for lenders who fund interest-only, stated-income, piggy-back loans and option ARMs to ensure that such loans are not issued to borrowers for whom they are not beneficial.

The improved underwriting standards should include such safeguards as: (1) not providing these types of loan products to borrowers with FICO scores below a certain level; (2) requiring a minimum level of downpayment by borrowers who are seeking purchase loans; (3) prohibiting prepayment penalties on these high-risk loans so that borrowers in distress can reasonably refinance; (4) capping interest rates on the second loan in a piggy-back and/or requiring that it be a fixed rate loan; and (5) requiring housing counseling before the closing of the loan (as discussed elsewhere in this letter).

G. Require home loan counseling for all HOEPA (after HOEPA's reach is extended, as discussed above), subprime, and nontraditional loan products.

Qualified home loan counseling may represent the consumer's best hope of evading the reach of predatory lenders and brokers. Any effort to tie high risk lending to home loan counseling can only work to the consumer's benefit. To ensure capacity at the counseling level, funding streams need to be identified to support this important work.

We write with a sense of urgency. Homeowners in California are suffering at the hands of unscrupulous industry actors. Homeowners in our state have no more time to wait. The FRB must act to stem the tide of abusive practices that have led to the current tidal wave of foreclosures impacting our families, communities, and economy.

Thank you for your consideration of these views.

Signed

Charise Fong
Director, Neighborhood Economic Development
East Bay Asian Local Development Corporation