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May 7, 2007

VIA ELECTRONIC MAIL

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Re: Proposed Statement on Subprime Mortgage Lending
OCC Docket No. 2007-0005
FRB Docket No. OP–1278
OTS Docket No. 2007–09

Ladies and Gentlemen:

I write on behalf of low-income homeowners. I commend the agencies for their restatement of the need for lending institutions to employ responsible underwriting criteria in the extension of subprime loans. I thank the agencies for this opportunity to comment. Given the enormous risks posed by subprime lending made highly visible by the foreclosure crisis, I respectfully request that the agencies move beyond the proposed statement on subprime mortgage lending to binding, substantive regulation and a more aggressive posture on risk layering.

Land of Lincoln Legal Assistance Foundation, Inc. is a federally funded legal services provider, serving low income individuals, families, and community groups in 65 counties in southern and central Illinois. I have worked in the East St. Louis office since 1994, primarily representing homeowners threatened with foreclosure. For five years, I served as corporate counsel for the largest nonprofit provider of affordable homeownership in East St. Louis. I currently am the homeownership specialist for Land of Lincoln Legal Assistance, providing supervision of all homeownership cases we handle in our 65 counties. I served as a member of the Consumer Advisory Council of the Board of Governors of the Federal Reserve System from 2003-2005.

The proposed statement does restate and reemphasize the agencies' long-standing position that underwriting should be required in lending. Given how far many subprime lenders have abandoned any pretense of underwriting, such a reminder is undoubtedly useful. Yes, loans should be underwritten based on a ability to pay and not collateral. Yes, borrowers should not be sold a loan with lower payments by cutting a tax and insurance escrow. Yes, the use of limited documentation loans should be limited and should not be combined with other risky features. All of these statements are true; unfortunately, by themselves, they do nothing to address the crisis created by abusive subprime lending.

The agencies note correctly that the proposed statement is largely a restatement of existing guidance. That guidance has been ineffective. In order to fulfill their mandate of consumer protection, the agencies must do more than repeat ancient nostrums: the agencies must commit themselves to substantive regulation.

The proposed statement significantly understates the risk to low income families and communities.

It is well documented that even slight increases in the foreclosure rate have dramatic ripple effects on other families and on the communities in which the foreclosures occur.[1] Violent crime increases 2% for every 1% increase in the foreclosure rate within a census tract.[2] Every individual foreclosure within an eighth of a mile may reduce surrounding property values by over 1%, and the effect of concentrated foreclosures is more than additive.[3] Communities spend

[1] Ira J. Goldstein, The Reinvestment Fund, Lost Values: A Study of Predatory Lending in Philadelphia 62-63 (2007) (discussing disastrous community impact left behind by failed subprime lenders), *available at* http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf.

[2] Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, Housing Studies (forthcoming 2006), *available at* https://www.prism.gatech.edu/~di17/housingstudies.doc.

[3] Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Pol'y Debate 57, 69, 75.

millions of dollars attempting to deal with the immediate problem posed by foreclosures and remedy the blight that is left behind.[4]

For individual families foreclosed on, particularly African-American and Latino families, the path back to homeownership is difficult. On average, it takes more than ten years for a family to regain homeownership after a foreclosure. It takes an additional 3 to 4 years for African-American and Latino families.[5] The cost of foreclosure is real and large.[6]

Risk-layering greatly increases the risks to communities and homeowners and should be strictly limited.

Many features of typical subprime loans, including prepayment penalties, balloon payments, low or no documentation, and variable interest rates, particularly in combination, have been shown to increase the risk of foreclosure.[7]

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[4] William Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom* 4 (May 11, 2005), *available at* http://www.hpfonline.org/PDF/Apgar-Duda_Study_Final.pdf (estimating costs to the City of Chicago per foreclosure upwards of $30,000 for some vacant properties); *see also* Erik Eckholm, *Foreclosures Force Suburbs to Fight Blight*, N.Y. Times, Mar. 23, 2007 ("suburbs of Cleveland . . . are spending millions of dollars to maintain vacant houses as they try to contain blight and real estate panic.")

[5] Haurin & Rosenthal, The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells (Dec. 2004), *available at* www.huduser.org/publications/homeown.html.

[6] Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 11 (Dec. 2006) (projecting subprime foreclosures costs to individual families of $164 billion).

[7] *See, e.g.*, Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); *id.* at 23 (finding in a review of Chicago subprime foreclosures that low or no documentation led to significant increases in the rate of foreclosure for refinance loans but had no statistically significant relationship to foreclosures on purchase loans); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation); Roberto Quercia, et al. The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments (Jan. 2005), at 28-29 (subprime refinance ARMs are 50% more likely than fixed rate subprime refinance loans to result in foreclosure), *available at* www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf; Michelle A. Danis & Anthony Pennington-Cross, *Delinquency of Subprime Mortgages*, Working Paper 2005-022A, at 20, available at http://research.stlouisfed.org/wp/more/2005-022/ ("Loans with limited documentation also are delinquent and default more frequently than full documentation loans. The impact for loans with no documentation is even larger."); Susan E. Barnes, Patrice Jordan, Victoria Wagner & David

Subprime ARMs by themselves, even without any additional risk factors, are risky for homeowners and communities.[8] Subprime ARMs foreclose at high rates well before the payment shock.[9] ARMs have been widely used to qualify borrowers for overly risky loans, loans at the margin of the borrowers' ability to repay. As with all such procedures, there is an increased risk of failure to the loan. This risk is present from the loans' inception, and not solely or even primarily at the time of reset. The statement focuses excessively on the risk posed by payment shock and ignores the large risk posed by subprime ARMs and other dubious loan products.

The layering of inherently risky products, like subprime ARMs or balloon payments, with other risky practices, like piggy back loans and reduced documentation, leads inevitably to high default rates.[10] These effects are independent of and occur before any adjustable rate reset,

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Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007) (subprime loans with no documentation associated with early payment default).

[8] Andrey Pavlov & Susan Wachter, Aggressive Lending and Real Estate Markets (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf 13 (each 1% increase in purchase adjustable rate mortgages leads to housing value decline—itself a risk for foreclosure—of 1.3%).

[9] Roberto Quercia, et al. The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments (Jan. 2005), at 28-29 (subprime refinance ARMs are 50% more likely than fixed rate subprime refinance loans to result in foreclosure), *available at* www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf; Keith Ernst, C'tr. for Responsible Lending, Case Study in Subprime Hybrid ARM Refinance Outcomes (Feb. 21, 2007), http://www.responsiblelending.org/issues/mortgage/briefs/page.jsp?itemID=31730766 (less than three years out, 8.5% of 106 hybrid subprime ARMS made by Option One in 2004 had been foreclosed on); Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category* 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (showing mean age at foreclosure of loans in study was shorter for ARMs than for FRMs, with the average purchase money ARM that entered foreclosure taking only 12.4 months to enter foreclosure from origination and the average refinance 13.3 months); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases for the first two years, when there is no payment shock); Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000 at 23 (July 2003) (from 1996 to 2000, the proportion of foreclosure judgments attributable to adjustable rate mortgages rose from 11% to 30%; at the same time, the median age of the loan entering foreclosure declined from 4.1 years to 2.06 years).

[10] *Cf.* Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007) (subprime loans with no documentation and piggyback loans showing pattern of default within four months of origination); Keith Ernst, C'tr. for Responsible Lending, Case Study in Subprime Hybrid ARM Refinance Outcomes (Feb. 21, 2007),

prepayment, or balloon payment due date.[11] Thus, balloon payments and ARMs appear to be markers for lack of loan affordability and consequent default risk rather than the cause of default in themselves. These risky products are being extended to households in situations where there is no reasonable expectation of repayment.

Interest-only loans and adjustable rate mortgages generally are geared for households expecting significant increases in income, for those with fluctuations in income where the borrower is able to pay down principal during certain periods, or investors seeking to maximize cash flow. Subprime borrowers generally do not fit any of these criteria. Many are on fixed incomes and those with fluctuating incomes do not see substantial swings in incoming funds. Accordingly, these loans can only be made to such borrowers without underwriting that analyzes whether the borrower can afford the loan. While originators may adjust for this possibility by raising interest rates to cover future default or foreclosure, this process stands apart from underwriting that considers repayment ability.

ARMs offer in the current market, at best, an uncertain benefit to borrowers. ARMs do not currently offer borrowers much of an advantage on interest rates: the interest rate spread between ARMs and fixed rate mortgages is currently virtually nonexistent.[12] Nor is it clear that now is a good time to take out an ARM, since interest rates are beginning to rise after years of historical lows. Yet the incidence of subprime ARMs, and the use of subprime ARMs for

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http://www.responsiblelending.org/issues/mortgage/briefs/page.jsp?itemID=31730766 (less than three years out, 8.5% of 106 hybrid subprime ARMS made by Option One in 2004 had been foreclosed on).

[11] .[11] *E.g.*, Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category* 25 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (discussing balloon payments); *id.* at 32 (showing mean age at foreclosure of loans in study was shorter for ARMs than for FRMs, with the average purchase money ARM that entered foreclosure taking only 12.4 months to enter foreclosure from origination and the average refinance 13.3 months); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases for the first two years, when there is no payment shock); Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000 at 23 (July 2003) (from 1996 to 2000, the proportion of foreclosure judgments attributable to adjustable rate mortgages rose from 11% to 30%; at the same time, the median age of the loan entering foreclosure declined from 4.1 years to 2.06 years); *cf.* Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007) (increase in early payment defaults within four months of origination, particularly for loans with low documentation and a piggyback loan).

[12] Joint Center for Housing Studies, *State of the Nation's Housing 2006* at 17 *available at* http://www.jchs.harvard.edu/publications/markets/son2006/index.htm

purchase money mortgages, have increased dramatically over the last decade. Overall, ARMs constitute 31% of all outstanding home mortgages.[13] The number is higher for subprime loans, including home purchases. Potentially, ARMs offer a good deal for a sophisticated borrower who plans to move or refinance before the interest rate resets—provided that the house will have appreciated enough to cover the refinancing costs and provided that there is not a prepayment penalty.

My clients, almost universally, have ARMs. Typically, the loans have teaser rates of 10% to 13%. In some loans, the cap is as high as 19%. For none of my clients was an ARM a good thing. Their houses are not appreciating fast enough to make refinancing easy. Their incomes are either fixed or low wage employment; in either event, their income is not appreciating and has no realistic prospect of appreciating quickly enough to cover the bump up to the fully indexed rate. In most cases, their loans are for more than their homes are worth. In most cases, my clients' loans contain prepayment penalties a year or two longer than the period to reset of the ARM interest rate. By and large, my clients do not choose ARMs, do not understand they are getting an ARM, and do not want ARMs. They are sold ARMs.

Lenders and brokers push ARMs, even though ARMs carry a higher risk of default.[14] Why? There are two answers. The first is volume. ARMs with low teaser rates will encourage some families who are focused on the initial monthly payment to take out debt they otherwise would avoid. In a climate where loan officers as well as brokers continue to be rewarded based on the number and dollar amount of loans they originate, and where no one—neither the loan officer, nor the broker, nor the original lender—is around two years later when the loan goes bad, the emphasis remains on selling the initial loan.[15] The second reason involves risk reduction. In a fixed rate loan, the lender or investor bears the interest rate risk. Under an ARM, particularly the modern variety, made with a high floor during a time of historically low interest rates, the borrower bears the interest rate risk. ARMs shift risk from presumably sophisticated lenders

[13] Joint Center for Housing Studies, *State of the Nation's Housing 2006* at 17 *available at* http://www.jchs.harvard.edu/publications/markets/son2006/index.htm .

[14] Quercia, et al. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, January 2005 (subprime refinance ARMs are 50% more likely than fixed rate loans to result in foreclosure), *available at* www.kenan-flagler.unc.edu/ assets/documents/foreclosurepaper.pdf.

[15] My office is currently suing an individual broker. In five years, he worked for at least four different mortgage broker companies. Only one of those companies is still in business. He at least is still in the area. Several of our defendants have moved to Florida and disappeared. In my last request to a lender to produce employees from three years before, when the loan was originated, I listed ten individuals who had been involved in what appeared to be mid-level positions in approving the loan. Not a single one was still with the company, and the lender was only able to produce a good address on two of the individuals.

with a detailed understanding of the capital markets and interest rate fluctuations to elderly women dependent on Social Security who completed only the 8th grade.

Industry typically understands and prices the risk for itself.[16] The connection between high default and nontraditional mortgage products is evidenced by Standard & Poor's requiring, as of last August, increased credit enhancements for option-ARMs.[17] What industry does not do, however, is ensure that consumers understand the risk. The investors and originators know that it is likely that these products will lead to high foreclosure rates; consumers, who bear the brunt of the risk, who stand to lose their homes, their credit ratings, and their life savings, do not know.

Rigorous underwriting requires documentation of income, residual income standards, and evaluation of full debt to income ratios at likely interest rates.

Meaningful assessment of the ability to repay requires full documentation to the extent possible given the consumer's source of income, residual income testing to ensure that the family has sufficient remaining income to cover projected utility and food costs, and review of the likely monthly payments for principal and interest over the projected life of the loan.

Falsified income is rampant in the subprime market. In my experience, the income is almost always falsified by either the broker or lender's loan officer and often with the connivance of the underwriting staff of the lender. In one typical case, there were multiple faxes back and forth between the loan officer, the underwriter, and the broker, detailing the need for additional

[16] @ *See, e.g.*, Aames Mortgage Trust 2001-1 Mortgage Pass-Through Certificates, Series 2001-1, Aames Capital Corporation as Sponsor, Countrywide Home Loans, Inc. as Servicer, Prospectus Supplement to Prospectus dated March 13, 2001, S-10 (stating that no underwriting done on the fully indexed payment levels of the adjustable rate mortgages in the pool and there is likely to be a high rate of default after the initial teaser period); *see also* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039, 2054-76 (2007); Christopher L. Peterson, Predatory Structured Finance 19-21 (Sept. 7, 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929118&high=%20securitization%20peterson; *cf. See also* Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States*, 88 Geografiska Annaler, Series B: Human Geography 105, 123-25 (2006) (describing a review of five pooling and servicing agreement (PSAs) from major mortgage backed securities issuers, noting that PSAs "offer a full-blast firehose of cogent analysis and rich empirical description"). For a discussion of the critical and destructive role played by ratings agencies in this process, see David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (2006).
[17] Remarks by Federal Reserve Governor Susan Schmidt Bies (Oct. 12, 2005), *available at* http://www.federalreserve.gov/BoardDocs/Speeches/2005/200510122/default.htm.

income to be "found," a subsequent change of the applicant's status from "retired" to "employed," and discussing the fact that the W-2 ultimately created by the broker reflected income and taxes that did match. All of this was done with the lender's knowledge but without the borrower's. In the vast majority of cases, there is no reason for lenders not to require verification of income. Reduced documentation loans are more expensive for borrowers. By definition, reduced documentation loans violate the spirit of the proposed statement in supplanting "a higher interest rate" for more meaningful risk mitigation. The agencies should require full documentation of income, to the extent feasible.

Underwriters should be required to critically examine the ability to repay of the household for the entire projected life of the loan, at all likely interest rates. Undoubtedly, lenders and underwriters make interest rate projections that determine the required margin and the initial rate. It is unreasonable to allow lenders, who have the capacity to make these complex assessments, to shift the entire interest rate risk to unsophisticated consumers. This is what the prevalence of unregulated and undisclosed ARMs has done.

Residual income testing is particularly important in an era of extending credit to borrowers on limited incomes, without escrow payments for taxes and insurance. A borrower on $800 a month cannot sustain a debt to income ratio of 50%, absent some showing of additional external resources. To do so sets the borrower and the loan up for failure.

The subprime statement fails to address the significant role of the secondary market in making risky loans.

According to the Chariman of the FDIC, 75% of all subprime loans are securitized.[18] The secondary market therefore plays a significant role in determining what kinds of loans get made.[19]

In my experience, the typical trustees of a subprime loan pool are large regulated banks. Those banks will typically disclaim any liability for the loans in the pool. I have been told repeatedly in discovery battles that a national bank, for example, is not acting as a national bank when it acquires the rights to thousands of subprime loans and that there is no regulatory oversight that

[18] *Possible Responses to Rising Mortgage Foreclosures: Hearings Before the Comm. on Financial Services*, 110th Cong., 1st Sess. (2006) (Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) (75% of all subprime loans securitized in 2006), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/ht041707.shtml.

[19] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039 (2007)

the national bank must comply with. In short, the position of many regulated institutions is that they have no responsibility to avoid abusive subprime lending when they act in a secondary market capacity.

This statement, by failing to address the key role that the secondary market plays in making available the capital necessary and in defining the terms under which that capital is extended, endorses regulated lending institutions' continuing participation in risky and predatory subprime lending. The role of the regulated institutions in bundling, selling, and purchasing securitized loans is perhaps the single largest contribution of regulated institutions to the prevalence of abusive subprime lending. Previous guidance has acknowledged the role regulated institutions play in the secondary market and their concomitant responsibilities.[20] This statement should do no less.

The subprime statement fails to adequately define predatory lending.
Without doubt, predatory lending occurs beyond the three indicia posed by the agencies. For example, some number of borrowers continue to receive subprime loans who are eligible for prime loans.[21] Undoubtedly, most of these borrowers are African-American or Latino.[22]

Abusive and discretionary pricing continues to be rampant in subprime lending. Many borrowers are pushed without adequate disclosure into loans more expensive than they are eligible for as a result of private arrangements between the brokers and the lenders. The use of yield spread premiums continues to drive interest rates higher for broker originated subprime loans than for nonbroker originated loans, without reducing the financed costs.[23] Almost always,

[20] *See, e.g.*, Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006); Interagency Independent Appraisal and Evaluation Functions, Financial Institution Letter 84-2003 (Oct. 27, 2003).
[21] *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for American Families*, Pub. No. 259 (Freddie Mac Sept. 1996) (estimating that 10%-to 30% of borrowers with subprime loans eligible for prime loans).
[22] New research by the Center for Responsible Lending shows that the higher an African American or Latino's credit score, the more likely it is that they will receive a subprime loan, compared to similar white borrowers. The numbers suggest that much of the observed pricing disparity between white and African American or Latino borrowers involves borrowers with prime level FICO scores of 680 or greater. *See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 11 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.
[23] Howell Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (Jan. 2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (finding that brokers receive higher total compensation on average where there is a yield spread premium and that two-thirds of all borrowers with yield spread premiums could finance the broker fee, usually at a lower total cost than the increased interest); *see also* Lloyd T. Wilson, *A Taxonomic Analysis of Mortgage Broker Licensing Statutes: Developing a Programmatic*

my clients were eligible for a loan at a lower rate, but were upsold, either to pay broker commission, a loan officer's commission, or for some other reason. There is no transparency in this upselling. Sometimes brokers provide borrowers with a form containing language that vaguely informs the borrower that they may have to pay a higher interest rate if the lender pays all of the compensation to the broker. Practically, this disclosure is ineffective, since borrowers are not given loan specific information as to what is the trade off. Borrowers are not told by how much the interest rate and monthly payment will increase if the lender provides broker compensation. Rate sheets are closely guarded as "proprietary secrets," preventing borrowers from either shopping or discovering the true cost of using a broker. In light of the mounting evidence that discretionary pricing in the area of broker compensation is a leading contributor to the persistent racial pricing disparities observed in mortgage lending,[24] the agencies' failure to rein in discretionary and abusive pricing is disheartening.

The agencies ask about possible limitation on the use of prepayment penalties. The use of prepayment penalties may compound payment shock, by restricting the ability of a borrower to refinance. However, as discussed above, I do not believe that payment shock is the primary driver of the high foreclosure rates shown by ARMs. More significantly, prepayment penalties, like yield spread premiums, are associated with abusive, racially disparate pricing.[25]

Response to Predatory Lending, 36 N.M. L. Rev. 297, 329 (2006) ("YSPs reward a broker for engaging in opportunistic loan pricing instead of risk-based pricing.").

[24] *See, e.g.,* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A157-58 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf; Robert B. Avery & Glenn B. Canner, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, Fed. Reserve Bulletin 344, 380, 394 (Summer 2005), *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf; *see also* Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for origination channel, in which case the difference shrank); Press Release, Office of the New York State Attorney General, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 5, 2006), *available at* http://www.oag.state.ny.us/press/2006/dec/dec05a_06.html (unexplained price disparities between whites, on the one hand, and African Americans and Latinos, on the other, increase when brokers involved in transaction); *cf.* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21-23 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives).

[25] Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), *available at*

The agencies compound the timidity of their listing of predatory practices by suggesting that mortgage loans made under such clearly illegal terms and conditions may not necessarily be illegal. The agencies have already and repeatedly stated that loans made on collateral value alone can be the basis for an FTC violation;[26] loan flipping has been widely condemned for many years; and fraud is by definition an FTC violation. Loans made in this fashion do not "carry an elevated risk" of violating the prohibition of unfair or deceptive acts; loans made in this fashion do violate the FTC Act. The agencies should have the courage of their convictions and say so.

The federal agencies have not required any effective disclosure of the risk to borrowers. There is now a bewildering assortment of nontraditional mortgage products for consumers to choose among, including loans with flexible "pick-a-payment" options, no points up front, a fixed rate conversion option, or a short introductory period of a fixed rate followed by ARM terms.[27] Consumers, particularly younger, poorer, less educated, and minority consumers, fare particularly badly when they try to understand even moderately complex products, like an adjustable rate mortgage.[28] African Americans and Hispanics are more likely than not to believe that lenders are required to give them the best possible rate.[29] Current disclosures do not give consumers the basic information they need to be able to assess their interest rate exposure[30]; there is no disclosure of the maximum payment. Given both the riskiness and the complexity of

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http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

[26] *Cf.* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609, 58614 (Oct. 4, 2006) ("Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.").

[27]. *See, e.g.*, World Savings, Loan Features, available at http://www.worldsavings.com/servlet/wsavings/loans-new/popular-combinations.html.

[28] "Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages," p. 3, Consumer Federation of America press release, July 26, 2004, available at http://www.consumerfederation.org/releases.cfm#Consumer%20Literacy (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment).

[29] Mortgage Foreclosure Filings in Pennsylvania:A Study by The Reinvestment Fund for the Pennsylvania Department of Banking, March 2005, at 74 available at http://www.trfund.com/policy/pa_foreclosures.htm, citing Fannie Mae's 2002 National Housing Survey.

[30] @ *See* Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 21-22, 52-54 (2006), *available at* http://www.gao.gov/new.items/d061021.pdf; *see also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Legis. 123, 139-49 (2007) (discussing lack of price transparency).

the products, however, it is implausible that consumers, regardless of the amount of education and disclosure given, could ever protect themselves adequately.[31]

Lenders provide more and better information about the risk of default due to poor or faulty underwriting to investors than they do to consumers. While lenders tell investors that there is a high risk of default at rate reset for a teaser ARM, I have only once had an individual borrower receive even the CHARM booklet. I have never had a borrower receive more loan specific disclosures. Indeed, in litigation, lenders typically resist acknowledging or producing the pooling and servicing agreements and other standard documents that explain and evalutate the risk, although these documents are publicly available due to SEC regulation. We have chosen to protect investors rather than homeowners, although the possible consequences of loss are much greater for the individual homeowner.

The current disclosure requirements for adjustable rate mortgages are inadequate. They are not loan specific, there are few penalties for failing to provide them, and what detailed information is given is not given at closing. Fundamentally, the existing disclosures do not provide consumers with basic information that allows consumers to assess the interest rate risk in a meaningful way.

The existing disclosures, even if given, are of little use to consumers. The creditor does not tell the consumer the critical practical effect of the variable rate feature: what the payment amount will reach if the interest rate adjusts to the maximum. The creditor is required only to disclose the payment that would be required on a hypothetical $10,000 loan if the interest rate went up to the maximum. As is clear from the Consumer Federation of America July 2004 survey, most consumers cannot calculate the payment change for an adjustable rate mortgage. According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate went from 6% to 8% by approximately 30%. Younger, poorer, and less-educated respondents underestimated by as much as 50%.[32] Most consumers minimize the interest rate risk by underestimating the amount by which payments are likely to increase.

[31] *See generally* William C. Apgar, Allegra Calder & Gary Fauth, *Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations* at 50-51 (Jt. Ctr. for Housing Studies, Harvard University, Mar. 2004) (discussing inability of even sophisticated consumers to understand mortgage products); Ronald H. Silverman, *Toward Curing Predatory Lending,* 122 Banking L.J. 483, 546 (2005) (borrowers, due to a variety of psychological effects, tend to underestimate the risk of foreclosure); A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. Marshall L. Rev 19, 42-47 (2004) (discussing limitation of financial literacy and disclosures due to cognitive biases).
[32] "Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages," p. 3, Consumer Federation of America press release, July 26, 2004.

TILA requires a consumer who is entering into a closed-end home-secured loan to be given a second set of disclosures at closing. These disclosures give almost no information about the adjustable rate feature of the mortgage. They do not disclose the maximum payment, the maximum interest rate, or the index used. The creditor only discloses the existence of a variable rate feature: "Your loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier."[33] This uninformative disclosure is placed in a non-prominent spot on the disclosure statement. It refers to disclosures that the consumer may (or may not) have received months earlier, that were not loan specific, and that the consumer is unlikely to have at closing. Even though the actual terms of the consumer's loan are known at closing, the disclosure does not state the maximum interest rate, apply the potential interest rate increase to the consumer's actual principal, or state what the consumer's payment could reach.[34] Although the creditor knows what the maximum payment will be, the creditor does not tell the consumer.

The weak disclosures currently required virtually ensure that consumers will not understand the risks they are facing when they enter into ARMs. The current disclosure requirements are not even sufficient to alert consumers that the interest rate is adjustable. Consumers can and do apply for fixed rate loans, believe they have a fixed rate loan, only to discover upon the first payment adjustment that the loan was an ARM. Even consumers who knowingly obtain variable rate loans are not told the single most important piece of information that they need in order to evaluate the riskiness of the loan - the maximum potential payment. Since consumers are likely to lose their homes if the payment increases to an amount they cannot afford, they should be given this information. The failure to give this information may account, in part, for the high rates of default among subprime ARMs relative to fixed rate subprime mortgages.[35]

Despite repeated requests from consumer advocates, the Federal Reserve Board has failed to require lenders to disclose to consumers the single most important piece of information a consumer needs to evaluate the interest rate risk of an ARM: the maximum possible payment.

[33] Reg. Z § 226.18(f)(2); Appx. H-4(B).

[34] The final disclosures do disclose the payment schedule. However, the disclosed payment schedule is calculated based solely on the index rate then in effect. Only in the case of a teaser rate, that is an initial rate lower than the fully-indexed rate, is there any adjustment in the payment schedule to reflect the adjustable nature of the mortgage.

[35] Statistical evidence suggests that subprime ARMs are significantly more likely to result in foreclosure than subprime fixed rate mortgages. Roberto Quercia, Michael A. Stegman, Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, January 2005, p. 28-29; Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000, July 2003, p. 23.

The proposed statement is unlikely to restrict the flow of credit.
The statement announces itself as largely a reiteration of existing law and guidance; as such, no effect should be expected from its adoption by the agencies. The statement does not impose any substantive limitations on the manner or nature of credit that can be extended and certainly does not impose any new restrictions on credit.

Even if the statement were to undertake the long-overdue and much needed task of substantive regulation of credit, it is unlikely that any such regulation would restrict the flow of credit in harmful ways. The best research to date shows that regulation of credit does not restrict the flow of credit in undesirable ways.[36]

Subprime lending, to the extent it has been used for home purchase lending, has not created sustainable homeownership. It has created serial homeownership. Subprime lending offers none of the possibilities for wealth accumulation promised by sustainable homeownership and it is doubtful whether it achieves any of the social goals promoted for homeownership. It has the costs of both renting with its limited tenure and increasing payments without equity accumulation and the risks of homeownership—a drop in real estate values, a calamitous repair. Evidence is beginning to accumulate suggesting that subprime lending has decreased both minority and low-income homeownership.[37]

To the extent that there is a reduction in credit, the agencies should push for a greater extension of CRA and FHA lending. Subprime lending has largely supplanted FHA lending—although FHA lending is far less risky to homeowners. CRA lending has similarly been shown to perform much better than lending driven entirely by discretionary pricing, based on what the market will bear.[38]

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[36] *See, e.g.*, Raphael W. Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan M. Wachter, State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms (Jan. 31, 2007), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_44_bostic_state_laws_enforcement_mechanisms_1_31_07.pdf.

[37] *See, e.g.*, Geoff Smith, Woodstock Institute, Key Trends in Chicago Area Mortgage Lending: Analysis of Data From the 2004 Chicago Area Community Lending Fact Book 2 (low income homebuyers as a share of total homebuyers declined in the Chicago region from 1999 to 2004, *available at* http://www.woodstockinst.org/.; Ctr. for Responsible Lending, CRL Issue Paper No. 14, Subprime Lending Is a Net Drain on Homeownership (Mar. 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Losership-3-26.pdf.

[38] Sound Loans for Communities: An Analysis of the Performance of Community Reinvestment Loans (Woodstock Institute, Oct. 1993).

The proposed statement is unlikely to reduce the ability of borrowers to avoid payment shock by refinancing.

First, as discussed above, while the risk of payment shock is real, the much larger risk, already in the system, is a continuing domino of foreclosures caused by absent underwriting. To avoid underwriting is to suggest that we build the extension of credit on a continuing pyramid scheme and slight of hand. We will not ultimately stop, although we may delay, foreclosures by allowing refinancing of loans on chimerical terms.

Second, the proposed statement, while praiseworthy in intent, does not reach far enough to have much of any noticeable effect, either for good or ill. Thus, it matters little whether the principles are re-enunciated beyond the subprime market. As the agencies are at pains to point out, the critical elements of the proposed statement are long standing principles of safe and sound and responsible lending.

Conclusion

I thank the agencies for this opportunity to submit comments on the proposed statement on subprime lending and congratulate them again on their efforts to address the risk posed by subprime lending. I hope that the agencies will consider enforceable substantive regulation requiring meaningful underwriting guidelines and meaningful disclosure of the interest rate risk that will protect consumers as well as the legitimate safety and soundness concerns of regulators and investors.

Sincerely,
/s Diane E. Thompson
Diane E. Thompson