

February 27, 2001

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

Re: Regulation Z: Docket No. R-1090

Dear Ms. Johnson:

I am writing on behalf of the Woodstock Institute to respond to the request for comments by the Board of Governors of the Federal Reserve System on changes to Regulation Z under the Home Ownership and Equity Protection Act (HOEPA). HOEPA gives the Board broad regulatory authority over the predatory lending issue.

The Institute has been extremely active in researching and developing policy recommendations regarding predatory mortgage lending and welcomes the Board's consideration of action in this matter. The recent report of the Joint Task Force on Predatory Lending of the U.S. Department of Housing and Urban Development and the Department of the Treasury has confirmed the need for Board action.

The Woodstock Institute has conducted policy research on mortgage credit, fair lending, and community reinvestment for over 25 years. While the Institute recognizes the need for lenders to offer loan products to individuals with imperfect credit, it has found that the home equity loan market has become hypersegmented, with prime lenders focusing on nonminority communities and subprime specialists, many of which have exhibited abusive lending practices, targeting minority neighborhoods. Some of the abuses in the subprime industry are driven by the ability to extract excessive profits from less-sophisticated borrowers and by the very high returns available to unscrupulous lenders and brokers.

The Institute's 1999 report, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, documents the racial hypersegmentation of subprime lending and served as a model for later analyses by the U.S. Department of Housing and Urban Development (*Unequal Burden*) and other groups. The Institute was invited to testify both at the HUD/Treasury Hearing in May, 2000 in Chicago and at the Federal Reserve HOEPA hearing in August, 2000 in Chicago.

Background

Before detailing how the Board should increase and improve its efforts under HOEPA to curb predatory lending, I first want to point out the fundamental structural problems in the subprime market that precipitate the need for stronger regulation.

First, the home equity loan market is not well functioning, especially from the standpoint of a substantial segment of the borrower base – including less-educated, isolated, and elderly subprime borrowers. The subprime segment in particular suffers from market failure deriving from profoundly imperfect and asymmetric information as well as very large negative spillovers, or externalities.

The information problem is due, in part, to the fact that many subprime homeowners are simply not able to grasp basic fundamentals of the mortgage process. While examples of market failure in microeconomics texts tend to deal with differences in the availability of information between the buyer and seller, the problem here is much more fundamental than mere access to information. The problem is one of large and fundamental differences in basic literacy, financial reasoning skills and other cognitive abilities. Even relatively sophisticated and well-educated financial consumers tend not to understand many of the details of their mortgage. But they are able to identify and process basic cost and term issues such as interest rate, points and fees, balloon payments, etc. And, they often have many contacts with those experienced in mortgage issues, who they can turn to for advice.

For many subprime borrowers, fundamental mortgage concepts are not and will likely never be well in their grasp. A few hours of counseling will never compensate for a lifetime of poor education and exclusion from the financial system. At the same time, many of these borrowers are under substantial economic duress, and so are highly susceptible to manipulation by much better informed brokers who are highly compensated merely for selling and closing a loan. These borrowers have real financial needs. But they have few connections to individuals who have skills in negotiating mortgages or in financial matters generally. There are a disproportionate number of victims in the elderly, African-American community. Many of these homeowners bought their homes through seller financing – having earlier been victims of the more traditional form of redlining, and so have had limited exposure to mainstream mortgage markets.

A few minutes of discussion with one or two predatory lending victims is all that is necessary to understand why financial literacy efforts and homeowner counseling, while certainly laudatory, will not solve this problem by themselves. There is too much money to be made by the broker or lender for him to allow the deal to be lost due to the actions of a much less well-rewarded credit counselor. The counselor will usually find she's entered the picture after the homeowner has already been sold on the loan.

The second source of market failure is the externality arising from the trend that has spurred much of the public outrage over predatory lending -- skyrocketing foreclosures. Foreclosure is not a private event, especially in a low- or moderate-income community. It often results in a vacant and later abandoned property, which in-turn leads to blight and then to crime. This affects area property values, business investment, tax base, and overall community health. Because these costs are not internalized into the predatory lending transaction, the under-regulated market results in an excessive consumption of high-risk mortgage debt.

While growing dramatically across all parts of metropolitan America, subprime foreclosures are disproportionately affecting minority and mixed-race neighborhoods, causing them to become unstable. In the U.S. Department of Housing and Urban Development's detailed study of foreclosures in Baltimore from January to March of 2000, subprime lenders were found to account for 45 percent of the foreclosure petitions, even though subprime lenders accounted for only 21 percent of the mortgages originated in 1998 (the most common year for subprime foreclosures in the sample). In predominantly African-American neighborhoods, subprime loans accounted for 57 percent of foreclosures.

Data from the Mortgage Information Corporation show that rates of serious delinquency among C & D-grade loans are 40 to 90 times those of prime loans, respectively. The foreclosure rate for all subprime loans – including the 55 percent that are A- grade -- is 4 times the FHA rate. And FHA is a program whose foreclosures have devastated many urban neighborhoods. These extreme default and foreclosure rates are possible, in part, because market failure allows lenders to charge excessive fees and still tolerate high defaults. The public costs of these defaults and foreclosures are not internalized into the transactions, resulting in excessive and irresponsible lending to homeowners. There are many cases both of lenders lending to homeowners who should not be taking on debt at all and of lenders leaving homeowners with much more debt than they can afford.

The last major structural problem with the subprime lending market is that it is, in effect, separate from the prime market. The refinance market is a classic dual market – highly segmented by race. Prime lenders are generally loath to compete for refinance borrowers in many minority communities for two reasons. First, weak reinforcement of CRA and fair lending laws has meant that prime lenders have generally not perceived an expectation that they should be serving these markets. Second, some prime lenders have argued that it is difficult to compete with subprime lenders who allow mortgage brokers to collect fees exceeding 5 – 10 percent of the loan amount. (This has no credibility, of course, if the lender has a subprime affiliate allowing such fees.)

The market failure in the subprime mortgage industry requires more substantial government regulation than is currently in place. The Federal Reserve is the regulatory agency that has the greatest existing authority to address predatory lending practices. This authority exists under HOEPA, the Home Mortgage Disclosure Act (HMDA), the Community Reinvestment Act (CRA), and the Equal Credit Opportunity Act (ECOA). The Woodstock Institute recommends that the Board use the full extent of its authority to address this national problem, one that has substantially increased since the July 1998 HUD-Fed Joint Report Concerning Reform to TILA and RESPA. With respect to HOEPA regulations, the Board should undertake the following steps to address the predatory lending problem:

HOEPA, the Federal Reserve's Responsibility, and Needed Actions

In passing HOEPA in 1994, Congress granted the Board broad authority to expand the coverage of HOEPA. In a 1998 Report to Congress (Joint with HUD), the Board stated that “abusive practices continue to exist in some segments of the home-equity lending market, demonstrating the need for additional protections.” The Report also stated that it is “unlikely

that improved disclosures alone can adequately protect vulnerable consumers from unscrupulous creditors that engage in deceptive and unfair practices.” Congress also gave the Board an unlimited mandate to prohibit acts and practices that are unfair, deceptive, or designed to evade the HOEPA protections; or to prohibit refinancings of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.

I first take up the issues the proposals the Board raised in its notice. Then, additional steps to improve regulation are recommended.

Points and Fees Trigger

The Board proposes including only one new type of charge in the calculation of HOEPA points and fees: the cost of premiums or other charges for credit life, accident, health, or loss-of-income insurance, debt-cancellation coverage, or similar products paid by the borrower at or before closing. Disclosure should not substitute for legal protections. The Board is correct to find that the cost of these products represent a significant cost of the credit transaction. The Board is correct in stating that “including optional credit insurance and similar products in the points and fees test would prevent a creditor from evading HOEPA by packing a loan with such products in lieu of charging fees that would be included under the current HOEPA trigger.”

Credit insurance is a critical cost of the loan that must be included in the points and fees trigger in order to prevent lenders from circumventing the trigger by packing loans with insurance. Currently, HOEPA rules provide a perverse incentive for originators to sell credit insurance to borrowers. And because originators do not receive the entire premium as commission, the amount of insurance they lump into loans may far exceed the fees they would otherwise charge.

Credit insurance can amount to well more than 10 percent of a loan. Excessive profits to both lenders and insurers drive high-pressure and deceptive marketing of these products. Lenders often receive 40 percent or more of the premium as a commission. Often there are financial ties between the lender and insurer; if not full ownership then some sort of other affiliation. A mutual interest in credit insurance among the underwriters and the lenders was clearly evident at the Chicago HOEPA hearing, during which lenders and lender trade association representatives attempted to aggressively defend the practice of lump sum premiums.

Because single-premium credit insurance is much more prevalent in the subprime market, the product has a marked disparate impact on minority homeowners. Credit insurance is a particularly effective revenue-generating tool among less sophisticated borrowers. More than 40 percent of borrowers with credit insurance either thought it was necessary to receive their loan or are unaware they have the insurance.

There is no justification for not offering monthly premium credit insurance as a separate purchase in the subprime mortgage market. The largest provider of credit life insurance in the country, an affiliate of the Credit Union National Association, primarily offers monthly

premium insurance. Lenders are beginning to admit that they can deliver credit insurance in this way.

The Board asks whether there should be circumstances under which these premiums' costs should be excluded from the points and fees trigger in the event that the consumer receives a notice advising the consumer that she can cancel it and obtain a refund. The Institute strongly opposes such an approach. Disclosures have proven to be an inadequate response to the problem. Such exceptions will dominate practice. Subprime lenders and brokers have been notorious with finagling when, if at all, they provide the HOEPA notices. There is every reason to assume that this behavior will occur regarding a credit insurance notice.

The mere rebate of a portion of the premium does not undo the damage if the premium was financed over the term of the loan. Since the lump-sum premium is part of the principal, interest will continue to be charged on the premium, even after the consumer receives a rebate. The interest charges attributable to the premium itself can be significant. For example, if a consumer borrows \$60,000 for 30 years at 14%, s/he will pay about \$195,900 in interest. If, however, the consumer is sold a credit life policy with a price tag of \$5,000 which raises the same loan to \$65,000, that borrower will pay about \$212,200 in interest. The difference in the interest charges is \$15,300, the interest attributable the insurance premium alone. In addition, loan origination fees and other fees that are calculated as a percentage of the principal will be higher when the credit insurance is financed. These fees, in turn, are often financed, which results in the collection of interest on these fees. This also increases the cost to the consumer.

APR Trigger

The Board proposes to lower the APR trigger to 8 percent over the comparable Treasury rate. The Institute supports this action. Data from the Mortgage Information Corporation suggest that this would increase the portion of the subprime market under the coverage of HOEPA to only about 5 percent. It is estimated that lowering the trigger to Treasury plus 6% would only affect about 25 percent of the subprime market. Therefore, we urge the Board, in addition to lowering the trigger to 8 percent above Treasuries, to recommend to Congress to modify HOEPA to include a threshold of Treasury plus 6 percent.

The Board requests input on whether it should create a different trigger for mortgages that are not in a first lien position. The Institute supports this notion only if the trigger for first mortgages is lowered below Treasury plus 8 percent, and especially if the law is expanded to open-ended credit plans. Home equity lines of credit typically have somewhat higher interest rates. Also, home improvement loans sometimes entail greater costs than refinance loans. And, lenders generally prefer a senior to junior position on collateral.

Disclosures

The Board has proposed changes to the advance notice. The benefits of any additions to this notice should be carefully weighed with the goal of keeping the notice short and understandable. The notice does play a role in protecting homeowners against the worst

abuses in the high cost lending market. If a homeowner can be warned off a bad loan, an improved disclosure is warranted.

The proposed addition of the “total amount borrowed,” as reflected on the note, is merited. Further, moving the current requirement that the balloon payment be disclosed from the Official Staff Commentary to Regulation Z makes sense. All of the mandated information will then be located in one place in the regulation.

The Board seeks input on three questions related to the early warning notice.

- **Regular Payments:** The burden should be on the creditor to comply by obtaining actual, voluntary consent from the homeowner before calculating the regular payment that must be disclosed on the HOEPA notice. The Board should refrain from regulating how the creditors accomplish that task.
- **Tolerances in the HOEPA Notice:** The Institute opposes creating tolerances for the incorrect disclosure of the total loan amount. We have not seen the industry present any evidence that this is a real problem. However, if the Board decides to accommodate the industry on this issue, we strongly urge the Board to adopt the same tolerance standard that Congress did when a homeowner sues for damages under TILA. In that case, TILA permits the finance charge to be off by no more than \$100.
- **Counseling:** The Institute believes that adding information about counseling might be helpful but only if the Board also includes some explanation about why such counseling might be necessary. In other words, the consumer should be warned that this is “A HIGH RATE LOAN.” Without such a warning, consumers will have little or no reason to obtain counseling in this particular transaction, as opposed to others, such as when they purchase a car and finance it. However, the Institute is concerned that this type of pre-loan counseling is not actually available to most consumers. Most credit counseling services and non-profit providers do not assess whether a particular loan will benefit or harm a consumer. Most have not received training as to the “red flags” of a predatory transaction. Even if these providers existed in every community at little or no cost, they are not equipped to provide the necessary assessment. There are also many examples of scam credit repair and for-profit counseling services that are available to take advantage of consumers who do not understand the dynamics of the marketplace.

Substantive Protections

- **Refinancings within twelve months:** The Board’s recommendation to address the problem of loan flipping will do little to stop the practice. First, the 12-month timeframe is too short. A bright-line rule with such a short duration will encourage refinancings on the 366th day or later. Second, the rule should not limit the prohibition to one made by the same or an affiliated creditor. It is common practice for lenders to aggressively market their products to the customers of other lenders. Often, though not always, the same broker is involved and provides the common connection among the lenders and the homeowner. The regulation will grant no

protection to this situation. Third, the proposal contains a major loophole. The same lender or an affiliate may refinance a customer within twelve months if the refinancing is in the borrower's best interest. If this language is retained, the Commentary should also state that it is the creditor's burden to show this.

To provide a more effective disincentive for loan flipping, the Board should limit the amount of fees that can be charged in a refinancing within a two-year period. A lower limit might be placed on refinancing of existing funds, with a higher limit on an increased advance.

- **Refinancing of Certain Low-Rate Loans:** To address the issue of the refinancing of low-rate or no-rate loans, the Board suggests prohibiting creditors in the first five years of a zero interest rate or other low-cost loan from replacing that loan with a higher-rate loan, unless the refinancing is in the interest of the borrower. The Institute strongly supports a prohibition on the refinancing of such loans but recommends changes to the proposal. First, the Institute urges the Board to eliminate the five-year cap and ban the refinancing of these loans period so that none of these homeowners loses the substantial benefit of these loans. Second, the Institute also urges the Board to change the suggested Commentary, which allows the creditor to rely on a statement by the borrower regarding the current rate of interest on their existing loan. Most consumers do not know the interest rate on their current mortgage and do not know where to find it on the loan documents. Frequently, it can only be found on the loan note, which is not a consumer-friendly document. More importantly, the lender should be required to verify this number by asking the consumer to provide the documentation for review. After all, the lender is going to be transforming the best loan products in the country into a HOEPA loan. They should have the burden to determine whether they are violating any substantive prohibition.
- **Repayment Ability:** The Board tinkers with the current rule in HOEPA which prohibits a creditor from engaging in a pattern or practice of extending credit based on the consumers' collateral without regard to the consumer's ability to repay. The proposed Commentary is enlarged to state that whether a creditor has engaged in a pattern and practice depends on the totality of the circumstances in each case. The Commentary then points to cases decided under TILA, the Equal Credit Opportunity Act, the Fair Housing Act, and the Civil Rights Act as guides on this issue. The Institute agrees with the National Consumer Law Center in recommending the adoption of the judicial definition of a pattern under the Racketeer Influenced and Corrupt Organizations Act. The Supreme Court has defined such a "pattern" to mean an arrangement or order of multiple events that is reflective of relatedness and of ongoing practices, as opposed to random or isolated occurrences.
- **No Doc HOEPA Loans:** The Board addresses the issue of "no-doc loans" and verification requirements by creating a presumption in Regulation Z that the creditor violates HOEPA if the creditor engages in a pattern or practice of making loans without documenting and verifying the consumer's repayment ability. First, the Institute urges the Board to simply prohibit no-doc HOEPA loans. Without documentation, there is essentially no limit to the abuse that can occur with high-cost

loans. Given the nature of this lending, this segment of the market is not the appropriate place for the use of no-doc products. Failing such a prohibition, the Institute supports this Board proposal as a helpful way to address the use of “no doc” loans.

Open-End Credit

The exclusion of open-end mortgage loans from HOEPA must be addressed if the law is to remain an effective tool against predatory lending. The Board should make a strong recommendation that Congress fix this loophole through which an increasing number of loans are escaping coverage. In addition, the Board should make it an unfair or deceptive act or practice to structure a home-secured loan as an open-end plan to evade HOEPA. There should also be a rebuttable presumption that a creditor intended to evade HOEPA, if a consumer applies for a closed-end home-secured loan and, instead receives an open-end line of credit that is priced above the HOEPA triggers.

The Need for Further Action

There are a number of areas where the Board should take further action than it has proposed.

Points and fees trigger:

Yield Spread Premiums: The Board decided not to suggest including any points, fees, or other charges that are payable at or before closing into the points and fees trigger, other than credit insurance premiums. In making this decision, however, the Board added a sentence to the Supplementary Information which may foreclose arguments being made in cases that lender-advanced broker compensation payable by the consumer at or before closing are points and fees. However, HOEPA and the structure of the mortgage transactions themselves provide strong support for the argument that these payments are “points and fee” under the statutory definition. Starting with the statute: first, the points and fees must be payable by the consumer at or before closing; second, points and fees include all items added to the finance charge except interest or time-price differential; third, points and fees include all compensation paid to mortgage brokers.

Most lender-advanced broker fees are paid in a lump sum to the broker at or before closing. Such fees are paid or payable by the consumer because the lender advances the payment and subsequently repays itself through monthly payments made by the consumer. This process is identical to the way that all other financed closing costs are re-paid by the consumer. Appraisal charges, settlement agent closing fees, points, credit reports costs, title insurance premiums, etc. are advanced by the lender on behalf of the consumer at or before closing. The lender then reimburses itself through the monthly payments. Thus, the advancement of money to cover these costs and the repayment over the life of the loan is the same in both cases.

The Commentary supports the consumer position on this issue. It specifically addresses mortgage broker fees: “[C]ompensation paid by a consumer to a mortgage broker (directly

or through the creditor for delivery to the broker) is included in the calculation whether or not the amount is disclosed as a finance charge. Mortgage broker fees that are not paid by the consumer are not included.” Yield spread premiums meet this standard when they are paid by the lender to the broker at or before closing. This is the most common scenario. On the other hand, the Commentary recognizes that some lender payments to brokers are not counted, such as volume-based compensation. This type of payment is not repaid by the consumer but is based on the number and size of mortgage loans that the broker places with a particular lender.

The Institute urges the Board to add the following language in the Commentary:

Lender-paid or lender advanced payments to brokers may be counted in the points and fees trigger where the payment was payable by or on behalf of the consumer and at or before closing.

Prepayment Penalties: The Board should recognize prepayment penalties for what they are: deferred fees. Under the current Regulation Z, lenders can simply shift fee revenue into prepayment penalties to avoid coverage as points and fees. Whatever the merit or harm of such fees in the subprime market, they can add as much to the cost of financing as up-front points in many cases. Prepayment penalties of six months of interest are common, which for high-interest loans can easily amount to more than 5 percent of the loan balance.

An analysis by Lehman Brothers shows that, even with a 5 percent prepayment penalty, 53 percent of borrowers will prepay their loan. Thus, there is greater than even odds that the prepayment penalty will be paid. With lower prepayment penalties, the odds will be somewhat higher.

The Board may argue that HOEPA requires points and fees to be items that are “payable at or before closing.” The word payable is more inclusive than the word “paid,” and includes fees that are paid at a future date. The prepayment penalties is payable in the future if the loan is paid off within a certain time period. Industry advocates may argue that a prepayment penalty is not a fee because it is contingent on borrower behavior. This argument is easily resolved. The prepayment penalty can be discounted by a probability of not triggering the penalty, based on the average typical prepayment probabilities (e.g., 50 percent).

At a minimum, the Board should strongly urge Congress to close the loophole in the HOEPA definition of points and fees by including all fees, including those deferred or contingent, in the calculation of points and fees.

Liability for Broker Violations: Brokers account for well over 60 percent of subprime lending activity, and are often implicated in predatory lending cases. Due to the low barriers to entry and exit in the broker business, lenders can identify hundreds and even thousands of brokers to work with. The largest subprime lender in the Chicago market, and one of the largest in the country, utilizes a network of more than 5,000 brokers nationwide. Because brokers are thinly capitalized and come and go so frequently, they provide an effective shield for lenders involved with lending activity violating HOEPA and other laws.

The Board should make lenders funding the loan responsible for the broker's acts and omissions. A key goal of HOEPA was to create mechanisms for the lending industry to police itself. HOEPA has assignee liability already. But the Board's interpretation of HOEPA rarely includes broker conduct in the scope of assignee liability. The Board can address this problem by using its discretionary authority under HOEPA to prevent a lender from making a loan without becoming subject to all claims and defenses that the consumer could assert against the broker. At a minimum, the Board should define "creditor" to include mortgage brokers for the purpose of HOEPA.

We appreciate this opportunity to share our opinions on this important regulatory action. Given the tremendous changes in mortgage markets since HOEPA was enacted, to not act decisively and forcefully in modernizing and strengthening Regulation Z is to be complicit in predatory lending actions and their impacts, including lost homes and devastated neighborhoods.

Sincerely,
Dan Immergluck
Senior Vice President

cc: Malcolm Bush, President, Woodstock Institute