COMMENTS

of the

Center for Responsible Lending,
Consumer Federation of America, and
National Consumer Law Center (on behalf of its low-income clients)

on

Proposed Rules Regarding Regulation Z:
§§ 226.36 (d) and (e)

Docket No. R-1366
74 Federal Register 43232(August 26, 2009)

December 24, 2009

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Introduction and Summary of Recommendations

The Center for Responsible Lending,[1] the Consumer Federation of America,[2] and the National Consumer Law Center (on behalf of its low-income clients)[3] submit the following comments focusing exclusively on two key proposals in the proposed regulation: the rules regarding originator compensation, Proposed Reg. Z § 226.36 (d), and the rules prohibiting steering, Proposed Reg. Z § 226.36(e). The signatories have submitted another set of comments under separate cover discussing the remainder of the significant proposals for changes in the mortgage rules.[4]

These two proposed rules go a long way toward eliminating dangerous, market-distorting practices that significantly exacerbated the current mortgage crisis: the perverse incentives encouraging originators to sell more costly and dangerous loans to customers who could have qualified for lower-cost, less treacherous loans; and the discriminatory practices of originators attempting to maximize their own income.

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[1] The Center for Responsible Lending is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

[2] Consumer Federation of America (CFA) is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

[3] The National Consumer Law Center is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit.

[4] *See* Comments of the National Consumer Law Center (on behalf of its low-income clients), et al, Comments on Truth in Lending, Regulation Z, Docket No. R-1366 (December 24, 2009).

As the Board has noted, practices such as yield-spread premiums (YSPs) and steering are problematic because they create a conflict of interest in the originator-borrower relationship.[5] The best choice for the originator (from a financial standpoint) is not always the best choice for the customer. Yet the customer does not understand that this conflict even exists, and faced with a complex array of products in a complex market, the customer is likely to rely on the originator's advice and explanations.

The result is a "reverse competition" effect where the middlemen's demand, not the consumers' demand, drives the market. As long as the middlemen can shop among lenders across the market and can steer customers to the loan terms that maximize the originator's return, neither ethical, efficient lenders nor careful, responsible consumers can act as a check on that dynamic.

We commend the Board for considering these practices through the eyes of real consumers during its extensive testing program. The devastating consequences of the mortgage market failure are irrefutable proof that we must look at the reality, not just the theory, of the marketplace, and we are pleased that the Board has done so. Most important, the testing revealed that some problems cannot be solved simply through disclosure.[6]

Steering and harmful incentives are closely intertwined, and together they have played a part in the recent market failure. The Board can and should help move the mortgage market back on course. It can do so by enacting strong rules to realign the incentives of originators and consumers.

In this Comment, we make the following recommendations:

<u>Proposed Reg. Z §226.36(d) – Creditor compensation to originators</u>

- The Board should finalize the proposed prohibition against creditors and other third parties paying compensation to loan originators, including employees of creditors, based on the terms and conditions of the loan.

- The Board should delete the example in the Commentary that permits splitting of various fees between up-front fees and a higher rate. That type of arrangement invites continued abuse of back-end compensation and will make enforcement difficult. Instead, the Board should limit the use of YSPs to "true no-cost" loans where there are no up-front fees or prepayment penalties. If it does not, it should

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[5] Federal Reserve Board, Proposed Changes to Regulation Z (Truth-in-Lending), 74 Fed. Reg. at 43240 (August 26, 2009) ("Consumers generally are not aware of loan originators' conflict of interest and cannot reasonably protect themselves against it.").

[6] *See* 73 Fed. Reg. 44522, 44563-65 (July 30, 2008); 74 Fed. Reg. at 43280-82 (August 26, 2009) (citing Macro International, Inc., *Consumer Testing of Mortgage Broker Disclosures* at 27 (July 10, 2008).

at a minimum consider it a violation of the rule to pay a YSP when origination or discount fees are also imposed.

- The Board also should adopt a rule providing that creditors must accept legal accountability for the acts of third-party brokers where a YSP is paid.

- The Board should consider loan principal a "term or condition" upon which creditor compensation is prohibited under the rule.

- The Board should adopt its proposed ban on compensation to originators from both the borrower and the creditor.

- The rule should apply to the entire market, including home equity lines of credit (HELOCs). Problems created by these paid conflicts of interest were not limited to the higher-cost market, nor should the solutions be. Furthermore, exclusions invite evasions. Discrepancies in disclosures and substantive protections between open- and closed-end mortgages will cause more abuses to migrate to the open-end market.

- To facilitate compliance, the Board should expand the Commentary to provide more guidance to the market as to the permissible alternatives for compensation. As the proposed rule notes, a wide variety of fair and rational methods of compensation will be available if the rule is adopted as proposed. The Board should take advantage of this opportunity to encourage the market to use compensation criteria that give originators a stake in responsible, sustainable mortgages by taking loan performance into account.

- Records of compliance should be maintained by all parties subject to the rule for five years. The records should confirm actual disbursals to the originator.

<u>Proposed Reg. Z § 226.36(e) – Steering</u>

- A ban on steering is a necessary corollary to the ban on term-based compensation. A failure to adopt the steering ban would likely have the consequence of undermining the effectiveness of the proposed compensation reform.

- The proposed safe harbor would render the substantive anti-steering rule almost unenforceable without ensuring adequate protection for applicants from the harms of steering.

- Instead, there should be a rebuttable presumption of no steering if the terms and conditions of the loan meet the following standards: market or near-market interest rate; no more than two percent points and fees; no prepayment penalty; fully amortizing payments; underwritten based on full documentation; and fixed rate for at least five years.

I. Background on market incentives and steering

The growth of nonprime lending in the past decade was explosive, with extraordinary and damaging results. Subprime originations grew from $124.5 billion in 1997 to $600 billion in 2006.[7] So-called "payment option" adjustable rate mortgage (POARM) originations, many of which are "alt-A" rather than subprime, jumped from $145 billion to $255 billion in just three years (from 2004 through 2006).[8] The volume of nonprime loans purchased on the secondary market more than quadrupled between 2001 and 2007.

Table 2: Securitization Rates for Subprime and Alt-A[9]

Year	*Rate of MBS issuance*	*Volume*
2001	*45.8%*	*$98.4 billion*
2005	79.3%	$797.4 billion
2006	81.4%	$814.3 billion
2007	92.8%	$432.5 billion[10]

By 2006, nonprime originations outstripped prime originations: $1.6 trillion nonprime ($600 billion subprime and $958 billion alt-A) compared to $990 billion prime.[11]

The housing crisis was *not* the result of millions of Americans suddenly deciding to gamble with their homes. The phenomenal growth in the more costly, riskier loans was more supply-driven than consumer-driven. Rising home values created incentives for

[7] Inside Mortgage Finance: *The 2008 Mortgage Market Statistical Annual* Vol. 1 pp. 217, 229. The evidence is that the rapid expansion of the supply of money from securitization drove the bubble. *See* Atif Mian and Amir Sufi, *The Consequence of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis*, NBER Working Paper 13936 (April, 2008), p.2, *available at* *http://www.nber.org/papers/w13936* (finding that "the expansion in credit supply was driven by a shift in the mortgage industry towards 'disintermediation,' which we define as the process in which originators sell mortgages in the secondary market shortly after origination.").

[8] *Id.*, p. 6.

[9] Inside Mortgage Finance: The 2008 Mortgage Market Statistical Annual Vol. II, p. 3.

[10] Only $22.5 billion was sold in 4Q 2007, after the credit crunch began in August 2007.

[11] Figures compiled from Inside B&C Lending's 2008 Mortgage Market Statistical Annual Report. The alt-A figure includes jumbo mortgages, the increase of which was undoubtedly related to the housing bubble. Although at first blush this component of the nonprime market may seem some steps removed from the perverse incentives addressed in the proposal, they are not unrelated. As we discuss later, originator compensation based on the amount of the loan principal creates an incentive to "upsell" principal (Section III-B). Many claim that as to the chicken-and-egg question of whether the housing bubble or the credit bubble came first, it was the credit bubble that fed the housing bubble. *See, e.g.*, Keys, Benjamin J., Mukherjee, Tanmoy K., Seru, Amit and Vig, Vikrant, *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans* (EFA 2008 Athens Meetings Paper, December 25, 2008), *available at* http://ssrn.com/abstract=1093137; Paul Krugman, *Disaster and Denial* , New York Times (December 14, 2009) (dramatically loosened lending standards resulted in a credit boom and a "monstrous" real estate bubble).

new entrants to the industry to loosen underwriting standards and market alternative mortgage products to the general public as an "affordability product."[12] Consequently, the market for these products expanded rapidly, spanning the subprime, alt-A, and prime markets.[13] These non-traditional mortgage products were increasingly poorly underwritten, and were mass-marketed to homeowners and homebuyers for whom they were ill-suited and by whom they were poorly understood. Thus the story of the last decade was the "crowding out" of sensible, responsible, sustainable loans; it was a classic example of Gresham's Law in operation, as bad money drove out good money.[14]

Even former Federal Reserve Board Chairman Alan Greenspan acknowledged that the demand from investors drove the growth in the subprime market:

> "And so you had Wall Street's securitizers basically then talking to the mortgage brokers saying, 'We'll buy what you've got.'…The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size."[15]

The incentives to the front-line originators were designed to bring in more loans to feed Wall Street's insatiable appetite. The dynamics are illustrated in a few simple statistics involving one market leader. According to the New York Times, Countrywide's subprime loans in 2004 were producing gains of 3.64 percent compared to only .93 percent for prime loans and, just before the collapse in mid-2007, 2 percent for subprime

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[12] John. C. Dugan, Comptroller of the Currency, Remarks before the Consumer Federation of America (Dec. 1, 2005) at 10, *available at* http://www.occ.treas.gov/ftp/release/2005-117a.pdf. *See also* Allen J. Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, Consumer Federation of America at 5, citing "Financing Options for Home Buyers," KGO-TV San Francisco (Apr. 6, 2005) (A mortgage professional recommended, "If you are just getting into a home and you really need every single edge you can get, then an interest-only loan is the way to go."); Prashant Gopal, *The Next Real Estate Crisis*, Business Week (June 5, 2008) ("Option ARMs, which were originally designed for self-employed people with fluctuating incomes, gained popularity with other workers during the peak of the real estate boom in 2004, when rapidly rising home values would have otherwise kept many buyers out of the market.").

[13] *See* Office of Thrift Supervision, "Option ARMS: Part One," The Quarterly Review of Interest Rate Risk, Vol. 10, Iss. 2 at 3 (2005), *available at* http://files.ots.treas.gov/11520.pdf. According to the OTS, POARMs made up less than 5 percent of all mortgages during the first half of 2004 but accounted for 25 percent of prime and alt-A mortgages by mid-2005); 73 Fed. Reg. at 44524 (the share of interest-only mortgages with low or no documentation in alt-A securitized pools increased from around 64 percent in 2003 to nearly 80 percent in 2006.); 73 Fed. Reg. at 44541 (Option ARMs and interest-only loans accounted for 78 percent of alt-A originations in 2006).

[14] *See, e.g.*, Testimony of Patricia McCoy, Professor of Law, University of Connecticut Law School, Before the U.S. Senate Banking Committee (March 3, 2009), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=11be680d-04db-42cc-89bf-7fe4ffe4d9cd&Witness_ID=b6ba604a-d441-43e3-9951-1fbab4b11e57.

[15] "The Oracle Reveals All," Newsweek (Sept. 24, 2007).

versus .82 percent from prime.[16] Not surprisingly, both its brokers and its in-house loan officers were rewarded most for the riskiest loans and least for the most stable products: broker commissions were as much as 2.5 percent for POARMs and1.88 percent for subprime loans, but just 1.48 percent for standard, fixed rate loans.[17] With these incentives in place, Countrywide issued $70 billion in POARMs in 2006 – far outstripping its closest competitor, Washington Mutual, which weighed in at $41.11 billion – and heavily contributing to its whopping 17.7 percent market share in nontraditional loans that year.[18] It was number three in subprime originations from 2004 to 2007.[19]

While the incentive structure encouraged the originators to push risky loans on their customers, the customers had little ability to push back. The complexity of these products made it difficult for home buyers and refinancing homeowners to operate as a meaningful check on these products and practices. The highly distorting impact of the incentive structures created by the industry to encourage delivery of these products and the adverse impact on the most vulnerable communities is both predictable and obvious.

Third-party originators, in turn, looked for those lenders that offered them the best opportunity to maximize their own return on any given transaction, leading to a "reverse competition" problem of bad lenders crowding out the good: responsible lenders lost market share as third-party originators steered the consumers elsewhere. Even in the aftermath of the mortgage meltdown, we still see this principle in action.

All these dynamics feeding on each other led to the race to the bottom, where it all collapsed. The end result of these market distortions is all too evident to the world now. Millions of families, disproportionately families of color, have lost significant wealth. Foreclosures spiral out of control, depressing the overall housing market and making economic recovery difficult. Compared to the consequences that have played out, the Board's proposals for reforming originator incentives constitute crucial yet comparatively modest adjustments to the market.

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[16] Gretchen Morgenson, *Inside the Countrywide Spending Spree,* New York Times (August 26, 2008).

[17] *See* Ruth Simon and James R. Hagerty, *Countrywide's New Scare – Option ARM Delinquencies Bleed Into Profitable Prime Mortgages,* Wall Street Journal (Oct. 24, 200; s*ee also* Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender,* New York Times (Nov. 11, 2007) (former employee discussing compensation system).

[18] I Mortgage Market Statistical Annual: 2009, p. 147. It had a 17.7 percent market share for non-traditional loans in 2007. I 2009 Mortgage Market Statistical Annual, pp. 212-219. Nearly twice as many respondents to a 2006 Broker Survey ranked Countrywide as the most frequently used lender for POARMs as they ranked the survey's number two, Washington Mutual. Inside Mortgage Finance/Campbell Communications, *How Mortgage Brokers View Alt A Marketplace & Lender Relationships: Summary Report*,.at 17, 21 (November, 2006).

[19] *Id*.

II. Creditor-paid compensation based on terms or conditions of the loan results in much higher-cost loans to consumers than they would otherwise have received and does not provide consumers with any benefit in return.

The Board has ample justification for promulgating a strong and effective ban on creditors compensating originators based on the terms or conditions of a loan. The Board's supplemental information lays out the basic case for the proposal under the applicable three-pronged unfairness test. It is clear the compensation practices that evolved with the rise of the nonprime market caused substantial injury and brought few benefits, as a brief review of the evidence demonstrates.

A YSP is an upward adjustment to the interest rate that the borrower would normally pay for a loan based on creditworthiness and loan features. In the prime market, at least theoretically, the YSP was intended to be used at the borrower's choice as a trade-off against up-front mortgage origination fees, with the borrower financing up-front costs by agreeing to a higher rate loan instead of paying cash or adding the origination costs to the loan principal.[20]

However, this trade-off has not been substantiated empirically. As things in the market have played out, YSPs have been found to *increase* mortgage costs.[21] Borrowers typically end up paying both direct fees and YSPs, and there is little reliable evidence for any price trade-off. A CRL study released in 2008 showed that brokered loans, when compared to direct lender loans, cost subprime borrowers additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan. Even over a four-year period (a typical length of time that many people stay in their mortgage), the subprime consumer pays over $5,000 more for brokered loans.[22] Overall, we estimate that borrowers paid almost $20 billion ($19.8 billion to be exact) in extra

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[20] It is worth noting that paying up-front costs in cash at closing was virtually non-existent in the subprime market.

[21] *See, e.g.*, Howell E. Jackson, Professor of Law, Harvard Law School, Testimony Before the Senate Banking Committee (Jan. 8, 2002) ("Homeowners who are short on cash could, theoretically, use YSPs to finance settlement costs. My study, however, offers compelling evidence that YSPs are not being used in this way."), *available at* http://banking.senate.gov/02_01hrg/010802/jackson.htm#N_1_. *See also*, Michael LaCour-Little, *The Pricing of Mortgages by Brokers: An Agency Problem?*, 31 Journal of Real Estate Research 235 (2009) (Three-quarters of borrowers who used a broker paid more for their loans than borrowers who acquire loans directly through the lender, paying an average of twenty-five basis points more); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harvard J. on Leg. 123, 139 n. 94 (2006).

[22] *Steered Wrong: Brokers, Borrowers, and Subprime Loans*, Center for Responsible Lending (Apr. 2008), *available at* http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf. Also, according to the Mortgage Bankers Association, mortgage brokers originated the majority (71percent) of subprime loans. MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006, *available at* http://www.mortgagebankers.org/files/Bulletin/InternalResource/44664_September2006-ResidentialMortgageOriginationChannels.pdf.

interest on loans originated between 2004 and 2006 because they received their loans from brokers, a cost borne primarily by subprime borrowers.

Another study found that borrowers generally paid $1 in YSPs for between 20 and 35 cents in reduced fees.[23] Furthermore, HUD recently cited extensive evidence suggesting that, even in the prime market, borrowers with YSPs pay more in aggregated fees, interest, and other closing costs than borrowers who do not pay YSPs.[24] This evidence that the trade-off is more rationalization than reality for the YSP has more than economic significance: if the premium is simply payment by a lender to an originator to deliver a higher-rate loan, then it could arguably cross the line between compensation and kickbacks that would render it a violation of RESPA.[25]

Compounding the impact of YSPs is the fact that lenders' pricing systems frequently tied them to prepayment penalties. Prepayment penalties have a long history in connection with abusive YSPs. These costly penalties lock borrowers into these loans, imposing a steep "exit tax" that operates as a back-end fee. Many subprime lenders limited YSPs unless the originator also locked in the rate with a prepayment penalty so that the borrower could not refinance into the lower cost loan he or she should have received, and therefore many borrowers were placed into loans with those penalties to maximize the brokers' own compensation. (Most borrowers who received subprime loans then ended up paying the prepayment penalty, so they received no benefit from any purported trade-off). The incentive system, then, gave brokers the incentive to sell loans that cost the borrowers more at both the front and the back-end.[26]

Uncoupling prepayment penalties from YSPs restores market competition based oversight of the practice. Even if an originator receives a YSP for selling a borrower a more expensive loan than he or she qualified for, without a linked prepayment penalty, that borrower can refinance into the cheaper loan later.

The Board's proposal to level the playing field by including employees of creditors within the scope of the rule is appropriate, for employee-originators respond to incentives just as third-party originators do and loan officer "overages" can have the same unfair

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[23] Howell E. Jackson and Jeremy Berry, *Kickbacks or Compensation: The Case of YSPs*, 12 Stan. J. L, Bus & Fin. 289, 353 (2007) [hereinafter "Kickbacks or Compensation"].

[24] *See* U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-43 (2008). *See also* Kickbacks or Compensation.

[25] 24 U.S.C. §260. *See* III-A for further discussion of RESPA and YSPs.

[26] For a more complete explanation of the prepayment penalty and its interaction with YSPs, *see* Comments of the Center for Responsible Lending on the Home Equity Lending Market, Federal Reserve Board Docket OP-1288, at pp. 11-19 (Aug. 15, 2007) *available at* http://www.responsiblelending.org/pdfs/crl-frb-comment-aug-15-2007.pdf, and Comments of the Center for Responsible Lending on Proposed Rules Regarding Unfair, Deceptive and Abusive Lending and Servicing Practices, at pp. 34-42 (April 8, 2008), *available at* http://www.responsiblelending.org/pdfs/fed-udap-comments-final-040808.pdf.

impact on consumers as YSPs.[27]

Because of the complexity of pricing and the impact of hidden incentives, consumers are unable to avoid these substantial injuries. The testing of disclosures with focus groups and the interviews of individual consumers (including sophisticated, professional consumers) about their understanding of YSPs has already given the Board a good understanding of the inability of consumers to avoid the injuries caused by these perverse incentives. That testing made it abundantly clear there is virtually no way to explain all the pricing complexity behind originator compensation in a way that enables consumers to make an informed choice.[28] Rate adjustments are known to the originator but not to the borrower. Furthermore, with the risk layering for various factors (i.e. loan to value ratio, credit score, fees, documentation, etc.), multiple adjustments can be made for various features, sometimes counteracting each other: some would move the rate up a few basis points, while another (in theory) would move it down.

The case is clear for a strong ban on creditor-paid compensation to loan originators based on terms or conditions of the loan. We believe that the Board's basic proposed rule is a major step in improving market operation, although improvements are needed to ensure that the rule will have its intended effect.

III. The Board should prohibit creditor-paid compensation based on the terms or conditions of the loan. This common-sense limitation will permit ample originator compensation while encouraging responsible, sustainable lending.

A. Prohibiting creditor-paid compensation to all loan originators based on the terms or conditions of the loan removes perverse incentives while preserving payment options for both the originator and the consumer.

CRL urges the Board to finalize a strong, effective prohibition against creditors and other third parties paying compensation to loan originators based on the terms and conditions of the loan. The ban is a common-sense approach that will discourage a return to the market-distorting practices of the past years.

We also support applying the rule to originators who are employees of creditors as well as to third-party originators. Retail originators are equally adept at providing perverse incentives to their employee-originators. For example, the incentive arrangements that Ameriquest used in its retail channel were a factor in encouraging the abuses that led to the states' multi-million enforcement action.[29] The affidavits of former employees

[27] *See* Federal Reserve Board, Proposed Changes to Regulation Z (Truth-in-Lending), Press Release (July 23, 2009), Supplementary information to Section 36(d), Prohibited Payments to Loan Originators, pp. 191-192.

[28] See note 6 above. After its testing, the Board withdrew a proposal to solve the problems created by YSPs through disclosure alone. 73 Fed. Reg. 44522, 44563-65 (July 30, 2008).

[29] *See, e.g. Iowa v. Ameriquest Mortg. Co., et al.* Civ.No. CE 53090, Consent Order, Par.IV-N, O (barred incentives to encourage employees to include prepayment penalties, higher rates, or higher fees to increase

submitted in connection with a pending lawsuit against Wells Fargo also provide dramatic evidence of the distortions that result from incenting employees to steer customers to higher priced loans.[30] At many community banks, commission-based compensation, where these factors can most easily affect the originator's earnings, was more common than salaries.[31]

Much of the opposition to reform of the originator compensation system boils down to a simple assertion: "This is the way it's been done." Yet if ever there was a time to look at entrenched practices in the market, the time is now. If we find that practices contribute to a healthy, well-functioning market, then there is no reason to cast them aside. But if where, as here, practices have led to serious problems in the market, regulators must step in. YSPs, overages, and other forms of creditor compensation to originators based on the terms of the loan have harmed the market far more than they have helped it, and it is time for reform.

In several places in the NPRM, the Board asks, in effect, whether the compensation and steering proposals will disrupt the market. In our view, the market has been so badly disrupted already in part by compensation practices that the better question is whether changing originator practices will help *restore* the market in a way that produces sound, sustainable lending. For the most part, we believe the answer to that question is yes, particularly if the Commentary on the new rule is changed as we discuss in Section A-1 below.

Some opposition to this proposal stems from a misunderstanding of the proposal itself. The YSP can still be used for its purported purpose: enabling consumers to choose between paying origination charges up-front fees or through a higher rate.[32] Originators can still be fairly compensated for their work. Creditors can still offer incentives to originators to deliver quality loans. Even the standard percentage-based fee can still be used (whether for good or for ill) in direct broker-borrower compensation agreements.

Notably, the Board's proposal is consistent in many ways with HUD's existing regulation of YSPs through RESPA. According to HUD policy statements, YSPs to brokers are

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their compensation; also barred setting sales quotas that would employees to complete an unreasonable minimum number of loan applications or closings), *available at* http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_CJ.pdf. Public enforcement consent orders typically include denials of wrongdoing, but injunctive provisions are good indicators of the practices at issue.

[30] *See*, e.g. *Mayor and City of Baltimore v. Wells Fargo Bank, N.A.* Civ. No. L-08-62, declarations of Elizabeth M. Jacobsen and Tony Paschal, *available* on http://www.relmanlaw.com.

[31] *Sales Talent,* Inside Mortgage Profitability (December 16, 2005) (an annual compensation survey by America's Community Bankers found commissioned loan officers outnumbered salaried loan officers by two to one).

[32] Proposed OSC §226.36(d)(1)-5, 74 Fed. Reg. at 43408.

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allowable only when they are used as an alternative way to pay up-front costs for services actually performed, but not when they exceed the reasonable value of those services.[33]

The Board's rule works in parallel with the HUD rule. First, it creates a level playing field among originators.[34] Second, it clarifies when a YSP is not a kickback, which is useful in light of HUD's policy statements on this issue. Most important, it breathes new life into the long-standing but long-ignored principle that a method of payment should not create a conflict of interest between originators and customers.

1. To avoid undermining the rule, the Board's Commentary should prohibit any split of compensation between up-front origination fees and a higher interest rate.

While we are strongly supportive of the basic rule, as proposed, we are concerned about the example in the proposed Commentary that suggests it is permissible for the consumer to split their payment of any origination costs between up-front payment (through cash or proceeds) and on the back-end through a higher rate. These few Commentary sentences could undermine the effectiveness of the rules themselves.[35] The Board already has recognized that allowing payment from both the borrower and the creditor must be prohibited.[36] In our view, split payments even when the originator's compensation is from either the lender or the borrower but not both could equally undermine the rule and make monitoring and enforcement very difficult.

The Board should delete its split payment example and instead clarify that regardless of the source of the payment, trading up-front fees for a higher interest rate should be considered permissible under the rule only when that trade-off is a complete trade-off and

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[33] HUD *Real Estate Settlement Procedures Act Statement of Policy 2001-1, Clarification of Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b)*, 66 Fed. Reg. 53052 at 8-9 (October 18, 2001) *available at* http://portal.hud.gov/portal/page/portal/FHA_Home/lenders/mortgagee_letters/2001_mortgagee_letters/01-26att.pdf (When YSPs are used to "enhance the profitability of mortgage transactions without offering the borrower lower up-front fees….[serving] to increase the borrower's interest rate and the broker's overall compensation, without lowering up-front cash requirements for the borrower," the resulting compensation may exceed the reasonable value of the services, and therefore violate RESPA.).

[34] RESPA's anti-kickback rules do not apply to retail employee-originators or correspondent wholesale transactions.

[35] 74 Fed. Reg. at 43408 ("Section 226.36(d)(1) does not limit the creditor's ability to offer a higher interest rate in a transaction as a means for the consumer to finance the payment of the loan originator's compensation or other costs that the consumer would otherwise be required to pay directly (either in cash or out of the loan proceeds). A creditor may charge a higher interest rate to a consumer who will pay fewer of the costs of the transaction directly, or the creditor may offer the consumer a lower rate if the consumer pays more of the costs directly. For example, if the consumer pays half of the transaction costs directly, the creditor may charge an interest rate of 6 percent but, if the consumer pays none of the transaction costs directly, may charge an interest rate of 6.5 percent").

[36] 74 Fed. Reg. at 43284.

when there are no up-front costs (except government fees) and no prepayment penalties.[37] We recommend precluding the prepayment penalty even if the YSP size cannot be conditioned on its existence, because prepayment penalties are essentially back-end fees. Since they are theoretically offered in exchange for lower rates, the result of having one price point that raises the rate and a second that in theory lowers the rate would make the decisions facing the consumer extremely confusing.

As the Board has explained in connection with the ban on both consumer and creditor compensation to the originator, permitting a partial trade-off reduces borrower understanding of the trade-off and offers an easy way for originators to upsell a loan rate. Studies based on consumer testing have shown that weighing the value of multiple trade-offs is difficult and confusing.[38] And, as we noted earlier, evidence suggests that, even in the prime market, borrowers with YSPs pay more in aggregated fees, interest, and other closing costs than borrowers who do not pay YSPs.[39]

Moreover, it is a simple matter to inflate origination fees or pack in more junk fees, resulting in the consumer paying a higher rate while realizing no genuine trade-off in fees.[40] A partial fee-rate trade rule would therefore invite a return to the same kind of abuses that this rule is trying to prevent.[41]

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[37] This is consistent with our Comments to the Board's proposed HOEPA UDAP rules last year. We suggested as an alternative to a complete ban on YSPs that they be permitted only where there were no points or discount fees, no other compensation to the origination, no prepayment penalties, and no closing costs, except for fees to government officials or amounts to fund escrow accounts for taxes and insurance. *Comments of the Center for Responsible Lending on Proposed Rules Regarding Unfair, Deceptive, Abusive Lending and Servicing Practices,* p. 29, Docket R-1305 (April 8, 2008).

[38] James M. Lacko & Janis K. Pappalardo, Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* at 74-76 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (''[R]espondents had more difficulty recognizing and identifying mortgage cost in the complex-loan scenario. This implies that borrowers in the subprime market may have more difficulty understanding their loan terms than borrowers in the prime market. The difference in understanding, however, would be due largely to differences in the complexities of the loans, rather than the capabilities of the borrowers.''). *See also* Ren S. Essene and William Apgar, "Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans," Joint Center for Housing Studies. Harvard University (2007).

[39] *See* Susan Woodward, *A Study of Closing Costs for FHA Mortgages*, HUD Office of Policy Development and Research (May 2008). In the regulatory review accompanying the issuance of their recently-enacted proposed rule in March 2008, HUD cited extensive evidence to the fact that even in the prime market, borrowers with YSPs pay in the aggregate more in fees, interest, and other closing costs than borrowers who do not pay YSPs. *See also* Kickbacks or Compensation.

[40] The same kind of dynamic operates in the auto sales market where there are many interrelated price points, according to advocates and investigators familiar with auto finance practices. A dealer may nominally offer a good price on the trade-in, but simultaneously raise the cash price of the car, or pack in more add-on charges to "swallow-the trade" and deprive the buyer of much of the value of that "good price" on the trade-in. It may happen even with a cash down-payment, with the down-payment dollars being applied against inflated price points elsewhere in the deal, to "swallow" the down-payment.

[41] The Board's concern with disclosures focused more on the inability of disclosures to convey information about the potential conflict of interest, than on consumer ability to weigh different price points. 74 Fed.

By contrast, there is empirical support for the proposition that the benefits of a fee-rate trade are found in true no-cost loans in which all up-front fees are pushed into the rate. Studies done in conjunction with RESPA proposals found that consumers appear to maximize their shopping return with no-cost loans – and what's more, racial disparity in pricing appears to vanish.[42] The true no-cost loan is the only instance in which consumers actually benefit from the option to pay origination costs indirectly through the rate.

It is within the Board's unfairness authority to make the distinction between true no-cost loans and other types of payment arrangements. By making clear that a fee-rate trade-off is permitted only in true no-cost loans, the advertised benefits would remain available without opening the door to continued abuses and conflicts of interest.

There are other benefits to consumers and competition from imposing this limitation in the Commentary as well. No-cost loans help realign creditor incentives with borrower interests because the profit comes from the longer-term rate stream and depends on favorable loan performance. In fact, one option for encouraging sustainable lending would be for originators as well as creditors to be paid based on long-term loan performance rather than an up-front payment at closing.[43] This type of payment is far more consistent with the goals of the rule than allowing both front-and back-end payments, which will likely perpetuate consumer confusion and a "something-for-nothing" deal that provides only phantom value.

> ***Recommendation: Replace the first three sentences of proposed Commentary §226.36(d)-5 with:***
>
> *Section 226.37(d)(1) does not limit the creditor's ability to offer consumers the option to pay the originators' compensation costs and other up-front charges*

Reg. at 43280-82. *See also* Macro International, Inc., *Consumer Testing of Mortgage Broker Disclosures* at 27 (July 10, 2008), available at *http://www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf*; James M. Lacko & Janis K. Pappalardo, Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* at 24–26 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (FTC staff study found that consumers presented with mortgage loans with more complex terms were more likely to miss or misunderstand key terms)**.**

[42] U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev.& Research, RESPA Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis: Proposed Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs 2-43 (2008).

[43] Recently HUD Secretary Donovan expressed support for giving originators a stake in the outcome by paying the broker's fee over time, instead of at closing. Alan J. Heavens, *Federal Housing Administration to Play Expanded Role*, p C01, The Philadelphia Inquirer, June 19, 2009. The indirect auto finance market often does this. Dealer compensation, or some portion of it, is held back in reserve, subject to performance during a specified period of time.

indirectly through a higher interest rate rather than pay them directly either in cash or out of the loan proceeds. However, to avoid evasion of the compensation rule and to ensure that the higher rate is a substitute for, not an addition to, up-front costs, the originator's compensation and other up-front costs may be paid through a higher rate only if the following conditions are met:

> *(i) the mortgage broker receives no other compensation, however denominated, directly or indirectly, from the consumer, creditor, or other mortgage originator;*
> *(ii) the loan does not include discount points, origination points, or rate reduction points, however denominated, or any payment reduction fee, however denominated;*
> *(iii) the loan does not include a prepayment penalty; and*
> *(iv) there are no other closing costs associated with the loan, except for fees to government officials or amounts to fund escrow accounts for taxes and insurance.*

2. The Board should also ensure the integrity of the rule by providing that creditors are liable for the acts of third-party originators where a YSP is paid.

In addition to prohibiting creditor-paid compensation that varies with terms or conditions, the Board also should provide that lenders are liable for the acts of any brokers who receive such compensation.

Although the Board has chosen to extend its prohibition on certain types of compensation to all originators, not just mortgage brokers, brokers are inherently in a different position from loan officers in that the creditors who pay them also argue that they bear no legal responsibility for their actions. Thus, as an extra safeguard against broker misconduct, the Board should hold lenders liable for the misconduct of brokers to whom the lender pays a yield-spread. This action is well within the scope of the Board's authority to declare certain acts or practices "in connection with mortgage loans" to be unfair or deceptive or, in connection with refinancings to be "not in the interest of the borrower" under 15 U.S.C. § 1639*l.*

The Department of the Treasury has made a similar suggestion in connection with a review of regulations governing high-cost loans that the Board use its HOEPA authority to impose supervisory obligations on lenders for the conduct of brokers originating target loans.[44] Treasury requested that the Board "prohibit, as an unfair practice and a practice not in the interest of the borrower, a lender from funding a high-cost mortgage or refinancing arranged by a broker who violated an applicable state or federal law in the course of arranging the loan unless the lender had reasonably supervised the broker."[45]

[44] *See* Dept. of the Treasury, *Comments on Regulation Z, Docket No. R-1090,* p. 13-15 (January 19, 2001).

[45] Id.

The proposal further offered suggestions of evidence that could establish "reasonable supervision" and noted that the "contours of the duty" could be established through private actions and state attorney general actions, as well as FTC and regulatory enforcement actions.[46]

It has also been established in closely analogous circumstances that the practice of trying to insulate from liability lenders to whom originators bring borrowers is "unfair or deceptive" within the meaning of the FTC Act. The recommended rule would operate to impose derivative liability in a fashion similar to the FTC Preservation of Claims and Defense Rule, which holds that it is an "unfair or deceptive practice within the meaning of Section 5 of [the FTC Act]" for a creditor to take the benefit of seller-arranged credit without accepting liability for the seller's conduct.[47] For example, a home improvement mortgage lender is liable for the conduct of a home improvement contractor who simply refers the consumer to the lender.[48] This FTC rule has been in place for over 30 years without harm to the retail credit market. The YSP paid by the lender to the broker is a deeper and more direct tie between the lender and the originator, and it would certainly be deemed sufficient to impose lender liability for seller conduct under the FTC rule.

Imposing such liability also would reinforce guidance provided by the federal banking agencies. Noting that "institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans," the agencies have admonished lenders to "have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws."[49]

Whether the lender directly originates an abusive loan or funds an abusive loan originated by a broker, the borrower suffers injury and the lender gets the asset. Moreover, lenders, who are mortgage professionals themselves and who are repeat users of brokers' services, have the expertise, the leverage and the capacity to exercise oversight of the brokers with

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[46] Id.

[47] 16 C.F.R. 433. Please note that while we believe an explicit lender liability rule is important, there may already be circumstances under existing law where the lender may have liability for broker conduct through such theories as agency, aiding and abetting, civil conspiracy, or similar laws.

[48] 16 C.F.R. § 433.1(d), (g).

[49] Nontraditional Mortgage Guidance at 15; s*ee also* Statement on Subprime Mortgage Lending (June 2007) at 15; s*ee also* Mark W. Olson, Governor of Federal Reserve Board, "*Before the Consumer Bankers Association 2005 Fair Lending Conference, Arlington, VA*" (November 7, 2005), available at: http://www.federalreserve.gov/boarddocs/speeches/2005/20051107/default.htm (commenting on the need for "diligence and regular testing of its broker channels to verify that third parties are acting in accordance with your policies" and for lenders to "use brokers and correspondents to monitor the quality of loans by origination source in order to uncover problems and take appropriate action--including terminating the relationship--against any third-party originators that do not produce quality loans.").

whom they do business. Consumers do not. The costs of a lender's failure to do so should therefore be borne by the lender, not the consumer.

Allowing lenders to obtain the benefit of broker misconduct without associated liability distorts the market and substantially undermines the effectiveness of any regulations. It also leaves borrowers without adequate remedies. Brokers are typically thinly capitalized and transitory, leaving no assets for the borrower to recover against. Even more problematic are the hurdles that unclear lender liability creates as borrowers seek to defend foreclosures on the basis of origination improprieties. Although this is true of any brokered loan, it is particularly unfair to let lenders who have provided financial incentives that generate a conflict of interest between the broker and the borrower to deprive the borrower of the right to meaningful relief.

<u>Suggested Regulatory Language:</u>

It is an unfair and deceptive practice for a creditor or "lender" as defined in 24 C.F.R. § 3500.2 (2007)[50] *to disclaim or otherwise refuse to accept liability for acts, omissions, or representations by a mortgage broker who solicits, sells, or delivers a mortgage loan to or for the benefit of a creditor or lender from which the broker received compensation.*

B. <u>The Board should include loan principal among the "terms and conditions" with which the creditor payment cannot vary. Basing compensation on the principal loan amount creates the same kind of perverse incentives to make a loan more costly than the consumer wants or needs as other term-based compensation does.</u>

<u>Board Questions</u>:

- Should creditor or other third-party compensation be permitted on the basis of the loan amount?
- Would prohibiting compensation on this basis be unduly restrictive and unnecessary to achieve the purpose of the proposed rule?

<u>Response:</u>

Creditor and third-party compensation should not be permitted on the basis of the loan amount. The purpose of the proposed rule is to prevent perverse incentives that create a conflict of interest between the originator and the customer, and principal-based compensation encourages upselling the loan amount. As a result, homeowners end up

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[50] "*Lender* means, generally, the secured creditor or creditors named in the debt obligation and document creating the lien. For loans originated by a mortgage broker that closes a federally related mortgage loan in its own name in a table funding transaction, the lender is the person to whom the obligation is initially assigned at or after settlement. A lender, in connection with dealer loans, is the lender to whom the loan is assigned, unless the dealer meets the definition of creditor as defined under ``federally related mortgage loan" in this section. See also Sec. 3500.5(b)(7), secondary market transactions."

with higher monthly payments, greater debt than they wanted or needed, and an increased loan-to-value ratio that makes refinancing more difficult. Prohibiting such compensation would not be unduly restrictive. As we discuss more fully in Section III-E, there are many ways of compensating originators that do not create a conflict of interest and would encourage more responsible, sustainable loans.

As we observed earlier, the current crisis should lead us to examine established practices with a fresh eye. With this rule, the Board aims to ensure that consumers pay fair value for services fairly rendered. On the contrary, principal-based compensation gives originators an incentive to "upsell the loan amount," as the Board recognized. That, in turn, not only increases any up-front charge that is based on the loan amount, but can also trigger higher risk-based interest rates because it can increase the loan-to-value and the debt-to-income ratios. The resulting higher loan-to-value may also increase the consumer's payments by triggering requirements to pay mortgage insurance premiums. [51]

If the Board does permit compensation based on loan principal, we have an additional concern about abuse other than upselling: the discouraging of originators from originating small-balance loans. The Board implicitly recognizes both of these dynamics in the proposed Commentary to 226.36(d)(1)-10 (alternative 2), when it says that the rule would permit a fixed percentage of the loan amount "subject to a specified minimum or maximum dollar amount," citing an example of an agreement to pay 1percent of the loan amount with a $1,000 floor . If the Board adopts a rule permitting principal-based compensation, we believe that it will be useful for the Board to safeguard against discriminating against smaller loans by permitting a minimum fee. Such alternative minimum fees have been used successfully in many state predatory lending laws in setting fee levels for high-cost loans. However, we oppose the inclusion of a cap, as this could legitimize the charging of cap level fees in most loans even though such fees were unjustified.

C. <u>The Board should adopt the proposed ban on compensation from both the borrower and the creditor</u>.

We strongly support the Board's proposed rule to prohibit third-party originators from receiving compensation from both the consumer and the creditor simultaneously. The Board's supplementary information articulates the case for it. Consumers view third-party originators as professionals offering their best advice, unaffected by conflicts of interest. Consumers frequently do not understand that while they are paying origination fees, the originator may also be receiving compensation from the creditor.[52] Plus, as we discussed more extensively in Section III A-1, when compensation is paid from multiple sources, it is harder for consumers to keep track of the interaction of price points and their impact on the bottom line.

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[51] 74 Fed. Reg. at 43284. The rule against determining originator compensation based on terms such as debt-to-income and loan-to-value does not preclude prevent creditors from setting terms based on risk assessments. *See* proposed OSC 226.36(d)(1)-5, 74 Fed. Reg. at 43408.

[52] 74 Fed. Reg. at 43284.

In our view, mixing and matching compensation sources make it virtually impossible to enforce the creditor-paid compensation rule. If the creditor-paid compensation cannot factor in loan terms, the broker simply adjusts the consumer-paid part of the compensation accordingly, and current market-distorting practices will continue despite the regulation.

D. <u>The prohibition on creditor-paid compensation based on the terms or conditions of the mortgage should apply to all mortgages.</u>

<u>Board Questions:</u>

- Should the compensation rule apply to all closed-end mortgages, or just higher-cost mortgages?
  - What are the costs and benefits of applying the YSP ban to all segments rather than just to higher cost loans?
  - Do the costs outweigh the benefits below the higher-priced threshold?

<u>Summary Answers</u>:

- The rule should apply to all segments of the market. The problem was not limited to higher cost loans, nor should the solution be. Reverse competition, whereby originators look to the lender that serves their best interest, will remain to distort the market if there are gaps in the scope of the rule. Furthermore, because the market is changing and we do not know what will replace it, limiting the rule to one category of loans runs the risk of the rule being anachronistic before becoming effective.

- There are no proven benefits to paying originators more to deliver high-cost, riskier loans, yet the steep cost of those incentives is well known to be a broken market and a resulting foreclosure crisis. To the extent there are benefits in permitting consumers to pay up-front costs through the rate, which is a separate issue from the perverse incentive structures, the rule permits those benefits to continue. Those two issues have been improperly conflated for too long.

1. The rule should apply to all segments of the market. The problem was not limited to higher-cost loans, nor should the solution be.

Even if we were not already seeing problems across all parts of the mortgage market, there is no reason to limit this rule to just the higher-cost segment of the market. Sound, commonsense rules that apply to all players are necessary to avoid providing regulatory incentives to game the system. The rule by no means interferes with an originators' ability – responsibility, even – to provide consumers with any loan product or term that is appropriate to their needs, situation and desires and for which they qualify. The products and terms are not being prohibited, and the opportunity for originators to provide appropriate products and term is unhampered. As long as that is the case, it is appropriate to apply across the board a rule aimed at preventing conflicts of interest. No segment of the market is immune from conflicts of interest, so there is no justification for applying such rules to only part of the market. That is particularly the case where, as here, the consequences of widespread perverse incentives have been devastating across the whole market, the broader American economy, and much of the world.

In addition, the problem was not limited to the higher-cost market, therefore the solution should not be. For example, as we described earlier, Countrywide, a major issuer of POARMs, paid originators a full 100 basis points more for POARMs than other loans. Many POARMs did not breach the higher-priced threshold, yet these products layered risks through virtually every term: one-month teaser rates, adjustable rates, exploding payments, negative amortization, prepayment penalties, and underwriting to the minimum payment rather than the fully amortizing payment. What's more, some 83 percent of POARMs written between 2004 and 2007 were low-and no-doc loans.[53] In response to belated guidance from the bank regulatory agencies on POARMs, Countrywide admitted that few of its originations would have conformed with the guidance. The universe of people for whom such loans are appropriate and understood is relatively, so the only explanation for the explosion in originations is the conflict-of-interest incentives.

The consequences of abuses in the alt-A market are just as devastating to consumers as they are in the higher-cost market. A shocking 72 percent of the 2007-vintage option ARMs remaining is projected to default.[54] Many advocates and public enforcement personnel report seeing applicants offering their originators W-2s but instead being sold no-doc loans and paying an unnecessary premium to do so.[55]

Finally, the rule should apply across the board so it does not become vestigial even before it becomes effective. Some of the products the market was eager to pay a premium for have now dried up as their toxicity took its toll. We do not know what the market will look like when it all settles out. Regulating for yesterday's problems leaves no tools to deal with tomorrow's problems. As we have seen, regulation takes time, and we cannot wait until new problems have become widespread before attempting to prevent them. The purpose of having regulatory authority rather than simply enforcement authority is to prevent foreseeable and predictable market failures. Now, while the market is figuring

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[53] *See* Kathleen Keest, *The Way Ahead: A Framework for Policy Responses* presented at the University of Iowa Housing Crisis Symposium 5 (December 9, 2008) (citing Option ARMs: Its Later than it Seems, Fitch Ratings (September 2, 2008) at 5), *available at* http://www.peri.umass.edu/fileadmin/pdf/conference_papers/SAFER/Keest_Way_Ahead.pdf. . *See also*, Allen J. Fishbein and Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* (Consumer Federation of America, May 2006).

[54] Fitch Ratings, RMBS Loss Metrics (2009).

[55] Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People With Weak Credit Are Defaulting on Mortgages*, The New York Times, January 26, 2007, p.1 (quoting a former mortgage lender CEO: "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?") *available at* http://www.nytimes.com/2007/01/26/business/26mortgage.html?pagewanted=all.

out where it will go next, is the ideal time to set the ground rules that will govern market developments.

2. The benefits of applying the rule to the whole market far outweigh the costs, if any, of doing so.

For too long, the debate over compensation incentives has conflated two separate, but very distinct, issues: creditors paying originators YSPs to enable consumers a choice to finance their loan in that manner, and creditors paying originators compensation based on loan terms that results in consumers being sold wholly inappropriate loans.

The first type of YSP is still permitted under this loan. It is only compensation incentives to originate loans with higher costs and riskier terms, irrespective of the needs and capacity of the borrower, that are banned, and these provide no benefit to borrowers – only costs. For a long time, these costs were limited to the homeowners themselves, who lost equity, income, and even their homes to unnecessarily high costs and fees suffered the costs of those unfair practices. Unfortunately, this cost ultimately redounded to the detriment of the entire housing market and even the broader economy.

Therefore, the question is not whether there is any benefit to ARMs, stated income loans, or prepayment penalties themselves. They are not being restricted. The question is whether there is any benefit to those kinds of loans being written *because the originator gets paid more for them*, regardless of the borrower's needs or capacity. To state the basic question is to answer it: there is no evidence that incentive payment structures that encouraged massive growth in origination of risky loans had any benefit. There is much evidence to the contrary in the default and foreclosure rates, and their spill-over impacts.

However, as we discussed in more detail in Section III-A-1, in a situation where there is split compensation, the lines between the two practices become blurred: was the origination price paid through the rate legitimately set, or was the rate bump really disguising illegal incentive payments? Because the purported trade-off with multiple price points is so complex and difficult to understand, the empirical evidence is that, generally speaking, the benefits of this trade-off are not realized in practice.[56] The only situation in which the theory matches reality is in the "no-cost" loan situation, where there are no up-front fees and all costs are paid through the rate. As we discussed earlier, to be effective, the Commentary must not sanction the partial rate-fee trade but rather limit YSPs to the no-cost situation.

[56] *See* Sec. III-A, above.

E. The rule against creditor-paid compensation based on terms or conditions of a loan should apply to HELOCs.

Board Question:

- "What evidence exists that shows whether loan originators unfairly manipulate HELOC terms and conditions to receive greater compensation, injuring consumers as a result?"

Summary answer:

- The rule should apply to the entire market, including HELOCs. Without full-market coverage to create a level playing field for all lenders, abuses will migrate to the exceptions. It is easily foreseeable that the open-end loophole will be exploited in this case just as the HOEPA open-end loophole was. Further, many HELOCs sold in recent years were not free-standing loans, but 80/20s sold in tandem with closed-end first mortgages, subject to the same marketing abuses.

Unfortunately, we have limited data sources concerning HELOCs, other than knowing that the home equity lending market has moved increasingly toward them, comprising nearly 73percent of home equity loans from 2005-2008.[57] To exclude that large segment from the rule would leave a gaping hole and create an open-ended invitation to evasion.

The Board states that neither proponents nor opponents of excluding HELOCs from the 2008 HOEPA UDAP rules substantiated their positions with evidence.[58] But, given the dearth of real information of HELOCs, the absence of empirical evidence of the sort that has accumulated with closed-end mortgages cannot be assumed to reflect an absence of problems. Indeed, the federal government was too slow to respond to prodding about problems in the subprime market because of the perception that there was no "data," only "anecdotes." Rather than replaying earlier mistakes, the Board should cover HELOCs. There is no cost to treating HELOCs the same as closed-end loans, and much mischief to be prevented. (And if there is insufficient data to document the full extent of problems in the HELOC market, the better road for the Board to take is to find ways to improve the available data.)

The Board failed to ask the more pertinent question: "What are the predictable consequences of creating a loophole in this rule?" It is clear that such a loophole will be exploited. The huge gap in useable information between closed-end and open-end disclosures has created an incentive to abuse the open-end model for decades, as expensive financing is pushed on consumers who get no meaningful payment or price tag information. The information gap creates an opportunity – incentive, even – to misuse

[57] Inside Mortgage Finance.

[58] 74 Fed. Reg. at 43286.

the open-end model, and the HOEPA exclusion for HELOCs creates a second layer of regulatory opportunity for abuse. The 20-24 percent HELOCs that Household piggy-backed with its 12-14 percent refinanced first mortgages and that resulted in loans at 100 percent or more LTVs) were directly attributable to HOEPA's open-end exclusion.[59]

In addition to the growth in the number of HELOCS, in recent years, HELOC pairing with closed-end firsts in piggy-back 80/20's has also grown in the purchase money market. A 2005 report cited data indicating that 10 of the top 20 lenders had more than half of their home purchase loans in piggy-backs, and two of the lenders hit almost sixty percent; HELOCs were "an important component" of the piggy-back loan.[60] When HELOCs are used this way, the borrower draws down the entire line or nearly the entire line at origination.[61] For the borrowers, a HELOC piggy-back may mean more risk: a higher rate, and risk of payment shock. But for the originators and lenders, the author identifies "the potential for increased fee income" as one of the "more obvious explanations for the aggressive marketing of piggy-back loans."[62]

These are in essence single transactions – the sales abuses, the underwriting issues, the origination incentives all blur the lines between the closed-end loan and the HELOC. The borrower gets two loans simultaneously, one with useful information on price and terms, the other without.[63] Since an 80/20 deal is really a patched-together single mortgage, informational gaps and gaps in substantive protections will ensuredly be used and abused in marketing that deal.

More troubling yet is that, with the pair of proposed rules now before the Board, the regulatory and information gap between open- and closed-end is about to become wider. While the Board is proposing significant improvements in closed-end mortgages, its HELOC proposals make a bad situation worse.[64] Closed-end borrowers will get an APR that is a more accurate price tag than ever, along with an extremely useful graphic to let them know where that rate falls on the scale of market rates. The HELOC borrower gets absolutely no effective rate price tag, even though a fully-funded HELOC is functionally little different than the closed end loan. Adding an extra regulatory exclusion from the

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[59] This was one of the issues in the States' action against Household. S*ee*, *see*, *e.g.* State of Iowa ex. rel. Miller v. Household International, Petition, Para. 8(A), (H), http://www.state.ia.us/government/ag/images/pdfs/hhpetition.pdf. These interest rates exceeded HOEPA's APR threshold.

[60] Charles Calhoun, *The Hidden Risks of Piggyback Lending*, p. 5 (June, 2005).

[61] Id at 5.

[62] Id. at 6

[63] Obviously there can be no payment or price tag when one opens a credit card account with no charges on it That uncertainty does not exist when there's a $50,000 draw at origination on a $50,000 HELOC.

[64] *See generally* Comments of National Consumer Law Center (on behalf of its low-income clients), et al on Regulation Z, Docket No. R-1367 (on HELOCs), December 24, 2009.

rule that bans paid conflicts of interest makes abuses inevitable. There is no justification for the Board to issue such an open invitation to undermining its own rule.

The Board's articulated reasons for having more confidence in the HELOC market are not convincing. It explains that first, most HELOCs are portfolio loans, second, that they are "concentrated in the banking and thrift industries where the federal banking agencies can use their supervisory authority to protect consumers."[65] As to the first point, while theoretically portfolio lenders should be more careful, that is not always the case. We noted earlier Household's use of piggy-back HELOCs to make high-rate, high-cost, and high-LTV loans. Household, a market leader, was a portfolio lender – but not a safe one.

Also, there are many who can – and have – taken issue with the notion that the federal supervisory agencies have done an effective job of protecting consumers. The fall-out from "light-touch" regulation – even as to safety and soundness[66] – does not inspire the confidence necessary to let that be the reason to create a HELOC-loophole. The 2005 report on piggy-back loans cited above suggested, in fact, that federal policy makers considering other regulatory changes should take those opportunities "to address some of the unanticipated consequences of the recent rapid growth in piggy-back lending."[67] In short, HELOCs should be subject to both the origination compensation and steering rules.

E. <u>A strong, effective rule as proposed would not unduly restrict the origination market, and the Board should take advantage of this opportunity to move the market t toward fairer, more rational methods of compensation and incentives that encourage sound, sustainable loans.</u>

Some of the criticism – and fear – of the proposal seems based on uncertainty as to what methods of calculating creditor compensation would replace the familiar ones that would be foreclosed by the rule. The fears are not well-founded. Closing the door on creditor compensation that creates a clear conflict of interest steers the market toward methods that are not only fair, but could even engender additional positive incentives.

Direct broker-borrower agreements: Third-party originators can be compensated through direct agreements with their customers. The rule has no impact on how those

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[65] 74 Fed. Reg.REg. at 43286

[66] *See* generally Testimony of Michael C. Calhoun, Center for Responsible Lending, Before the U.S. House of Representatives Committee on Financial Services (September 30, 2009), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/cfpa-calhoun-testimony.pdf.).; Testimony of Patricia McCoy before the U.S. Senate Banking Committee, "Consumer Protections in Financial Services: Past Problems, Future Solutions, " at pp. 20-22, available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=11be680d-04db-42cc-89bf-7fe4ffe4d9cd&Witness_ID=b6ba604a-d441-43e3-9951-1fbab4b11e57.

[67] Charles A. Calhoun, *The Hidden Risks of Piggy-Back Lending*, p. 3 (June, 2005).

two parties set that fee. It only would eliminate the broker's opportunity for double-dipping.[68]

Creditor compensation based on its overall course of business with the originator: Creditors may adopt a variety of ways to set compensation based on aggregate loans. As the Board notes, creditors can recoup origination costs by simple methods such as a constant quarter percent rate premium.[69] But creditors could also use the opportunity to ensure that originators bring in better loans – ones without the high probability of failure that the past system encouraged. The Proposed Commentary cites "the long-term performance of the originator's loans," as a permissible factor upon which to base compensation.[70] There is general consensus that the market felt free to pursue short-term profitability because there was insufficient financial accountability in the system.[71] Too many players, from the originator all the way up the chain, had too little "skin in the game." The common sense solution to that problem is to put in some skin. One way to add skin is by using the performance record of the loans delivered to that lender by the originator. Given recent events, any responsible lender should be looking for ways to do that already.

A performance factor can, and should, overlay many methods by which creditors price compensation based on the aggregate course of dealings with the originator. The proposed Commentary also cites volume-based compensation as an example of a permissible compensation method.[72] Standing alone, volume-based compensation presents its own negative incentives: volume by the number of loans is an incentive to focus solely on quantity, without sound underwriting, the consequences of which we see all around us; volume by dollar amount is an incentive to upsell the principal. But when volume-based compensation also factors in long-term performance, there's a counterbalance to those negative incentives. The Board could encourage lenders to consider coupling volume-based compensation and long-term performance in part by adopting the lender liability rule recommended in Section III-A-2, above.

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[68] Even if the final rule precludes creditor-paid compensation based on loan principal, it would be permitted in the broker-borrower context. Although we have concerns that the same pressures to upsell principal would be present if the borrower pays directly based on principal, there are at least some countervailing pressures in this context. The costs are more transparent, and that transparency may allow competition to work better than it has to keep costs down.

[69] Proposed OSC §226.36(d)(1-5, 74 Fed. Reg. at 43408.

[70] Proposed Commentary 226.36(d)(1)-3(ii), 74 Fed. Reg. at 43408.

[71] This was exacerbated by a lack of regulatory accountability and a lack of legal accountability. *See* Testimony of Michael Calhoun, Center for Responsible Lending, Before the U.S. House of Representatives Committee on Financial Services at 4-8 (September 30, 2009), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/cfpa-calhoun-testimony.pdf.

[72] Proposed OSC §226.36(d)-3(i), 74 Fed. Reg.at 43408.

Tying compensation to performance gives originators incentives to write sound loans, appropriate to the needs and capacity of the borrower. It also gives the creditors a reason – a contractual need, even -- to monitor the performance of the originators, by monitoring the quality of the loans they produce. This kind of oversight has been strikingly absent,[73] and encouraging it is another example of the way performance criteria for compensation can steer the market in a healthier direction.

The expectation of performance and penalty pricing for those who fail to perform is a long-standing practice in the secondary market. Although not precisely the same, the relationship between Fannie Mae and Freddie Mac (the GSEs) and the seller-servicers who sell them loans or securitize loans through them is analogous. In this relationship, the GSE's explicitly require sellers to sign "reps and warrants" that they have followed the companies' underwriting guidelines. Failure to comply can lead to a forced buy-back of the offending loan, a very costly event for the originator and a significant incentive for the GSEs' agents – originators – to ensure that their business processes and underwriting meet the stated standards. This demonstrates that the market can create mechanisms that foster responsible behavior.

Transaction-specific methods of setting creditor-compensation. Finally, the rule does not interfere with a variety of methods for the creditors to price originator compensation on a transaction-specific basis. Here, too, there are viable alternatives which permit fair pricing without the significant side-effects of term-based compensation.

In short, the Board today has a rare opportunity to help steer the reeling market in a more promising direction as it seeks to regain its footing. The mortgage industry relies on the Official Staff Commentary for guidance. The illustrations given therein can either invite circumventions (as we discussed in section III-A), or they can be used to spur innovative thinking toward better results than the past paradigm brought. The Commentary can offer a suggested menu of positive examples and illustrations to help an industry looking for guidance in adapting to a post-implosion, and post-YSP world. Whatever base method is used to compute the level or method of payment, the Board can signal that giving the originators a stake in making sustainable loans is a lesson to be learned from the crisis.

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[73] In recent testimony to the Senate Banking Committee, Professor Patricia McCoy highlighted the folly of creditors' failure to do so: "In 2007, a Wells Fargo prospectus for one of those pools stated that Wells Fargo had relaxed its underwriting standards in mid-2005 and did not verify whether the mortgage brokers who had originated the weakest loans in that loan pool complied with its underwriting standards before closing. Not long after, as of July 25, 2008, 22.77percent of the loans in that loan pool were past due or in default**."** Prepared Statement of Patricia A. McCoy for the Hearing on "Consumer Protections in Financial Services: Past Problems, Future Solutions" before the U.S. Senate Committee on Banking, Housing, and Urban Affairs at 21 (Mar. 3, 2009), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=40666635-bc76-4d59-9c25-76daf0784239**.** Contrast this with the speech of Governor Mark Oldon, quoted in note 51, above, citing the need for lenders to exercise due diligence with respect to its broker channels.

F. **<u>The Board should require that all parties maintain compensation records for five years.</u>**

<u>Board Questions:</u>

- Should records to determine compliance be retained for some other period than the standard two-year requirement for TILA generally? Is two years adequate?
- The creditor must retain a copy of the compensation agreement in effect on the date when the rate was set for the transaction: Is some other date than that more appropriate? In the case of mortgage brokers, the HUD-1 would suffice to document the compensation paid. Are there comparable records for employee-originators that should be referenced in the Commentary?
- Should record retention requirements be imposed on parties other than the creditor?

<u>Summary Response:</u>

- This rule addresses "behind-the-scene" matters between two commercial parties that will be invisible to consumers, and potential violations are unlikely to come to light under the ordinary course of affairs in two years. To ensure the rule is effective, records should be retained for five years.

- The HUD-1 is an insufficient record for these purposes, as HUD-1s are too often inaccurate. Proof of the actual payments should be required by any party giving or receiving the payment.

The effectiveness of this rule depends on adequate enforcement of this rule, and adequate enforcement will require accurate and complete records located only in the hands of people other than the consumer. Records must be available to ensure adequate enforcement through both public and private enforcement mechanisms.[74] While we hope that public enforcement improves, it will never be fully adequate. Resources are too few, even when the will is present for public enforcement. Private enforceability will be the key to keeping this rule from being honored more in the breach than in fact. In the ordinary course of events, few consumers are likely to learn of a potential violation within two years. It is more likely to come to light during some catastrophic failure, such as a foreclosure. In ordinary times, early defaults are not frequent, and a two-year record retention requirement is simply too short to ensure that violations will be detected and acted upon.

We also suggest that the records be ones that reflect the actual disbursal, such as proof of payment by check or electronic payment, or some other document which would be suitable for the creditor's or originator's tax or accounting purposes. The proposal suggests, erroneously, that the HUD-1 would be a suitable record for mortgage brokers "because it itemizes the compensation received by the mortgage brokers." That is the idea behind a HUD-1, certainly. But as a record of actual disbursals in a loan, they are too notoriously inaccurate to serve as a compliance document for these purposes. Those

[74] The rule should be enforceable through 15 U.S.C. §1640.

of us who have had the opportunity to review hundreds of loan files frequently find multiple copies of "final" HUD-1s, all with different numbers. Which, if any, of those "final" HUD-1s reflects the amount the broker actually received is anybody's guess. Only the actual disbursal record or internal files kept by the payer or payee for tax or accounting purposes is reliable and accurate enough to serve for purposes of compliance.

Compliance evaluation will require knowing more than the bottom-line amount paid to the third-party originators, in any event. It is necessary to know, as well, how that amount was arrived at and how it was disbursed. The record retention requirement must cover all records necessary to ensure that the compensation was not based on a prohibited term.

Finally, the record requirement should apply to all parties covered by the rule. As we noted earlier, this rule governs arrangements between parties other than the consumer and that go on behind the scenes. Violations will not be "high-visibility" ones. There is no justification for making creditors but not other parties paying compensation subject to record retention rules.

IV. The Board should adopt the ban on steering, but the safe harbor proposed would be counterproductive and should be replaced with a rebuttable presumption related to the terms and conditions of the loan.

Board Questions:

- Should the Board adopt a ban on steering?
- Would the proposed rule and accompanying commentary be effective in achieving the stated purpose?
- Comment on the feasibility and practicality of the rule, its enforceability, and any unintended adverse consequences it might have.

Summary Response

- A ban on steering is a necessary corollary to the ban on term-based compensation; the unintended consequence of failing to adopt the steering ban would likely be to undermine the effectiveness of the proposed compensation reform.

- The proposed safe harbor would render the substantive anti-steering rule almost unenforceable without ensuring adequate protection for applicants from the harms of steering.

- Instead, there should be a rebuttable presumption of no steering if the terms and conditions of the loan meet the following standards: market or near-market interest rate; no more than 2percent points and fees; no prepayment penalty; fully amortizing; underwritten based on full documentation; and fixed rate for at least five years.

A. The proposed anti-steering rule is an appropriate and necessary corollary to originator compensation reform.

The Board cast its steering rule as an optional proposal. Because steering is inextricably linked to the perverse incentives created by loan originator compensation based on loan terms and conditions, the question is whether a strong, enforceable rule against these incentives alone would be sufficient to protect consumers, particularly the ones most vulnerable to steering. Despite the usefulness of the proposed incentives rule, the steering rule is a necessary corollary to eradicate these insidious practices.

The Board has identified the weak link in the incentives rule: while an originator would receive the same compensation from any given creditor irrespective of the loan's terms or conditions, nothing in that rule would prohibit the originator from "directing a consumer to transactions from a single creditor that offers greater compensation to the originator, while ignoring possible transactions having lower interest rates that are available from other creditors."[75]

Similarly, an originator could steer a consumer away from lenders offering fixed rate loans to ones that only offer ARM variants and/or lenders where prepayment penalties are standard. Certainly some brokers developed their working relationships only with nonprime lenders, meaning their prime-qualified customers likely would be channeled into nonprime, lest the broker lose the customer entirely. (In this respect, however, the rule needs strengthening, as we discuss below.) The distortion in the market is obvious: even those lenders who do not want to play this game must, or the brokers will take the consumers elsewhere.[76] Consequently, government regulation is the only force that can act as a circuit breaker for this vicious cycle – and regulation has to apply to the entire market – all closed-end loans and all HELOCs.

The incentives rule, then, is just one bookend. The second bookend – the steering rule – is also required if the Board is to rein in the distortions that have devastated so many families, particularly families of color.

While financial markets theoretically would provide equally qualified borrowers with equally competitive prices, both quantitative research and anecdotal evidence show that some borrowers, particularly minority borrowers, have less access to safer, lower-cost, prime, home-purchase loans.[77] Brokers and lenders in the subprime market have steered

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[75] 74 Fed. Reg. at 43285.

[76] When YSPs began to spread in the 1990s, some industry lawyers at American Bar Association meetings attended by one of the authors explained that their lender-clients did not like the practice, but could not afford to refrain from it because they would lose their brokers and the resulting business.

[77] Changing Mortgage Banking Industry at 41 (citing Anthony Pennington-Cross, Anthony Yezer, & Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Research Institute for Housing America (2000)).

borrowers into risky loans with higher costs and unfavorable features that are otherwise inappropriate. The rate upcharges offered as incentives to originators not only encouraged the steering of subprime borrowers into more costly and riskier loans, but also the steering of prime-credit borrowers into subprime loans. It is estimated that up to 60percent of subprime borrowers could have qualified for prime loans or loans through FHA, Fannie Mae, or Freddie Mac that would have given them interest rates that were lower by 3percent or more.[78]

The impact of steering does not fall randomly. There is an "unfair lending" dimension of steering that gives added urgency to a strong and meaningful steering rule. Within the subprime market, African American and Latino borrowers typically pay more for their mortgages than subprime Caucasian borrowers, even when controlling for legitimate credit factors.[79] A 2008 HUD study showed that minorities are much more likely to have higher priced mortgages.[80] What's more, homeowners in minority neighborhoods had greater odds of being trapped in those higher-cost mortgages by prepayment penalties, putting them on the wrong side of the foreclosure odds.[81]

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[78] *See* Rick Brooks & Ruth Simon, "Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market," *Wall Street Journal*, at A1 (Dec. 3, 2007), *available at* http://online.wsj.com/public/article/SB119662974358911035.html; Les Christie, "Wow, I Could've Had a Prime Mortgage: Why Many Borrowers Who Qualified For Prime-Rate Loans Wound Up With Subprimes Instead," CNNMoney.com (May 30, 2007), *available at* http://money.cnn.com/2007/05/29/real_estate/could_have_had_a_prime/index.htm; Lewis Ranieri, Presentation at Milken Institute Conference on Expanding Opportunities In The Global Marketplace (Apr. 25, 2007), *available at* http://calculatedrisk.blogspot.com/2007/04/ranieri-on-mbs-market-its-broke.html.

[79] *See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Effect of Subprime Mortgages*, Center for Responsible Lending (May 2006), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/rr011-Unfair_Lending-0506.pdf (after analyzing data submitted by mortgage lenders for loans originated in 2004, concluding that African-American and Latino families were at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors). There is insufficient data available to determine whether minorities pay higher rates within the prime market. The Unfair Lending study, however, offers a tantalizing glimpse into what may exist in the black-box world of lending below the HMDA reporting threshold: The more credit-worthy the borrower (as determined by FICO score and LTV), the greater the disparity ratio between African-Americans and whites. *Id* at Table 3, p. 12. By itself, this establishes nothing, but it does raise questions about whether the pattern also occurs within the prime market.

[80] Susan E. Woodward, *A Study of Closing Costs for FHA Mortgages*, The Urban Institute for Housing and Urban Development (May 2008).

[81] Homeowners in predominately minority neighborhoods have a 35percent greater chance of having a prepayment penalty than those living in neighborhoods with less than 10percent minority population. Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, p. 1 (Center for Responsible Lending, January 2005). The presence of a prepayment penalty, in turn, is associated with a 52percent increased likelihood of foreclosure (based on 2000 vintage subprime loans). Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market at their Cost to Homeowners* at p 21, Table 11 (December 2006), *available at http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report 2-17.pdf* .

The consequences are both devastating and shameful. A Federal Reserve Bank of Boston study found that almost half of the African-Americans in Massachusetts who moved out of their homes in 2007 did so following foreclosure.[82] In Chicago, half the properties that become bank-owned in the first quarter of 2009 were in neighborhoods where more than 80 percent of the residents were African-American.[83] Among African-Americans, the decline in homeownership rates between 2004 and 2008 dropped from 49.1 percent to 47.4.[84] Overall, researchers estimate that subprime foreclosures will displace almost 2 million children.[85]

Those stark statistics show what is at stake for the nation. The benefits of a rule that eliminates this insidious practice can be great. By contrast, the proposed rule asks little more of loan originators than to act ethically and responsibly. In a recent statement addressing the proposed steering ban, Federal Reserve Chairman Ben Bernanke stated, "Consumers rely on the professional expertise of brokers and other loan originators and expect that they will act fairly."[86] Bernanke continued by saying that borrowers' expectations are not realized when borrowers "are steered by their loan originator to more expensive loans."[87] Because borrowers generally lack the expertise necessary to fully understand their loan terms, borrowers are ill-equipped to evaluate whether the loan options with which they are presented are the best loan options.

The Board asks about the "unintended adverse consequences" of an anti-steering rule. While some industry representatives may claim that a steering rule will limit access to credit, it is difficult to think that a regulatory effort to make lending professionals offer fair services without conflicts of interest can restrict access more than the financial meltdown caused by these conflicts has ultimately restricted it. However hard it may be to find the right formulation for this mild regulatory vaccine, it can be no harder than the task the Board and others in Washington and across the country now face of dealing with the unintended consequences of the government's failure to act earlier. The worst adverse consequences would be if the rule in fact inadvertently *condoned* certain steering

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[82] Kristopher S. Gerardi and Paul S. Willen, "Subprime Mortgages, Foreclosures, and Urban Neighborhoods" (Federal Reserve Bank of Boston Public Policy Discussion Paper no. 2008-6, Dec. 2008), at 13.

[83] Geoff Smith and Sara Duda, "Roadblock to Recovery: Examining the Disparate Impact of Vacant Lender-owned Properties in Chicago," (Woodstock Institute Report, September 2009), at 7.

[84] Paul S. Calem, Marsha J Courchane and Susan M. Wachter, "Sustainable Homeownership" (Working Paper, March 19, 2009): 3-4.

[85] Phillip Lovell and Laura Isaacs, "The Impact of the Mortgage Crisis on Children and Their Education," (First Focus report, April 2008), p. 1.

[86] Statement of Chairman Bernanke, Federal Reserve Board, Proposed Changes to Regulation Z (Truth-in-Lending), Press Release (July 23, 2009), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bernanke20090723a.htm.

[87] *Id.*

practices by providing safe harbors that permitted abuses to continue. Implementing a rule that is effective should be the Board's priority.

B. The proposed safe harbor rule will undermine the efficacy and enforceability of the rule and should be replaced with a rebuttable presumption related to the terms and conditions of the loan.

The proposed rule bars an originator from steering a customer to a loan that would earn the originator more money than others the originator could offer unless the loan is in the borrower's interest.[88] This straightforward approach prohibiting originators from putting their own interest ahead of their clients' interests is potentially undermined, however, by the proposed "safe harbor."

The safe harbor deems originators to be in compliance with the anti-steering rule if they disclose a certain set of information to their clients.[89] Originators are in compliance with the rule if:

- the loan was chosen from at least three options for each type of loan in which the applicant expressed interest (e.g. ARM or FRM);
- the options were obtained from a "significant number" of the creditors with which the originator regularly does business;
- the options include the one with the lowest interest rate, the one with the second-lowest interest rate, and the one with the lowest dollar amount of points; and
- the originator believes in good faith that the applicant would likely qualify for the loans in the options presented.

In addition, while originators are not required to steer applicants to the loan that will be the least remunerative for the originator, they are deemed to be in compliance if they do so.[90]

There are two main problems with this safe harbor. Most critically, it does not offer a good solution to the problem of originators who do business only with lenders specializing in the most costly or risky types of loans. The proposal, somewhat inconsistently, says that the originator must present options from a "significant" number of the creditors "with which the originator regularly does business."[91] If the originator "regularly does business" with fewer than three creditors, presenting options for each of them is deemed compliance.[92] A specialty originator can thereby be deemed, as a matter

[88] Proposed Reg. Z §226.36(e)(1).

[89] Proposed Reg. Z §226.36(e)(2), (3).

[90] Proposed OSC § 226.36(e)(1)-2(ii).

[91] Proposed Reg. Z §226.36(e)(3).

[92] Proposed OSC §226.36(e)(3)-1.

of law, to be in compliance with the anti-steering rule if he gives a prime-qualified applicant the lowest prices offered only by higher-cost lenders with which he regularly deals. Or the three options could all be from lenders that routinely include prepayment penalties.[93] In addition, presenting these options does little to help a consumer compare the relative merits of fixed and variable rate loans.

We recognize that the Board wants to make the lines as bright as possible to give businesses some certainty. But the unintended consequence of drawing bright lines is that if those lines are drawn in the wrong place, they can weaken or preclude the goal of reducing dysfunctional and unfair market conduct.

Instead, we suggest a rebuttable presumption of compliance based on the outcome of the transaction. If a consumer is given a loan that has features widely considered the hallmarks of a responsible loan, the originator is presumed to have complied with the ban on steering.[94] While loans with risky features might be appropriate for some borrowers in some circumstances, only safer and sustainable loans without a history of exploitation should be entitled to a presumption of compliance as a matter of law. We suggest the following language to describe the loans that would qualify for the presumption:

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[93] Under the HOEPA UDAP rules, there are limitations on prepayment penalties in high-and higher-cost loans, *see* Reg. Z §§ 226.32, 226.35.

[94] Some states and the District of Columbia have enacted anti-steering legislation that focuses on the risk grade of the loan compared to the qualifications of the borrower, rather than simply the range of options on offer from the originator. *See, e.g,.***California** (CA Finance Code § 4970)("(l)(1) A person who originates a covered loan shall not steer, counsel, or direct any prospective consumer to accept a loan product with a risk grade less favorable than the risk grade that the consumer would qualify for based on that person's then current underwriting guidelines, prudently applied, considering the information available to that person, including the information provided by the consumer. A person shall not be deemed to have violated this section if the risk grade determination applied to a consumer is reasonably based on the person's underwriting guidelines if it is an appropriate risk grade category for which the consumer qualifies with the person. (2) If a broker originates a covered loan, the broker shall not steer, counsel, or direct any prospective consumer to accept a loan product at a higher cost than that for which the consumer could qualify based on the loan products offered by the persons with whom the broker regularly does business."); **District of Columbia** (D.C. Code § 26-1152.06)("A lender shall not steer, counsel, or direct any prospective borrower to accept a loan product with a risk grade less favorable than the risk grade that the borrower would qualify for…"); **Minnesota** (Minn. Stat 58.13, subd 1(a)(13)) (No person acting as a residential mortgage originator or servicer **…**make, provide, or arrange for a residential mortgage loan that is of a lower investment grade if the borrower's credit score or, if the originator does not utilize credit scoring or if a credit score is unavailable, then comparable underwriting data, indicates that the borrower may qualify for a residential mortgage loan, available from or through the originator, that is of a higher investment grade, unless the borrower is informed that the borrower may qualify for a higher investment grade loan with a lower interest rate and/or lower discount points, and consents in writing to receipt of the lower investment grade loan;) **Washington** (West's Wash. Rev. Code § 19.144.060)("A person licensed or subject to licensing, or otherwise subject to regulation pursuant to chapter 19.146, or a consumer loan company licensed or subject to licensing under chapter 31.04 RCW may not steer, counsel, or direct any borrower to accept a residential mortgage loan product with a risk grade less favorable than the risk grade that the borrower would qualify for.").

Suggested replacement language for proposed Reg. Z §226.36(e)(2) and (3):[95]

(e)(2): A transaction does not violate paragraph (e)(1) of this section if the loan accepted by the consumer meets the following conditions:

(i) the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;
(ii) the loan is fully amortizing;
(iii) the total points and fees payable in connection with the loan are no more than 2percent of the loan principal;
(iv) the interest rate is no more than .25percent of the prevailing prime loan rate [as determined pursuant to the sixth sentence of section 305(a)(2) of the Federal Home Loan Mortgage Corporation (12 U.S.C 1454(a)(2)];
(v) there is no prepayment penalty; and
(vi) the rate is fixed for at least five years.

C. The rule should provide for a rebuttable presumption rather than a "get-out-of-jail free" safe harbor.

Regardless of the method the Board chooses for providing business with more certainty, it is crucial that the provision be considered a rebuttable presumption rather than an inviolable safe harbor. It is particularly important to do so if the Board proceeds to use the three-notice approach, instead of the safe loan approach we suggest in the preceding subsection. Otherwise, compliance will be extremely difficult. In thinking about this question, we suggest comparing the enforcement record of ECOA. The heart of ECOA is a ban against discrimination against credit-worthy applicants based on membership in protected classes.[96] It also includes various notice requirements intended, such as the notice of adverse action. Ultimately, ECOA compliance work evolved more to a matter of looking at the paperwork than enforcing the heart of the law with its core ban on discrimination. A three-option safe harbor for the steering ban runs the same risk of focusing enforcement on the paper, not the problem.

D. If the Board adopts the "three-option" safe harbor proposal, the consumer should receive additional information that permits an informed choice among those options.

Finally, if the Board does proceed with the three-option method either as a safe harbor or as a rebuttable presumption, we encourage the Board to use testing to design notices that would help the consumer make the choice in an informed way. The proposed safe harbor requires notice of the lowest and next lowest interest rates and the loan with the lowest

[95] Earlier this year, the House of Representatives passed legislation that would create a similar category of "qualified" mortgage loans in lieu of a "safe harbor" for ability to repay requirements (H.R. 1728). If useful, the Board could track the requirements from that legislation rather than use the suggested requirements below.

[96] Equal Credit Opportunity Act, 15 U.S.C. 1691, et. seq. (1974); Regulation B, 12 C.F.R. 202.

dollar amount of points. Comparing the third option with the first two is comparing apples and oranges. As the Board notes in its Supplementary Information, whether a loan with higher points and a lower rate is a better deal that a loan with higher rate and lower points depends on the expected life of the loan.[97] The time horizon of mortgages has long been one of the imperfections in the APR generally

Perhaps the Board can test ways to convert the choices to a common comparison while also taking into account the expected life of the loan. For example, the three options might be illustrated by giving the applicant the sum of fees and accrued interest as a single total dollar figure if paid or refinanced at 3, 5, or 7 years. While the consumer, at the outset, may not have in mind an expected life of the loan, certainly the industry knows the average loan life for various loan products and could choose the illustrations accordingly. This type of information could help transform the three-option notice into a truly useful tool for the consumer rather than a gimmick for the originator to gain the safe harbor protection.

Conclusion

The Board is to be commended for taking on this pair of well-entrenched but highly destructive market practices. We believe that, if promulgated with the additions and substitutions we have recommended here, the proposed rules will provide significant protection against a recurrence of the market distortions that have so damaged so many families.

We urge the Board to finalize its proposed rules as soon as possible. Moreover, in the case of the two provisions discussed in this comment, we ask that they become effective immediately or very quickly. These practices will continue to harm consumers and perpetuate risky and unfair lending until the time that they are eradicated from the market, and there is no credible reason why the mortgage lending industry should need a lengthy period of time to implement them.

[97] 74 Fed. Reg. at 43285.