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Hon. Ben Bernanke, Chairman, and Board of Governors of the Federal Reserve System
Attention: Jennifer J. Johnson, Secretary
20th St. and Constitution Ave., NW
Washington, DC 20551

RE: **Docket Number R-1305 - Proposed Amendments to Regulation Z**

Dear Chairman Bernanke and Governors:

Californians are being hit hard by the current lending and foreclosure crisis. Foreclosures throughout the country continue to reach record highs, and California is one of the states hardest hit.[1] Given the catastrophic impact that this crisis has had on families and communities, the Board's efforts to prevent the kinds of predatory lending practices that have led to the current crisis are most welcome. Although the Board's efforts are commendable, the Board needs to address the widespread predatory lending problems more comprehensively to ensure that problems are corrected and the Board's regulations are not easily circumvented.

A. The Board Should Broaden the Types of Mortgage Loans to Which the Proposed Requirements of 12 C.F.R. Sections 226.34(a)(4) and 226.35(b) Will Apply.

Although the Board's ability-to-repay, income verification, and prepayment penalty proposals are essential to prevent the abusive lending practices that have led to the current lending and foreclosure crisis, they could be improved in three ways. First, these proposals will have limited effect if they are confined to "higher-priced mortgage loans," which the Board has defined solely on the basis of the rate spread between these loans and the interest rate on Treasury securities of comparable maturities. (See proposed 12 C.F.R. § 226.35(a)(1).) In

[1]See Mortgage Bankers Association, *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey* (March 6, 2006) available at http://www.mortgagebankersorg/NewsandMedia/PressCenter/60619.htm ("California and Florida continue to represent a disproportionate share of foreclosure starts in the county. Those two states represent 21 percent of all loans outstanding, but account for 30 percent of foreclosure state in the US").

addition to these higher-priced mortgage loans, the Board should apply the proposed regulations to two other types of loans that are also at the root of the current mortgage crisis: (1) all nontraditional mortgage loans, as defined in the Board's 2006 *Interagency Guidance on Nontraditional Mortgage Product Risks*, and (2) all mortgage loans where the monthly payment has the potential of increasing 10% or more.

Second, the Board has proposed excluding closed-end subordinate lien loans that do not have a spread of five or more percentage points between the annual percentage rate (APR) and the yield on comparable Treasury securities, as well as home equity lines of credit (HELOCs). (See proposed 12 C.F.R. §§ 226.35(a)(1) and (a)(5).) These loans, however, have also contributed to the current mortgage crises – they reduce homeowner equity and increase the risk of foreclosure when, in combination with simultaneous or previously made first mortgages, they result in high loan-to-value and/or debt-to-income ratios. The Board should therefore apply the proposed repayment ability and income verification regulations to all HELOCs and closed-end subordinate lien loans with high combined loan-to-value and debt-to-income ratios. A reasonable threshold would involve applying the proposed regulations whenever (1) the loan-to-value ratio of the combined first and second mortgage loans is 90% or greater or (2) the consumer's debt-to-income ratio is 45% or greater. Moreover, for purposes of calculating combined loan-to-value ratios with respect to HELOCs, the Board should require creditors to use the full amount of the potential loan draw, regardless of whether the full amount is initially drawn by the borrower.

Third, if the Board decides not to apply the regulations to HELOCs and second-lien mortgage loans, it would be possible for creditors to stay under the proposed 3% APR threshold for first mortgages by separating a mortgage loan into two loans – the second being either a HELOC or a closed-end mortgage loan – and apportioning the fees between the two loans. In order to prevent this type of evasion, the Board should add the following provision to 12 C.F.R. § 226.35(b)(5): "A creditor shall not divide a home-secured loan into separate parts, including through the use of open-end plans or closed-end mortgage loans, to avoid the requirements of this section."

1. <u>First Mortgage Loans</u>.

High cost loans, however, are not the only types of loans at the root of the current mortgage crisis. Abuses are as likely to occur with equal vigor and pernicious effect in a variety of "exotic" or nontraditional loans that allow the deferral of the payment of interest, principal, or both interest and principal. Likewise, these abuses plague loans that allow, often predictably, for "payment shock" as a result of a significant increase in monthly payments. These types of loans usually are made as first mortgage loans. They may be, but are not necessarily, "higher-priced" as defined by the Board. Regardless of pricing, these loans should be covered by the repayment ability, income verification, and prepayment requirements. .

The Board itself has recognized that these nontraditional loans and loans prone to payment shock pose serious concerns. The Board observed that the failure to assess adequately a borrower's ability to repay a mortgage loan according to its terms is especially prevalent for "nontraditional mortgage loans," which the Board has defined as "mortgage products that allow borrowers to defer payment of principal or interest." (FRB, *Interagency Guidance on Nontraditional Mortgage Product Risks* (Sept. 2006, Docket No. OP-1246) (the "*2006 Interagency Guidance*") at p. 4.) The Board has also highlighted that such nontraditional mortgage loans "present heightened risks to lenders and borrowers" because they (1) "result in payment shock," and (2) "impos[e] substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period." (FRB, *Statement on Subprime Mortgage Lending* (June 2007, Docket No. OP-1278) (the "*2007 Subprime Statement*") at p. 2.) The failure to make a meaningful assessment of the borrower's ability to pay, moreover, includes failing to obtain reliable income and asset data in so-called "no doc" or "stated income" loans that could be used in responsibly determining the borrower's true repayment capacity.

Although nontraditional mortgage loans were initially offered primarily to subprime borrowers, they are increasingly being offered to Alt-A borrowers. As noted by the Board, 78% of Alt-A originations in 2006 were nontraditional mortgage loans, the majority of which "were underwritten without full documentation of income." (73 Fed.Reg. 1672, 1684.) Thus, in order to achieve its avowed purpose of applying the proposed regulations "as broadly as needed to protect consumers from actual or potential injury, but not so broadly that the costs . . . would clearly outweigh the benefits" (*ibid.*), the Board should broaden the coverage of the proposed regulations to include nontraditional mortgage loans. Any time a consumer obtains a mortgage loan that allows for the deferral of interest and/or principal, regardless of the cost of that loan, the consumer will face financial distress and perhaps foreclosure if future increased monthly payments are unaffordable, especially if the imposition of prepayment penalties thwarts refinancing into a more affordable loan.

In addition, some adjustable rate loans that do not involve the deferred payments of principal and interest can result in payment shock. All higher-priced and nontraditional mortgage loan borrowers, as well as adjustable rate loan borrowers that face payment shock of 10% or more, should be protected from unfair or deceptive acts and practices -- regardless of where they fall in the prime/Alt-A/subprime spectrum.

Moreover, regardless of the cost of the loan, the practice of lending to any borrower who does not have the ability to repay, or preventing a borrower from refinancing an unaffordable loan through the imposition of prepayment penalties, is not a sound lending practice. Such a practice is not sound for the lender, the investor, the borrower, or the borrower's community. As the Board itself has stated, "a credible analysis of both a borrower's willingness and ability to repay is consistent with sound and prudent lending practices." (*2006 Interagency Guidance* at pp. 6-7.)

The application of these regulations to nontraditional mortgage loans and adjustable rate loans with the potential monthly payment increase of 10% or more, in addition to higher-priced mortgage loans, should not deprive consumers of access to credit. There is no doubt that consumers must have access to credit in order to finance home ownership, the most important source of wealth for most American families. But the credit to which consumers have access must be affordable and sustainable. Otherwise, consumers unwittingly use home loans to fund temporary housing and pay heavily, both emotionally and financially, for the turmoil caused by foreclosure. Ultimately, the application of the proposed regulations to all of the types of mortgages that have been characterized by abusive practices will safeguard home ownership by ensuring that families will be able to stay in the homes they buy and that surrounding homes will maintain their value. Thus, the cost of complying with such common-sense regulations with respect to higher-priced mortgage loans, as non-traditional mortgage and adjustable rate loans with a certain level of potential payment shock, cannot outweigh the benefit of preventing harm to individual borrowers, their neighborhoods, and the investors who ultimately buy the mortgage loans.

Furthermore, the failure to apply the Board's proposed standards to all types of problem loans merely invites circumvention as lenders offer loans under the threshold rate of the proposed regulation but lard the loans with onerous features like prepayment penalties or special penalty default interest rate provisions. For example, suppose a payment option ARM loan that has an interest rate of 2.875% more than a comparable Treasury security and a 3-year prepayment penalty has the same value on the secondary market as a similar loan with an interest rate that is 3.125% above a comparable Treasury security. Lenders would be clearly tempted to offer the former loan because it is not subject to the Board's proposed regulations and is just as profitable, yet the consumer may be in a worse position.

For the reasons expressed, the Board should apply the proposed regulations to higher-priced mortgage loans *and* to (1) all nontraditional mortgage loans, as defined in the *2006 Interagency Guidance*, and (2) all mortgage loans where the monthly payment has the potential of increasing 10% or more.

2. <u>Second and Junior Mortgage Loans</u>.

The Board should broaden the applicability of the repayment ability and income verification regulations for (1) specified HELOCs and (2) specified closed-end subordinate lien loans with an APR yield 5% less than the yield on comparable Treasury securities. Many lenders have been funding 80-20 mortgage loans, in which borrowers take out two loans -- the first for 80% of the purchase price of the home along with a second loan, commonly called a "piggy-back," for some or all of the remaining 20%. In California, where home prices have sky-rocketed in past years, this practice allowed borrowers to buy homes without hefty down payments and the additional cost of mortgage insurance. Although these loans may be appropriate for borrowers who can afford them, they are disastrous for borrowers who obtain higher-priced mortgages or nontraditional mortgages but do not have the ability to repay both loans. When payment shock hits these homeowners, they cannot afford to meet the recast payments, and they do not have the equity necessary to refinance into a more affordable mortgage loan. Moreover, borrowers often face the same dilemma when they obtain "cash-out" second loans, whether HELOCs or closed-end, long after obtaining the first mortgage loan. Particularly unsavory is the common practice of lenders and brokers to induce financially burdened consumers to convert short-term unsecured debt, which may be subject to discharge, compromise, or restructuring in bankruptcy, into long-term mortgage debt that stresses or exceeds the consumer's ability to repay it.

The Board has recognized that "[s]imultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. . . . In addition, second-lien [HELOCs] typically increase borrower exposure to increasing interest rates and monthly payment burdens." (*2006 Interagency Guidance* at p. 13.) The Board has also recommended that interest-only and variable rate HELOCs not be made unless "borrowers should demonstrate the ability to amortize the fully drawn line over the loan term." (*2006 Interagency Guidance* at p. 6, n. 4 (citing FRB, *Credit Risk Management Guidance for Home Equity Lending* (May 2005)).)

Thus, the Board should apply the proposed repayment ability and income verification regulations of proposed 12 C.F.R. §§ 226.34(a)(4) and 226.35(b)(1) and (b)(2) to all HELOCs and closed-end subordinate lien loans with high combined loan-to-value and debt-to-income ratios. A reasonable threshold would involve applying the proposed regulations whenever (1) the loan-to-value ratio of the combined first and second mortgage loans is 90% or greater or (2) the consumer's debt-to-income ratio is 45% or greater. These two underwriting criteria are appropriate, given the Board's recognition that "payment shock" on nontraditional mortgage loans subjects "borrowers with high loan-to-value (LTV) ratios [and] high debt-to-income (DTI) ratios" to higher risks of default. (*2006 Interagency Guidance* at p. 11.) For purposes of calculating combined loan-to-value ratios with respect to HELOCs, the Board should require creditors to use the full amount of the potential loan draw, regardless of whether the full amount is initially drawn by the borrower.

Moreover, creditors could easily circumvent the higher-priced mortgage loan regulations if the proposed regulations do not apply to HELOCs or second-lien mortgage loans. In particular, it would be possible for creditors to stay under the proposed 3% APR threshold for first mortgages by separating a mortgage loan into two loans – the second being either a HELOC or a closed-end mortgage loan – and apportioning the fees between the two loans. In order to prevent this type of evasion, the Board should add the following provision to 12 C.F.R. § 226.35(b)(5): "A creditor shall not divide a home-secured loan into separate parts, including through the use of open-end plans or closed-end mortgage loans, to avoid the requirements of this section."

B. The Board Should Enhance the Proposed Repayment Ability Provisions.

The Board takes an important step in insisting that a borrower's income and assets be properly documented. (See proposed 12 C.F.R. § 226.35(b)(2).) There are three ways, however, by which the Board may significantly improve its proposal requiring that a borrower show a "pattern or practice" of one or more of the factors listed in proposed 12 C.F.R. § 226.34(a)(4)(i) in order to create a presumption that a creditor has "[e]ngage[d] in a pattern or practice of extending credit . . . based on the value of consumers' collateral without regard to consumers' repayment ability."

First, proving a pattern or practice – anything beyond the consumer's own circumstances – places a likely insuperable practical burden on a borrower. The term "pattern or practice" is not defined, but the term certainly implies repeated conduct. How is a consumer to establish a violation as to his or her own loan unless the consumer takes on the lender's entire lending practice and proves similar underwriting lapses for multiple consumers? In order to address this problem, the Board should declare it an unfair practice for a lender to make a home mortgage loan to a borrower who does not have an apparent ability to repay the loan from the borrower's income and assets other than the mortgaged home, recognizing exceptions for extraordinary documented circumstances involving a temporary interruption of income. Such circumstances should include the following: (1) the borrower reasonably anticipates to rebound from a loss of income caused by a temporary disability or illness, unemployment or reduction of salary; or (2) the borrower seeks a short-term loan because he or she must sell the home due to a permanent reduction in income (caused for example by death, divorce from a co-borrower, or unemployment) or some other event (such as a pending foreclosure or the occurrence of a natural disaster).

Second, the Board should place the burden on the lender to justify its underwriting if a prima facie violation is shown. The lender has access to the facts, while the consumer has no practical ability to muster the facts without incurring the high cost of litigation. The Board should therefore replace the current proposed presumption with a rebuttable presumption that 12 C.F.R. § 226.34(a)(4) has been violated if the lender failed any applicable requirement listed in subsection (a)(4)(i) with respect to the borrower's own loan.

Third, the Board should strengthen the underwriting requirements to account for loans that have the potential to negatively amortize and for loans with high loan-to-value ratios, high debt-to-income ratios, and borrowers with low credit scores. If a borrower makes monthly payments that do not cover the full amount of interest accruing on a loan, a practice permitted on payment option ARM loans, negative amortization will cause an increase in both the loan amount and monthly payments. In order to deter the unfair and deceptive practice of extending these loans to borrowers who cannot afford to pay the higher resulting balance or monthly payments, the Board should modify 12 C.F.R. § 226.36(a)(4)(i)(B) to require lenders to assess a borrower's repayment ability based upon (1) the initial loan amount plus any balance increase that may accrue while the borrower is permitted to make minimum payments and (2) the borrower's capacity to make the monthly payments when payments are recast after the negative amortization limit is reached (assuming the fully indexed rate at loan consummation would apply at that time).

Additionally, lenders should be required to consider loan-to-value and debt-to-income ratios in determining a borrower's ability to repay, ratios which are a common feature of any responsible mortgage underwriting standards. The Board should add to the proposed rebuttable presumption that the lender has engaged in a pattern or practice of extending credit without regard to repayment ability if, considering both the first mortgage loan and any second mortgage loan, the lender has extended credit with (1) a combined loan-to-value ratio of 90% or more; (2) a combined debt-to-income ratio of 45% or more, the debt-to-income ratio including the payments set forth at proposed 12 C.F.R. § 226.34(a)(4)(i)(C); or (3) in combination with either of these, the borrower has a credit score of 660 or less.

1. <u>The Board Correctly Proposes To Require Proper Income and Asset Documentation</u>.

The current lending and foreclosure crisis has been caused, in large part, by lenders' failure to use common sense underwriting criteria for all of the loan products described in Section A, above. It is fundamental that before extending any mortgage loan, lenders should obtain income and asset documentation. "No income, no asset" loans, for which the borrower is expressly told *not* to state potential sources of repayment, is a gross example of collateral-based loans that have no legitimate purpose for consumer borrowers risking their homes as security. The all too common "no doc" or "stated income loans" were designed for the relatively small segment of borrowers with irregular, non-salaried income but were sold to a large segment of borrowers with easily verifiable income from W-2 or 1099 forms. Even borrowers who derive income from irregular, non-salaried sources such as sales commissions, royalties, or the occasional publication of a best seller novel have income tax returns and sources of repayment other than wage income, such as bank deposits, stock and mutual fund holdings, or other real estate, that could be reasonably documented and verified. There is a reason that "no doc" or "stated income" loans are commonly called "liar loans" with the lies generated not just by borrowers but by unscrupulous brokers and lenders fabricating inflated loan applications that are presented in a stack of documents for the borrower's unwitting signature. An income and asset verification requirement brings integrity back to underwriting, prevents the extension of unaffordable mortgage loans, and will reduce the cost of mortgage loans to consumers who are able to document their income and assets but who were unwittingly placed in no doc/stated income loans because those loans have higher interest rates for lenders or generate a higher yield spread premium for brokers.

2. The Board Should Declare That Lending To Borrowers Without An Ability To Pay, Absent Extraordinary Circumstances, Is An Unfair Practice.

It is also fundamental that lenders should predicate the underwriting of each loan on the borrower's ability to repay the loan according to its terms. No lender could credibly argue that it is a sound lending practice to extend credit to borrowers who do not have the ability to repay the loan when this fact is apparent from the outset. Accordingly, the Board should declare it an unfair practice for a lender to make a home mortgage loan to a borrower who does not have an apparent ability to repay the loan as provided in the loan instrument from the borrower's income and assets other than the mortgaged home. Exceptions should be recognized for extraordinary documented circumstances involving a temporary interruption of income, such as occasioned by disability, illness, unemployment or reduction of salary, from which the borrower reasonably anticipates to rebound or a loan anticipated to be short term in nature to enable the borrower to sell the home as the result of a permanent reduction in income, occasioned for example by death, divorce from a co-borrower, or unemployment, or as the result of some other event that would prevent the borrower from retaining the home such as a pending foreclosure or the occurrence of a natural disaster.

The Board has the authority to prohibit acts as well as practices that are or unfair or deceptive or that are not in the interest of borrowers in connection with refinancing mortgages. (15 U.S.C. § 1639(*l*)(2).) Lending to a particular homeowner borrower who has no demonstrable ability to repay the loan and thereby exposes the borrower to probable foreclosure is, absent extraordinary circumstances, a gravely unfair act particularly if the homeowner has been refinanced out of the safety of an affordable loan into a perilously unsafe one. The proposal set forth in this comment addresses perhaps the most fundamental problem contributing to the present mortgage and foreclosure crisis.

3. The Board Should Create a Rebuttable Presumption that An Unfair Practice Has Been Committed if the Lender Has Failed Any Underwriting Requirement with Respect to the Borrower's Own Loan.

The Board also should modify the proposed presumption in order to impose appropriate evidentiary burdens on the borrower and the creditor. As drafted, a borrower must show a "pattern and practice" of one or more of the factors listed in proposed 12 C.F.R. § 226.34(a)(4)(i) in order to create a presumption that a creditor has "[e]ngage[d] in a pattern or practice of extending credit . . . based on the value of consumers' collateral without regard to consumers' repayment ability." A borrower, however, usually has knowledge of the lender's conduct only with respect to his own mortgage loan. Evidence concerning the underwriting practices of the lender is uniquely in the control of the lending institution, and may only be obtained by the borrower though extensive discovery. Although the burden may be reduced by the Board's proposed comment specifying that a pattern or practice may be established with a lending policy and without the use of a statistical process, establishing an unwritten lending policy will require extensive evidence in the possession of the lender – other borrowers' loan files, the testimony and communications of borrowers, brokers and/or employees, training manuals, etc. This is an obstacle that most borrowers trapped in unaffordable mortgage loans will be unable to overcome, because few would be able to afford the litigation expense this discovery effort would entail.

"[S]ome presumptions are created to correct an imbalance resulting from one party's superior access to the proof." (Kenneth S. Broun, McCormick on Evidence § 343 (2008).) Accordingly, the Board should replace the current proposed presumption with a rebuttable presumption that 12 C.F.R. § 226.34(a)(4) has been violated if the lender failed any applicable requirement listed in subsection (a)(4)(i) with respect to the borrower's own loan. This rule would allow the borrower to seek an appropriate remedy and the lender to respond by either rescinding the loan or presenting proof, within its possession, that it has not disregarded the borrower's ability to repay. If the lender chose the latter course, the burden would then shift to the borrower to show that the lender did in fact engage in an unfair practice. In this instance, the Board's proposed comments would apply. (See proposed comments to 12 C.F.R. § 226.34(a)(4).)

4. <u>The Board Should Also Strengthen the Underwriting Requirements</u>.

First, the ability to pay standard should be enhanced even if the Board declines to follow the above recommendation for declaring an unfair practice based on a creditor's placing a consumer at risk for foreclosure by extending credit that the consumer has no apparent capacity to repay.

Proposed 12 C.F.R. § 224.34(a)(4)(i)(B)(1) provides that, for variable rate mortgages, a presumption that the lender has violated (a)(4) is created if there is a pattern and practice of failing to consider a borrower's repayment ability at the fully-indexed rate as of consummation. While this requirement will deter lenders from qualifying borrowers based upon a short-term introductory rate, it does not adequately assess the repayment ability of borrowers who make minimum payments on option ARMs.

Option ARMs usually allow borrowers to make one of four different payments -- payments that are fully amortizing over 15 and 30 years, a payment that only covers interest, and a payment that does not cover the full amount of interest accruing on the loan. In the event the borrower chooses the latter payment option, the loan will negatively amortize until a specified date or until a negative amortization cap is reached, at which time the monthly payment will increase dramatically. Payment option ARMs are perhaps the most complex consumer credit instrument and least likely to be understood by the average consumer. Consumers, for example, commonly pay only the minimum monthly payment without realizing that the loan would negatively amortize and result in a staggering higher monthly payment when the payments are recast after the negative amortization cap is reached within a relatively short period of time.

In order to deter the unfair and deceptive practice of extending unaffordable loans that are most susceptible to misleading marketing tactics and most difficult for borrowers to understand, the Board should require that lenders assess a borrower's repayment ability based upon (1) the initial loan amount plus any balance increase that may accrue while the borrower is permitted to make minimum payments and (2) the borrower's capacity to make the monthly payments when payments are recast after the negative amortization limit is reached (assuming the fully indexed rate at loan consummation would apply at that time).

This proposal reflects the Board's concern regarding payment option ARMs: "Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization." (*2006 Interagency Guidance* at p. 11.) In light of this concern, the Board has stated that it "expect[s] a borrower to demonstrate the capacity to repay the full loan amount that may be advanced. This includes the initial loan amount plus any balance increase that may accrue from a negative amortization provision." (*Id.* at p. 6.) The Board further stated, "[F]or products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision." (*Id.* at p. 12.)

The Board, therefore, should modify 12 C.F.R. § 226.34(a)(4)(i)(B) to provide that a lender engages in an unfair practice if the lender allows minimum payments of payment option ARM loans that do not cover the interest accruing on the mortgage loan and fails to predicate its underwriting of the loan on the borrower's ability to timely make all of the monthly payments, including the payments as they may increase when recast according to the loan terms, to repay the initial loan amount plus any additional amount that may accrue from negative amortization.

Second, the Board should adopt additional quantitative standards for determining a borrower's ability to repay based on loan-to-value and debt-to-income ratios. These ratios are a common feature of any responsible mortgage underwriting standards. As the Board has recognized, "Historically, as combined loan-to-value ratios rise, so do defaults. . . . Loans with minimal or low owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors." (*2006 Interagency Guidance* at p. 13.) In addition, the Board provided that "an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores." (*Id.* at p. 11.)

The Board, therefore, should add to the rebuttable presumption that the lender has engaged in a pattern or practice of extending credit without regard to repayment ability if, considering both the first mortgage loan and any second mortgage loan (both closed- and open-end, see Section A, above), the lender has extended credit with (1) a combined loan-to-value ratio of 90% or more; (2) a combined debt-to-income ratio of 45% or more, the debt-to-income ratio including the payments set forth at proposed 12 C.F.R. § 226.34(a)(4)(i)(C);

or (3) in combination with either of these, the borrower has a credit score of 660 or less.

C. The Board Should Ban Prepayment Penalties for All Higher-Priced and Nontraditional Mortgage Loans, as well as Loans Involving Payment Increases of 10% or More.

In the context of higher-priced mortgage loans, nontraditional mortgage loans, and mortgage loans with the potential for substantial hikes in monthly payments, prepayment penalties are often imposed as a result of unfair or deceptive practices, trapping borrowers into unaffordable mortgage loans and greatly increasing the risk of foreclosure. The Board's proposed requirement that the prepayment penalty period expire 60 days before any monthly payment reset (see proposed 12 C.F.R. § 226.32(d)(7)(iv)) may not allow most borrowers sufficient time to refinance and precludes the borrower from sooner refinancing an abusive loan without having to pay penalties. For this reason, the Board should modify the proposed regulation to prohibit prepayment penalties with respect to higher-priced loans, nontraditional mortgage loans, and loans involving potential payment increases of 10% or more. In the event, however, the Board decides to permit prepayment penalties for these loans, the Board should (1) prohibit the inclusion of a prepayment penalty provision whenever the lender or broker represents that the borrower will be able to refinance the loan before a rate reset and, (2) when that representation is not present, suspend a prepayment penalty provision for at least 120 days before the rate or payment resets in order to allow a borrower sufficient opportunity to refinance.

Given the complexity of higher-priced and nontraditional mortgage loans and the ease with which brokers and lenders may mislead borrowers by focusing on low, beginning monthly payments, many borrowers with these loans are unaware that monthly payments and interest rates will eventually adjust upward. Other borrowers know that the monthly payments and interest rates will increase, but accept the risky mortgage loans based on the brokers' or lenders' assurances that by the time the rates or payments reset, the borrowers will be able to refinance into more affordable loans because their homes will have appreciated or their credit ratings will have improved by making the introductory payments on the risky loans. Often these assurances are misleading, because homes do not appreciate as expected or the expectations of credit improvement are unrealistic. This problem is especially acute in California, where high housing prices have declined, particularly sharply in the neighborhoods hardest hit by the foreclosure crisis. Still other borrowers are improperly steered into these loans, unaware that they would qualify for fixed-rate or reasonably priced adjustable rate mortgage loans.

In all of these scenarios, the borrowers often do not discover the existence of prepayment penalties until they attempt to refinance into a more affordable loan - sometimes after the payments or rates have reset and the borrowers have missed monthly payments. Such borrowers find themselves locked into unaffordable mortgage loans and face the prospect of losing their homes; due to the limited equity available and the negative impact on their credit, they cannot afford the prepayment penalties that would be imposed if they refinanced.

Lenders often argue that borrowers knowingly agree to prepayment penalties in order to "buy down" the rate on their loans. This argument, however, does not make sense in the context of higher-priced and nontraditional loans subject to rate resets and subsequent higher payments where prepayment penalties merely cement the borrower into a disadvantageous loan rather than provide meaningfully lower rates. And, given the complexity of these loan products and the fact that brokers have an incentive to negotiate prepayment penalties, unbeknownst to the borrower, in order to obtain higher yield spread premiums (see Section E below), it is highly unlikely that most borrowers even understand that they have the option of negotiating loans without prepayment penalties.

Given the great risk that prepayment penalties pose for borrowers trapped in higher-priced and nontraditional mortgage loans, as well as adjustable rate loans with payments that have the potential to increase 10% or more, the Board should modify the proposed regulation to prohibit prepayment penalties with respect to such loans. Borrowers with such loans, who face an uphill battle to obtain more affordable loans due to lack of equity, poor credit, or insufficient income and assets, should have the ability to refinance into more affordable loans at the first opportunity to do so to reduce the chances of foreclosure.

In the event the Board decides to permit prepayment penalties for these loans, the proposed 60-day window does not afford sufficient opportunity to refinance and precludes the borrower from sooner refinancing an abusive loan without having to pay penalties. At a minimum, the Board should (1) prohibit the inclusion of a prepayment penalty provision whenever the lender or broker represents that the borrower will be able to refinance the loan before a rate reset and, (2) when that representation is not present, suspend a prepayment penalty provision for at least 120 days before the rate or payment resets in order to allow a borrower sufficient opportunity to refinance.

D. The Board Should Not Require the Establishment of Escrow Accounts for Taxes and Insurance But Should Require That A Borrower's Obligation To Pay for Taxes and Insurance Be a Factor in Determining The Borrower's Ability To Pay.

Many borrowers have legitimate reasons for declining to set up escrow accounts for taxes and insurance – including that the lender and/or loan servicer, rather than the borrower, earns interest on the account while the funds go unpaid. Moreover, the Board can achieve its objective of preventing borrowers from "inadvertently tak[ing] on mortgages they cannot afford because they focus only on the payment of principal and interest," without considering the payments required for property taxes and insurance, by requiring that lenders consider such payments in determining repayment ability. (Proposed 12 C.F.R. § 226.34(a)(4)(i)(C); 73 Fed.Reg. at p. 1697.) The Board should therefore refrain from mandating the establishment of escrow accounts for taxes and insurance as proposed in 12 C.F.R. § 226.35(b)(4). Instead, lenders should be permitted to offer optional impound accounts but should be required to either pay interest or account for the earnings benefits derived by the lenders or servicers on the borrowers' money.

Requiring impound accounts for taxes and insurance is unnecessary. Many borrowers understandably opt out of tax and insurance escrow accounts. Some borrowers use irregular sources of income, such as tax refunds, to make such payments. Others have had bad experiences with loan servicers or lenders in the administration of such escrow accounts. Borrowers, for example, have complained that lenders or loan servicers fail to pay taxes or insurance when due despite sufficiently funded escrow accounts and despite RESPA requirements. These borrowers face hefty tax penalties and more costly and less valuable force-placed insurance. Moreover, requiring impound accounts allows lenders or loan servicers to take advantage of the float until taxes and premiums are due and reap substantial revenues or earnings credits on deposits.

As a result, the Board should refrain from mandating the establishment of escrow accounts for taxes and insurance as proposed in 12 C.F.R. § 226.35(b)(4). Lenders should be permitted to offer an optional impound account but should be required to either pay interest or account for the earnings benefits derived by the lenders or servicers on the borrowers' money.

E. The Board Should Prohibit The Payment of Yield Spread Premiums and Apply the Regulations Applicable to Yield Spread Premiums to HELOCs.

The Board's proposal to require a written agreement between a mortgage broker and a borrower capping the broker's compensation does not adequately address the fundamental unfair and deceptive lending practices created by yield spread premiums. (See proposed 12 C.F.R. § 226.36(a)(1).) Yield spread premiums, by their very nature, create a conflict between the borrower and the broker, who is obligated in states like California to negotiate the best loan terms available for the borrower. Moreover, given the complicated nature of most mortgage loan transactions and the methods by which a borrower may negotiate more affordable loan terms through the payment of higher yield spread premiums, written disclosures and/or agreements are highly unlikely to protect borrowers from the unfair and deceptive use of yield spread premiums.

The Board should therefore modify proposed 12 C.F.R. § 226.36(a)(1) to prohibit lenders from paying to a mortgage broker any compensation, directly or indirectly, including any yield spread premium, that is based on or varies with the terms of any loan. In the event the Board decides not to prohibit yield spread premiums, the Board should ensure that lenders do not profit from the conflict they create by enacting a regulation that allows a borrower to assert any claims or defenses against a lender that the borrower could assert against a broker whenever the lender pays the broker a yield spread premium. And, in the event the Board decides not to adopt either of these proposals, it should require (1) the broker to offer the borrower the best rate obtainable by the broker for the borrower and (2) provide full disclosure of the yield spread premium for the rate offered and for all other rates that might reasonably affect the borrower's decision. Finally, because yield spread premiums create this conflict regardless of the type of loan for which they are paid, the Board should apply the yield spread premium regulation to HELOCs.

It is clear that most consumers believe that brokers act on their behalf to seek mortgage loans with the best available terms – a justifiable belief in California and other states that recognize a fiduciary relation between brokers and borrowers. The reality, however, is that brokers all too often do not act in the best interests of their client borrowers, an unfortunate result induced by yield spread premiums and the inherent conflict they create. Brokers earn higher yield spread premiums by placing the borrower in "no doc" loans and loans with high rates, prepayment penalties, or other disadvantageous terms – in other words, lenders pay brokers to steer their clients into loans far more expensive or burdensome than those for which they would otherwise qualify. Most of the time, this steering goes on unbeknownst to the consumer who believes that broker is obtaining the best possible loan for which the consumer qualifies.

The great likelihood that unfair and deceptive business practices result from yield spread premiums is demonstrated by a 2006 study that linked yield spread premiums to racial disparities in loan pricing. By controlling for the lender, the researchers were able to analyze 2005 HMDA data and determine that African Americans pay more far more than whites for mortgage loans, largely as a result of broker loan origination. (Robert B. Avery, Kenneth P. Bevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. (2006) (controlling for lender reduces gap between whites and blacks, from 37.5% to 10%) available at www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.)

Given the blizzard of paperwork involved in mortgage transactions, an agreement/disclosure of the nature proposed by the Board will most likely be entirely inadequate to inform the average consumer of the risks and choices the consumer faces. This potential problem is highlighted by the study of a disclosure proposed by the Department of Housing and Urban Development to educate consumers about yield spread premiums so that consumers could prevent "brokers from placing [them] in above-par loans without their knowledge." (James M. Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment, An Executive Summary*, Federal Trade Commission Bureau of Economics Staff Report (Feb. 2004) ("FTC Study") at p. ES-1.) The study concluded that it was "likely to confuse consumers, cause a significant proportion to choose loans that are more expensive than the available alternatives, and create a substantial consumer bias against broker loans . . . ." (*Ibid.*) The study also concluded that "[i]f consumers notice and read the compensation disclosure, the resulting consumer confusion and mistaken loan choices will lead a significant portion of borrowers to pay more for their loans than they would otherwise." (*Ibid.*)

If yield spread premium disclosures were meaningful, contrary to this study, full disclosure should be required. Yet, nothing in the Board's proposal requires a full explanation of how the yield spread premium is determined; nothing mandates that the broker offer and explain the full range of loan options and yield spread premiums available from the lender to enable the borrower to choose which loan terms meet the borrowers needs. Using such information, a borrower theoretically might choose to negotiate the broker's compensation and pay the compensation plus costs out of the yield spread premium generated by a higher interest rate, to pay the compensation and costs out-of-pocket, or to finance the compensation and costs by increasing the loan principal or through some other source. But as is, the proposed regulation does not offer sufficient useful information to even the hypothetical informed and perspicacious borrower. Furthermore, even with full disclosure, the complexity involved would likely lead borrowers to seek explanation from the broker or lender which could likely undercut the efficacy of the disclosure.

In light of these challenges, the only effective way to eliminate the unfair and deceptive practices inherent in yield spread premiums is to ban them entirely. The Board should modify proposed 12 C.F.R. § 226.36(a)(1) to prohibit lenders from paying to a mortgage broker any compensation, directly or indirectly, including any yield spread premium, that is based on or varies with the terms of any loan.

In the event the Board decides not to prohibit yield spread premiums, the Board should ensure that lenders do not profit from the conflict they create by paying yield-spread premiums. The Board can do so by enacting a regulation that allows a borrower to assert any claims or defenses against a lender that the borrower could assert against a broker whenever the lender pays the broker a yield spread premium. Such a regulation would be similar, in concept, to the FTC Holder Rule, which essentially provides that it is an "unfair or deceptive practice within the meaning of Section 5 of [the FTC Act]" for a seller to accept any funds from seller-arranged credit without ensuring that the credit obligation contains a clause providing that the creditor is subject to the claims and defenses that could be asserted against the seller." (16 C.F.R. § 433.2.) As an example, under the FTC Holder Rule a home improvement contractor is prohibited from accepting funds from a mortgage lender to whom he refers consumers unless the mortgage lender agrees to be held liable for the conduct of the home improvement contractor. The Rule, in place for over 30 years, has provided an effective remedy to consumers who are victims of fraudulent contractors without any harm to the still flourishing retail home improvement credit market. Applying a similar provision to lenders and the brokers they use as a matter of law without a contractual clause would similarly cause lenders to monitor their brokers' activities.

The rationale behind such a rule, as with the FTC Holder Rule, is that the lender is in a far better position than a consumer to exercise oversight of brokers and bear the costs of broker misconduct. Unlike borrowers, lenders have the expertise necessary to understand complex mortgage loans. They are repeat users of brokers' services and, also unlike borrowers, they have the financial capacity to monitor brokers with whom they do business. Indeed, the Board has acknowledged that lenders must engage in such oversight. Noting that "institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans," the Board has 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." *(2006*

Interagency Guidance at p. 15.) In addition, such a regulation is more appropriate in the broker/home lender context, as yield spread premium payments and the broker's involvement in negotiating a mortgage create a closer relationship than that required between a seller and creditor under the FTC Holder Rule.

Creating lender liability for broker misconduct whenever a yield spread premium is paid is important for another reason. Allowing lenders to benefit from broker misconduct without associated liability leaves borrowers without adequate remedies. Brokers are usually thinly capitalized and transitory, leaving no assets from which the borrower may recover. Even more problematic are the difficulties borrowers face defending against foreclosures on the basis of broker misconduct. A lender who has paid a yield spread premium to a broker - and thus created a conflict of interest between the broker and his client - should not be able to abet the broker's breach of duty, profit from it, disadvantage the borrower who may be in jeopardy of losing his or her home, and then be immune from any meaningful relief.

Finally, in the event the Board decides not to ban yield spread premiums or create lender liability for broker misconduct when such premiums are paid, the Board should require (1) the broker to offer the borrower the best rate obtainable by the broker for the borrower and (2) provide full disclosure of the yield spread premium for the rate offered and for all other rates that might reasonably affect the borrower's decision (e.g., the borrower may desire a loan at a higher interest rate to obtain the benefit of the yield spread premium if it is used to pay agreed-upon broker commissions and loan closing charges). However, in light of the questionable effectiveness of any such disclosure as discussed above, this option should be carefully considered and studied by the Board, because it is unlikely that such disclosures will ultimately prevent yield spread premium abuses.

As a separate matter, the Board should apply the yield spread premium regulations to HELOCs for two reasons. First, although rare, lenders may pay yield spread premiums to a broker for HELOCs. There is no reason to believe that the kinds of abuses created by the conflict inherent in the payment of yield spread premiums would be any different with respect to such open-end, as opposed to closed-end, loans. Second, this would prevent lenders and brokers from extending HELOCs, in addition to closed-end loans, in order to fund yield spread premiums through HELOCs and thus avoid the application of the stricter controls suggested in these comments.

F. The Board Should Enact Additional Provisions to Ensure the Independence of Appraisers and Should Apply the Proposed Appraisal Regulations to HELOCs.

Inflated appraisals trap borrowers in unaffordable loans they cannot refinance. Thus, the Attorney General's office supports the Board's proposals aimed at preventing the mis-representation of home values. (See proposed 12 C.F.R. § 226.36(b).) The Board, however, should add two additional prohibitions in order to adequately remove the incentives that lead to inflated home appraisals.

First, the Board should require the use of independent appraisers by prohibiting lenders from using appraisal businesses that are owned or operated, in whole or in part, by any company owned or affiliated with the lender.

Second, the Board should require the independence of appraisers by prohibiting them from generating more than a certain percentage of their revenue from any single lender or broker. Such a requirement would ensure fair competition among appraisers and prevent lenders from improperly influencing appraisers through the promise of repeat business or the threat of withdrawing repeat business. The Board's objective of removing coercion in the appraisal process can only be achieved by removing the more subtle forms of coercion that may emanate from the implicit threat that a lender or broker will take its appraisal business elsewhere if the appraiser does not generate appraisals supporting the loans the lender and broker want to make. Although the Board should determine the proper maximum threshold of business with any particular lender or broker that would promote complete financial independence, a 10% threshold seems reasonable given the vast number of lenders and brokers offering mortgage loans. An appraiser dependent on any particular lender or broker for more than 10% of the appraiser's revenue would seem to be particularly motivated to retain that business; given the somewhat inexact nature of appraisals, even a scrupulous appraiser might be tempted to err on the side of supporting loan approval. A 10% rule would not unduly restrict any appraiser's ability to earn revenue especially since this would allow a greater distribution of business among appraisers. Whether 10% or another percentage is chosen, a financial independence standard is essential to ensuring the accuracy of home appraisals.

In addition, the Board should include HELOCs in the coverage of these appraisal regulations. As detailed in Section A above, the number of borrowers who obtain HELOCs subordinate to closed-end mortgage loans has increased exponentially in booming housing markets like California's. In such markets, borrowers obtain HELOCs to either (1) cash out the increasing equity in their homes or (2) buy expensive homes that they otherwise could not afford. In both scenarios, the HELOCs often result in combined loan-to-value ratios of 80% or more - thus creating incentives to brokers and lenders to pressure appraisers to inflate home values. To prevent such deceptive conduct, HELOCs must be included in the coverage of proposed 12 C.F.R. § 226.36(b).

G. The Board's Proposed Regulations Regarding Servicing Should Be Clarified and Expanded and Applied to HELOCs.

The Board's proposals do much to address some of the most prevalent unfair and deceptive practices engaged in by loan servicers. However, the Board should enhance the proposed regulations in the following ways, more fully discussed below, in order to better protect borrowers from the most prevalent loan servicing abuses: (1) make the agency relationship between lenders and loan servicers explicit; (2) clarify that servicers may only charge fees that are authorized by governing state and federal law, expressly identified in the promissory note, and reasonable in amount; (3) require that partial payments be accepted by servicers and timely credited to the borrower's account; (4) adopt the following definition of what constitutes a payment, both with respect to the latter proposed regulation regarding the acceptance of a partial payment and the Board's proposed prohibitions regarding the assessment of late fees or other delinquency charges: any amount paid by or on behalf of the borrower that is equal to the scheduled monthly principal and interest amount, or is short of that scheduled amount by $25 or less; (5) make clear that payments made by borrowers must first be applied to principal and interest, even when the servicer contends other fees are also due and owing; (6) create a rebuttable presumption that a servicer provides a payoff statement within a reasonable time if the servicer responds to a payoff demand within three business days or such lesser time as may be required to address an emergency like a pending foreclosure sale reasonably known to the servicer; and (7) apply all the proposed loan servicing regulations to HELOCs.

First, servicers collect payments made by borrowers on behalf of the holders of the loans under the terms of contracts they enter into with the holders (or other agents of the holders). As such, they are acting as the agent of the creditor, and the Board should recognize and make the agency relationship explicit. This will provide lenders and creditors with the incentive to monitor the conduct of the servicers they hire to collect, process, and distribute borrowers' payments.

Second, the promissory note governs both the borrower's and the creditor's obligations under the terms of the loan. Third-party servicers are not parties to, or assignees of, the note, and may assess fees that conflict with, or are not authorized by, the note. Therefore, the Board should make clear that servicers may only charge fees that are (1) authorized by governing state and federal law, (2) expressly identified in the promissory note, and (3) reasonable in amount. Freddie Mac's servicing policies, for example, only allow fees permitted by the loan documents. (See http://www.freddiemac.com/service/msp/responsible_practices.html.)

Third, the proposed rule properly requires the timely crediting of payments made by consumers. (Proposed 12 C.F.R. § 226.36(d)(1)(i).) This is also consistent with policies endorsed by Freddie Mac. (See http://www.freddiemac.com/service/msp/responsible_practices.html, specifying that "A borrower's monthly payment must be applied to the loan when the payment is received.") Many consumers, however, have complained that payments are placed in suspense or escrow accounts and late fees are assessed under improper circumstances. In order to better prevent this conduct, the rule should be clarified as follows.

The Board should require that partial payments be accepted by servicers and timely credited to the borrower's account. The Board should adopt the following definition of what constitutes a payment: any amount paid by or on behalf of the borrower that is equal to the scheduled monthly principal and interest amount, or is short of that scheduled amount by $25 or less. Lenders would then be required to accept and credit any payment in that amount. This is consistent with the provisions of the Stipulated Final Judgment obtained by the FTC and HUD in the *United States of America v. Select Portfolio Servicing, Inc.* (formerly known as Fairbanks Capital Corp.) matter,[2] and removes any ambiguity or doubt over whether a servicer is required to accept a payment sufficient to cover principal and interest, but not previously assessed fees or charges or, for example, the cost of force-placed insurance. In addition to removing this ambiguity, this clarification will help ensure that all payments made by a consumer are applied to the loan as they are made, regardless of whether there is some contention that more money may also be due. This in turn will help prevent borrowers from incurring additional interest, fees, and charges and thus help borrowers avoid delinquencies and maintain homeownership.

Consistent with this definition of payment, the Board should also use these regulations to make clear that payments made by borrowers must first be applied to principal and interest, even when the servicer contends other fees are also due and owing. This will enable borrowers to receive the benefit of having made a payment sufficient to cover the scheduled principal and interest payment. Requiring that payments first be applied to principal and interest rather than fees claimed owing is also consistent with the provisions of most mortgage notes.

Fourth, the Board properly proposes to bar the assessment of late fees or other delinquency charges when delinquency is only attributable to late fees or delinquency charges assessed on an earlier payment. (Proposed 12 C.F.R. § 226.36(d)(1)(ii).) This provision is consistent with the Board's determination in Regulation AA that the assessment of late fees under this circumstance is unfair. (12 C.F.R. § 227.15(a).) However, the proposed regulation should be clarified to make clear that the definition of payment used for subdivision (d)(1)(i) recommended above applies here as well. This will prevent consumers from being penalized when they have submitted a payment sufficient to cover the scheduled principal and interest, and also ensure that the new regulations are construed and applied on a consistent basis.

Fifth, the Board proposes to mandate that servicers respond to payoff demands within a "reasonable time." (Proposed 12 C.F.R. § 226.36(d)(1)(iv).) This rule is important because consumers frequently complain that their servicers have unreasonably delayed responding to their requests for a payoff demand. Delays in providing payoff demands may cause consumers to incur additional interest charges on unfavorable loans they are trying to refinance and, in some circumstances, may cause consumers to become ineligible for a beneficial refinance loan. In its comments to the proposed regulations, the Board indicated that three business days was a reasonable period under normal market conditions to provide a payoff demand statement, but the Board recognized that more time might be needed if the servicer experienced a high demand for payoff statements.

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[2]See http://www.ftc.gov/os/2003/11/070802selectportfoliomodiifiedstip.pdf.

The Official Comment should also recognize that exigencies faced by the borrower and reasonably known by the servicer may militate for the servicer's response to a payoff demand statement in less than three business days. For example, if a borrower has just arranged financing to repay a defaulted loan and stop a foreclosure sale set one or two days hence, the servicer should be obliged to make every reasonable effort to provide the payoff demand statement so that the foreclosure sale can be averted.

To create more certainty concerning the Board's "reasonable time" standard, the Board should create a rebuttable presumption that a servicer complies with the standard if the servicer responds to a payoff demand within three business days or such lesser time as may be required to address an emergency like a pending foreclosure sale reasonably known to the servicer. The servicer would then be able to rebut the presumption based on facts most directly in the servicer's possession.

Sixth, the proposed regulations regarding servicing specifically exclude home equity lines of credit. (See proposed 12 C.F.R. § 226.36(e).) However, there is no reason to exclude home equity lines of credit from the proposed regulations regarding servicing. Like other mortgage loan products, HELOCs, or payment streams due under the terms of HELOCs, are sold on the secondary market, and the servicing of such lines of credit is often contracted out to third party servicers. In addition, the servicing abuses and concerns recognized by the Board for other mortgages also exist for home equity lines of credit. Indeed, there is no reason to believe that servicers who engage in unfair or deceptive practices with respect to closed-end loans treat HELOC accounts any differently. Presumably, they have systemic policies and procedures that apply to all accounts regardless of type. Therefore, there is no reason not to extend the proposed servicing regulations to borrowers with HELOCs. For regulatory consistency and clarity, the rules should apply to all lines of credit.

H. The Board's Proposed Regulations Regarding Advertising Should be Enhanced in Order to Better Prevent Deceptive and Misleading Statements.

The Board's proposed regulations regarding advertisements recognize the tremendous harm caused by false, misleading, and deceptive advertisements. A portion of the Board's proposed regulations target advertisements that regularly trumpet initial or teaser rates while burying the most important information - such as the APR or the rate that will apply for the vast majority of the loan's full term - in fine print. (See proposed 12 C.F.R. § 226.16(d)(1) (d)(3), (d)(6), 226.24(d), (f).) As the Board recognizes, such advertisements often fail to disclose key terms, such as the existence or amount of origination fees, prepayment penalties, and yield spread premiums, and otherwise fail to advise consumers of the true terms of the loan products being promoted. In order to adequately protect consumers from deception, the Board should supplement its proposed regulations to require the inclusion of all of the following in advertisements regarding loans with introductory rates or payments: (1) the disclosure of the payment amount that will apply after any initial payment period expires, assuming that the borrower makes the lowest payment advertised, on a more prominent basis than the initial payment amount; (2) the disclosure of the fully-indexed rate, maximum interest rate and the APR, as well as the information related to such rates, on a more prominent basis than the initial, short-term rate and the information related to such short-term rates; (3) to the extent any advertised loan may include prepayment penalties, the clear and conspicuous disclosure of the fact that prepayment penalties may be imposed, the term during which such penalties may be imposed, and the potential amount of such penalties; and (4) if the loan has the potential to negatively amortize, the disclosure that such negative amortization will result in an increase in the balance of the loan and the loss of home equity and the maximum potential amount by which the balance of the loan may increase due to negative amortization.

The Board should also supplement its other misleading advertising proposals. (See proposed 12 C.F.R. § 226.24(i).) The Board should prohibit brokers from "giving consumers unwarranted assurances or predictions about the future direction of interest rates." (See *2006 Interagency Guidelines* at p. 20.) With respect to the provision regarding the misleading comparison of loan terms (proposed 12 C.F.R. § 226.24(i)(2)), the Board should prohibit any implication that a loan will carry lower payments than the borrower's current loan unless the lender knows actual amounts of the borrower's current loan payments. In addition, all the proposed advertising regulations should be applied to HELOCs.

Although the Board's proposal regarding teaser or introductory rate advertisements goes some of the way in addressing unfair and deceptive practices, the proposal does not address all the types of misinformation included in these advertisements or adequately address how loans involving introductory or teaser rates may be advertised. First, the Board has recognized, in its publication of the proposed regulations and request for comment, the deceptive nature of advertising used to market payment option ARMs. In order to adequately inform a consumer about the true costs of such loans, the Board should require the disclosure of the payment amount that will apply after the initial payment period expires, assuming that the borrower makes the lowest payment advertised, on a more prominent basis than the initial payment amount. In addition, the fully-indexed rate, maximum interest rate and the APR for such loans, as well as the information related to such rates, should be more prominently displayed than the initial, short-term rate and the information related to such short-term rates. Allowing equally prominent disclosures of such information is inherently misleading, because it may cause the borrower confusion about which terms are applicable for the vast majority of the loan term.

Second, the Board should require the inclusion of information related to the risks and costs of loans with prepayment penalties, negative amortization, and other burdensome terms. The Board should require that to the extent any advertised loan may include prepayment penalties, the advertisement must include information that discloses, clearly and conspicuously, the fact that prepayment penalties may be imposed, the term during which such penalties may be imposed, and the potential amount of such penalties. In addition, if the loan has the potential to negatively amortize, the Board should require an explanation that such negative amortization will result in an increase in the balance of the loan and the loss of home equity and a disclosure of the maximum potential amount by which the balance of the loan may increase due to negative amortization.

The Board's very constructive proposal barring certain types of misleading advertising should be supplemented with two additional requirements. (See proposed 12 C.F.R. § 226.24(i).) The Board should prohibit brokers from "giving consumers unwarranted assurances or predictions about the future direction of interest rates," a prevalent practice described in Section C above. (See *2006 Interagency Guidelines* at p. 20.) In addition, with respect to the provision regarding the misleading comparison of loan terms (proposed 12 C.F.R. § 226.24(i)(2)), the Board should prohibit any implication that a loan will carry lower payments than the borrower's current loan unless the lender knows actual amounts of the borrower's current loan payments.

Finally, because many HELOCs also carry short-term initial rates before adjusting to a higher rate, the proposed advertising regulations should be expanded to apply to HELOCs.

I. The Board Should Permit Borrowers to Rescind Loans Held by Assignees for Violations of the Proposed Regulations.

To prevent the recurrence of the lending and foreclosure crisis we now find ourselves in, the families who end up in unaffordable higher-priced loans, nontraditional mortgage loans, and adjustable rate loans with monthly payments that have the potential to increase by 10% or more must have means to redress violations of the Board's proposed repayment ability and income documentation regulations. The Board should therefore provide rescission, the most effective remedy available, as a remedy for violations of the Board's proposed regulations against the current holder of the loan.

Rescission will only be effective, in today's secondary market environment, if it is assertable against the current holder of such a family's mortgage loan. The current lending and mortgage crisis has been caused, in large part, by lenders which are motivated by demands from the secondary market to make as many loans as possible without regard to their long-term viability. After the lenders sell the loans, they have little or no interest in how they perform; and the loan buyers, because they are not liable for any misconduct associated with the loan unless it is transparent on the face of the loan documents, have no incentive to perform due diligence regarding the long-term viability of the mortgage loans that they buy. As a result, hundreds of thousands of unsound loans have been made to borrowers who cannot afford them - and many of these borrowers have no way of forcing the holders of the loans to rescind or modify their loans, although many should never have been made in the first place.

Thus, the Board should provide rescission as a remedy for violations of the Board's proposed regulations against the current holder of the loan.

Conclusion

The Board has taken a major step to deter the kinds of unfair and deceptive practices that have led to the lending and foreclosure crisis now faced by this nation. Given the enormous adverse impact that this crisis is having on families, communities, creditors, and investors, it is imperative that the Board do all in its power to prevent a similar crisis from recurring in the future. Although these comments are not intended to suggest solutions to all the unfair and deceptive practices currently engaged in by mortgage loan lenders, brokers, loan services, and appraisers, they do address the core abuses observed in California and will go far in both promoting sustainable home ownership and stabilizing the mortgage loan market. The Board should use its broad authority to modify its proposals as suggested in these comments.

Thank you for your consideration of these comments.

Sincerely,

ROBYN C. SMITH
Deputy Attorney General

For EDMUND G. BROWN JR.
Attorney General