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April 8, 2008

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1305; Truth in Lending; 73 Federal Register 1672; January 9, 2008

Dear Ms. Johnson,

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (the Federal Reserve) proposed amendments to Regulation Z.[2] The proposed amendments are intended to protect consumers from unfair or deceptive home mortgage lending and advertising practices while preserving responsible lending and sustainable homeownership. Much of the proposal would provide additional consumer protections to subprime borrowers, but other sections of the amendments would apply to all loans that are secured by a consumer's principal dwelling. The Federal Reserve issued the proposed amendment under the authority of the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA).

The ABA supports the Federal Reserve's efforts to curb abusive mortgage lending practices and to provide increased transparency for borrowers. We agree that it is appropriate for the Federal Reserve to provide additional consumer protections for the subprime market. However, we have a number of concerns regarding the proposed definition of higher-priced loans as well as the potential liabilities for violating the proposed requirements. We also have several recommendations for ensuring that the proposed amendments apply to the intended market and that they provide meaningful information for consumers. The following bullets summarize our position on key issues raised by the proposal.

[1] The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

[2] 73 Fed. Reg. 1672 (Jan. 9, 2008).

- Generally. Non-bank lenders, servicers, brokers, and others involved in the mortgage lending business should be subject to the same lending requirements as federally insured depository institutions. There should be comparable enforcement and supervision for non-bank financial firms.

- Alternative Index for Higher-Priced Mortgage Loans. The Federal Reserve should adopt a test for higher-priced loans that excludes the prime market. This could best be accomplished by basing the definition of a higher-priced loan on an index that is more relevant to pricing in the mortgage market than the yield that is paid on Treasury securities. Possible alternative benchmarks include the Freddie Mac Weekly Mortgage Market Survey, as included in the Federal Reserve's H.15 Schedule. If the Federal Reserve elects to use Treasury securities as the basis for identifying higher-priced loans, it is important that the spread over the comparable Treasury security be increased substantially.

- Comparable Treasury Securities. If the Federal Reserve retains the proposed index for determining higher-priced loans, there should a different methodology for determining the comparable Treasury security for purposes of identifying higher-priced loans under separate statutory authorities. We recommend that the Federal Reserve issue an Advance Notice of Proposed Rulemaking to evaluate establishing one standard for determining whether a loan is higher-priced/higher-cost under Home Mortgage Disclosure Act and Home Ownership and Equity Protection Act.

- Ability to Repay. We agree that lenders should evaluate a consumer's ability to repay a loan based on the borrower's circumstances at the time of origination. If the Federal Reserve moves forward with a final rule, the rule and its accompanying commentary should provide clear guidance regarding what an institution must do in order to "consider" income, debt, ordinary living expenses, and residual income. We also request that the Federal Reserve define these underwriting terms so that the level of underwriting discretion available to lenders is clear.

- Pattern or Practice. We request that the Federal Reserve define what constitutes a "pattern or practice" of failing to determine a consumer's repayment ability. We also request that the Federal Reserve specify that lenders that use automated underwriting systems (that are developed in-house or by an aggregator) are not considered to engage in a pattern or practice for purposes of the regulation as long as the creditor is regularly examined by a Federal regulatory agency for compliance with fair lending laws and regulations. In addition, lenders that use underwriting systems developed by Government Sponsored Enterprises (GSEs) should not be held liable if loans originated using the GSEs' underwriting systems are found to constitute a pattern or practice of failing to consider a borrower's repayment ability.

- Prepayment Penalties. We generally agree with the proposed limitations on prepayment penalties for higher-priced loans. We recommend that the 60-day rule be limited to cases where the interest payment would increase significantly.

- Escrow. We request that the Federal Reserve adopt a disclosure alternative to the proposed escrow requirement for higher-priced loans.

- Broker Compensation. Consumers should receive information that is more specific about a broker's role and compensation in a mortgage transaction. We request that the Federal Reserve 1) specify that creditors may rely on the face of the broker compensation agreement; 2) impose a direct obligation on the mortgage broker to provide the broker disclosure/fee agreement; and 3) expressly prohibit brokers from accepting fees until the consumer signs the fee agreement.

- RESPA. New rules regarding broker compensation should be adopted in conjunction with HUD's initiative to reform settlement procedures under RESPA. The Federal Reserve should work with all relevant agencies, including HUD and the FTC, to adopt a simplified and improved disclosure package for consumers.

- Appraisals. We request that the "reason to know" standard in the proposed rule be replaced with a standard that prohibits a lender from making a loan if the lender had actual knowledge that the appraisal was inflated.

- Servicing. We request that the Federal Reserve specify that a violation of the servicing requirements is not considered "material" for the civil liability provision of TILA. We also request clarification regarding a number of servicing practices.

- Advertising Rules. We request the Federal Reserve to conduct consumer testing in order to study whether the proposed advertising disclosures would be useful to consumers or whether such detailed information would be more helpful if it were provided in other disclosure contexts.

- Electronic Advertisements. We support permitting television and radio advertisements to provide a toll-free telephone number that consumers could call in order to receive more information about the product. Similarly, lenders should be permitted to use links in Internet advertisements in order to comply with mortgage advertising disclosure requirements.

- Prohibition on Certain Acts or Practices. ABA supports the proposed prohibited acts and practices in connection with mortgage advertisements.

- Early Mortgage Disclosures. We request that, in addition to credit report fees, creditors be permitted to collect appraisal fees and rate-lock fees prior to providing transaction-specific disclosures.

Our comments are organized as follows:

I. Background

Many of the lending abuses that have come to light have occurred in the subprime segment of the mortgage market. Subprime mortgage loans are made to borrowers that are perceived to pose a higher credit risk due to weakened credit histories that result from payment delinquencies, charge-offs, judgments, and bankruptcies. To account for this increased risk, lenders charge subprime borrowers a higher rate of interest than prime customers.

While subprime lending increases a lender's risk exposure, the ABA firmly believes that these loans, when made responsibly, serve an important role in our society. The Federal Reserve's proposal takes the correct approach in that it does not regard subprime lending as a predatory practice. In recent years, the increased availability of subprime credit has expanded homeownership opportunities for underserved populations, as well as for individuals who have impaired credit due to temporary financial setbacks.

While subprime lending can benefit consumers and communities, problems have occurred in a number of subprime loans. In some instances, investors mistakenly assumed that real estate values would continue to rise and used subprime loans to purchase investment properties. In other instances, lenders – particularly loosely-regulated non-bank lenders and brokers – appear to have engaged in practices that resulted in borrowers taking out loans that they did not understand and/or could not afford. And in some cases, borrowers misrepresented their ability to repay unaffordable loans. As a result of this combination of events, and in response to macroeconomic forces that otherwise are placing downward pressure on home prices, many subprime loans are now delinquent or in foreclosure. Approximately 190,000 foreclosures were started on subprime adjustable rate mortgages (ARMs) in the fourth quarter of 2007. This was an increase of 11 percent over the previous quarter.[3] While subprime ARMs represent 7 percent of the mortgage loans outstanding, they represent 42 percent of the foreclosures that were initiated during the fourth quarter. Subprime fixed rate mortgages accounted for 12 percent of foreclosures started, but represent 7 percent of the loans outstanding.[4]

The financial services industry, policymakers, and community groups are working on a number of foreclosure prevention initiatives. However, the Federal Reserve's proposed regulatory amendments are particularly significant in that they will help to close the regulatory gaps that allowed unregulated lenders and brokers to flood the marketplace with problematic loans.

II. Importance of Developing National Lending Standards

The ABA supports the Federal Reserve's use of its authority under TILA and HOEPA to establish national standards that would protect borrowers from abusive or predatory mortgage lending practices. We particularly support the development of a uniform standard that would apply to all financial firms, including non-federally regulated mortgage lenders and mortgage brokers. Non-bank lenders, servicers, brokers, and others involved in the mortgage lending business should be subject to the same lending requirements that apply to federally insured depository institutions. Moreover, in order to ensure that all borrowers are thoroughly protected from predatory lending practices, state and federal officials must apply and enforce national lending standards in a consistent manner.

A. Federally Regulated Financial Institutions. Abusive mortgage origination practices are generally not a problem among financial institutions that are subject to regular examination by federal and state banking agencies. As has been noted by all of the federal banking regulators in testimony before Congress, the majority of abuses in the mortgage market were not committed by members of the banking industry but by state-licensed brokers and lenders. Likewise, an editorial in the September 14, 2007 edition of the *Boston Globe* written by Congressman Barney Frank (D-MA) stated that:

> Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis.[5]

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[3] Speech by Federal Reserve Governor Randall S. Kroszner at the National Association of Hispanic Real Estate Professionals Legislative Conference 2008, Washington D.C., March 27, 2008. http://www.federalreserve.gov/newsevents/speech/kroszner20080327a.htm

[4] Mortgage Bankers Association National Delinquency Survey, March 6, 2008. http://www.mortgagebankers.org/NewsandMedia/PressCenter/60619.htm.

[5] Barney Frank, Editorial, *Lessons of the Subprime Crisis*, Boston Globe, Sept. 14, 2007. http://www.boston.com/news/globe/editorial_opinion/oped/articles/2007/09/14/lessons_of_the_subprime_crisis/

The federal banking agencies have issued guidance on prudent underwriting practices, non-traditional mortgages, and subprime lending.[6] However, these guidance documents are not applicable to state-licensed brokers and non-federally regulated lenders. It is important that the Federal Reserve's proposed amendments apply not only to the banking industry but also to non-bank lenders, servicers, brokers, and others involved in the mortgage lending business. These entities should be subject to the same lending standards as federally regulated depository institutions.

Generally, few ABA members have participated heavily in the origination of subprime mortgages. Banks and savings associations have generally maintained conservative and prudent mortgage underwriting standards, including those institutions that offer a range of products with risk-based pricing. Moreover, these institutions have strong ties to the neighborhoods in which they lend and have very strong incentives to preserve the health of their communities and to meet the needs of their customers in a responsible, sustainable fashion. This has not consistently been the case with mortgage brokers and non-federally regulated lenders. These market participants generally have little or no continuing interest in the loans that they originate.

B. National Mortgage Markets and Inconsistent State Laws. Today's mortgage market transcends local and state boundaries. Due to technological advances, a consumer may obtain a mortgage loan from a lender that is located on the other side of the country. This nationwide market requires nationwide protections in order to protect borrowers, lenders, and investors.

Some states have enacted highly differentiated consumer protection laws that govern mortgage lending practices. While many of these laws apply to finance companies and mortgage brokers, they lack uniformity. We believe that uniform laws for a national mortgage market would do a better job of protecting consumers than the inconsistent state laws that currently exist. In addition, well-intentioned state laws are not always effective because brokers and non-federally insured financial institutions are not routinely examined, nor are they subject to the same level of regulatory enforcement as federally regulated institutions.

C. Comparable Enforcement is Necessary. Of course, establishing national mortgage lending standards solves only part of the problem. Amendments to the HOEPA rules and Regulation Z will be accompanied by extensive supervision and enforcement by the federal banking agencies. We are concerned, however, that there will not be comparable supervision and enforcement for non-bank financial firms. These mortgage market participants do not undergo bank-like examination and supervision and have marketed products that, in some cases, resulted in borrowers financing homes that they could not afford over the long-term. Until there is a comparable enforcement program for all lenders, consumer protection will be incomplete.

The current regulatory regime thus presents a dilemma for policymakers: The new regulations will be felt most by those who need them the least. Insured depository institutions and their affiliates are, as a group, extraordinarily vigilant about complying with applicable laws and regulations. New regulations will be met by these lenders with the same vigilance, thus causing them to expend additional sums to provide more protections to people who are not at risk. Loosely regulated lenders, by contrast, would have their practices most improved by the

[6] Interagency Statement on Subprime Lending, 72 Fed. Reg. 37569 (July 10, 2007); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed Reg. 58609 (October 4, 2006); Expanded Guidance for Subprime Lending Programs, http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/default.htm, January 31, 2001.

proposed regulation and yet are the least likely to be examined for compliance under the current system. Thus, while we appreciate the need for non-bank lenders and brokers to do a better job of ensuring that consumers are treated fairly, we are concerned that the proposed rules will not affect the real target as intended.

We urge the Federal Reserve to continue its efforts – whether through the joint initiatives with the states in the reviews of affiliated entities, through testimony to Congress, or through some other vehicle – to ensure that consumers receive the same level of protection regardless of which lender they select.

III. Higher-Priced Loans

To address abusive subprime lending practices, the Federal Reserve's mortgage lending proposal would provide special consumer protections to a subset of consumer residential mortgages that would be called "higher-priced mortgage loans." Lenders that make higher-priced loans would be required to engage in an underwriting and documentation process that would be more burdensome than what is required by existing law. Specifically, creditors would be required to determine and document a consumer's ability to repay the loan and would be required to establish an escrow account for property taxes and homeowners insurance. In addition, the proposal would prohibit prepayment penalties on higher-priced loans in certain circumstances. A lender that engages in a pattern or practice of making a higher-priced loan without considering a consumer's repayment ability, or that violates other requirements that would be applicable to higher-priced loans, would be subject to administrative enforcement as well as civil liability.

On balance, the ABA supports the Federal Reserve's efforts to address subprime lending abuses. We agree that the amendments to Regulation Z should provide important protections for subprime borrowers and help restore confidence in the mortgage and credit markets. We are concerned, however, that the proposed regulations for higher-priced loans would unintentionally and unnecessarily apply to a substantial portion of the prime market and thereby impose additional costs for a large portion of the mortgage market with little or no offsetting benefit. We are also concerned that the amendments would expose banks to significant legal liability.

A. Definition of Higher-Priced Loans.

Proposed §226.35(a) would define a higher-priced loan as a consumer residential mortgage loan with an APR greater than three percentage points over comparable Treasury securities, or five percentage points over Treasury securities for subordinate liens. This test is unreliable and in the current market environment is too broad and would encompass a significant amount of prime loans. The working group of members that ABA formed to discuss the proposed rule commonly reported that the definition of higher-priced loans would encompass up to one-third of the prime loans that they originated between November 2007 and January 2008. Several members tell us that 100 percent of the prime loans originated during this period would be considered higher-priced. As a general matter, these originators were not engaged in subprime lending.

The preamble to the proposal demonstrates that the Federal Reserve is concerned about a) protecting vulnerable borrowers while b) avoiding layering on regulations that are not needed for other segments of the market. While we appreciate that the Federal Reserve is attempting to strike an appropriate balance, and that the line between those who need help and those who do not is difficult to draw, we respectfully submit that the proposal would cover far too many prime

loans in many market environments. Applying the requirements for higher-priced loans to prime borrowers would increase the cost of credit for prime consumers and would tighten liquidity detrimentally for all borrowers. These results would frustrate the goals that the Federal Reserve wishes to achieve by amending Regulation Z. There is simply not a demonstrated need for the proposed amendments to apply to such a large swath of the mortgage market.

To ensure that prime loans are not included unintentionally in the higher-priced category, the ABA recommends that the definition of a higher-priced loan be based on an index that is more relevant to pricing in the mortgage market than the yield that is paid on Treasury securities. An index that consistently tracks mortgage rates would be especially important when the yield curve is inverted. One possible alternative would be to measure a higher-priced loan as a mortgage that has an APR that exceeds a specified threshold over a rate published by a government sponsored enterprise (GSE), such as the Freddie Mac Weekly Mortgage Market Survey,[7] as is included in the Federal Reserve's H.15 schedule.[8] If the Federal Reserve elects to use Treasury securities as the benchmark for identifying higher-priced loans, it is important that the spread over the comparable Treasury security be increased substantially.

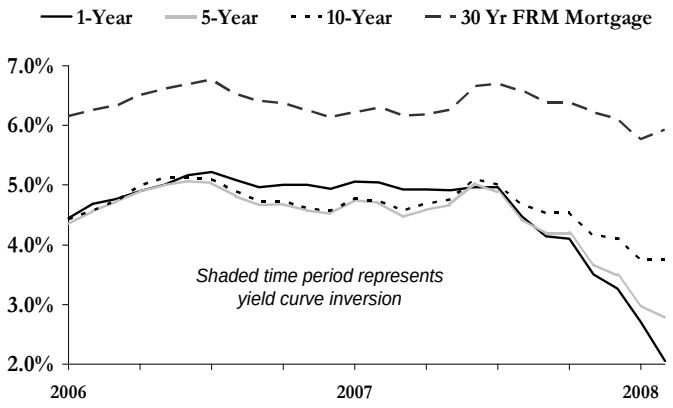
Below is a detailed explanation of our rationale for substantially revising the proposed definition of a higher-priced loan.

1. Treasury Securities as a Benchmark. Due to pervasive and perhaps permanent disruptions in the historical correlation between Treasury securities and mortgage rates, Treasury securities would be a distorted yardstick for measuring what constitutes a higher-priced loan. The disruption in the link between Treasury securities and mortgage rates has been caused, in part, by two developments. Both of these developments are demonstrated in the graph below.

   First, in recent years, there has been a flight to quality by domestic and international investors. Economic uncertainty increased demand for Treasury securities, which, in turn, decreased the yield that is paid on those securities. As a result, whatever relationship that may have existed between Treasury rates and mortgage rates has been broken, as illustrated in the following graph.

Yield Curve

(Average Monthly Rates, 2006 – February 2008)



Source: Federal Reserve (H.15)

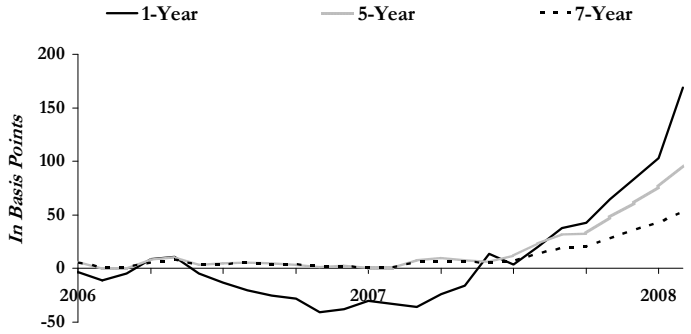
[7] http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp.
[8] http://www.federalreserve.gov/releases/h15/update/.

Second, the shape of the yield curve creates problems for choosing Treasury rates as a benchmark for defining higher-priced mortgage loans. The shaded area in the graph above represents the yield curve inversion (i.e., the period during which the short-term yield is higher than long-term rates). When the yield curve is inverted, prime loans would be more likely to be categorized as higher-priced mortgages.

The graph below is another illustration of a yield curve inversion. This graph represents the difference between each short-term rate compared to the 10-year Treasury. Within the last two and half years, there were two periods when the yield on long-term rates dipped below short-term rates. The inversion that occurred in between 2006 and 2007 lasted for approximately three quarters.

Spread Between Short-term Treasuries and 10-Year Treasury

(Average Monthly Rates, 2006 – February 2008)



Note: Negative numbers indicates short-term Treasury yield is greater than 10-year Treasury.

Source: Federal Reserve (H.15)

The change in the number of loans that one ABA member reported under the Home Mortgage Disclosure Act (HMDA) illustrates how an inverted yield curve would affect the classification of a lender's mortgage loan originations for purposes of what would constitute a higher-priced mortgage under the proposed rule. In 2005, 2 percent of the first lien loans that the institution originated exceeded the benchmark Treasury by over three percentage points. That number jumped to over 36 percent of first lien loans in 2007 without any significant change in the institution's loan products or underwriting standards. We are aware that the Federal Reserve is proposing a different methodology for determining the comparable Treasury security than is used currently for HMDA reporting purposes. Nevertheless, we believe that the experience of this institution demonstrates the effect that a fluctuating yield curve will have on the number of loans that would be included in the higher-priced category. An examination of the aggregate HMDA data submitted for loans originated during this period would be instructive in determining the volume of industry loans that would be affected by the proposed amendments.

This variability in the loans that would be considered higher-priced underscores the inappropriateness of using the Treasury rates as a benchmark. Borrowers are not made more vulnerable by virtue of an inverted yield curve, and yet the Federal Reserve's proposal would apply as if they were. Given the Federal Reserve's appropriate emphasis on trying to confine the application of the protections for higher-priced loans to those

who need the additional protection, the Federal Reserve should select a benchmark that more reliably tracks the market rates that mortgage borrowers pay.

The evolution of the secondary mortgage market is the second reason that there is a disconnect between Treasury securities and mortgage rates. Mortgage products have become a commodity due to the maturity of the secondary market. As a result, broader market forces, not Treasury securities as a proxy for funding costs, determine competitive mortgage rates. Because mortgage rates are driven largely by the capital markets, changes in rates on Treasury securities would not be an accurate benchmark for identifying higher-priced loans.

Moreover, other external factors will make Treasury securities a less reliable indicator of market pricing. In March 2008, Fannie Mae and Freddie Mac instituted a 25 basis point surcharge that will apply to all mortgages that lenders deliver under standard or negotiated terms.[9] This "adverse market surcharge" is in addition to the risk-based pricing structure that Fannie Mae and Freddie Mac rolled out in late 2007. Freddie Mac announced recently that a second wave of risk-based pricing increases will take effect in June 2008. Under the fee increases, the GSEs will charge originators significant post-settlement fees based on the loan product, a consumer's credit bureau score, and the amount of the downpayment.[10]

This practice by the GSEs reflects changing risk in the marketplace and will include loans that are made to prime customers. For example, under the new Freddie Mac pricing structure, a loan with an 80 percent loan-to-value ratio and a credit score between 700 and 719 will be charged a delivery fee of 50 basis points. This charge will be in addition to the 25 basis point adverse market surcharge. This new pricing structure will make it more expensive for lenders to originate conforming loans. These costs will ultimately be passed along to consumers in the form of a higher interest rate or increased closing costs, either of which would inadvertently push the APR on a mortgage loan toward the higher-priced category.

In addition, recent adjustments to the rates for mortgage guarantee insurance will impact the price of a home loan. Like the GSEs, private mortgage insurance companies (MIs) have adjusted their pricing structure in recent months in order to protect against additional losses stemming from the downturn in the housing market. On average, mortgage insurance premiums add 50 basis points to the cost of a loan. This amount can increase or decrease depending on the borrower's credit score and the property's loan-to-value ratio.

Because premiums for private mortgage insurance must be incorporated into APR and finance charge disclosures, increasing premiums for private mortgage insurance will increase the likelihood that prime mortgage loans would fall inadvertently into the higher-priced category. The increased GSE delivery fees and the stepped-up rates for mortgage insurance premiums further illustrate why market pricing of mortgage loans

[9] Announcement 07-21, Adverse Market Delivery Charge (December 5, 2007) https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2007/0721.pdf; Bulletin, New Market Condition Postsettlement Delivery Fee Applies to All Mortgages With Settlement Dates On or After March 9, 2008 (December 11, 2007) http://www.freddiemac.com/sell/guide/bulletins/pdf/bll121107.pdf.

[10] Bulletin, Selling Requirements (February 21, 2008) http://www.freddiemac.com/sell/guide/bulletins/pdf/bll022108.pdf.

does not automatically correlate to the yield on Treasury securities and why prime loans could exceed the proposed three percentage point spread.

These problems can be minimized by using an index that will, we believe, produce a more reliable indicator of prime loans and loans that are priced higher to compensate for greater risk. The Freddie Mac Weekly Mortgage Market Survey, as reflected in the Federal Reserve's H.15, is an example of an alternative benchmark that should be considered as part of this rulemaking. The Freddie Mac survey is easily accessible and, unlike Treasury securities, would be a consistent indicator of market pricing for prime mortgage loans. We emphasize, however, that the Freddie Mac survey data is an index that reflects wholesale pricing for only the very lowest risk customers. A spread above this rate is essential to accommodate risk pricing for other prime loans to accommodate risk pricing by the GSEs and MIs, and to accommodate rate adjustments to permit no-closing cost loans which borrowers frequently demand.

2. Spread Over the Index. If the Federal Reserve were to adopt an alternative index that tracks market rates, a spread close to the proposed three and five percentage points would be appropriate. However, we would emphasize that any spread would be workable only if it takes into account the pricing differences that result from loan terms and other risk parameters of a low-risk, benchmark mortgage.

   If the Federal Reserve uses Treasury securities to identify higher-priced loans, we request that a significantly larger spread be adopted in order to offset the variations that can occur between Treasuries and mortgage rates. As previously discussed, the proposed three percentage point and five percentage point thresholds would capture many prime mortgages that are not high-risk loans due to the changes in the yield curve as well as other factors that affect the pricing of a loan, including, but not limited to the loan-to-value ratio, the borrower's credit score, and secondary market surcharges. A March 27, 2008 article from Bloomberg, L.P. illustrates this point.

   > The difference between the 10-year government bond yield and the aggregate U.S. fixed mortgage rate was 2.7 percentage points last month….For the moment, fixed mortgage rates seem to have disconnected from the 10-year Treasury bond.[11]

   Without more comprehensive industry data, we are unable to determine with certainty what the appropriate spread over Treasuries should be. However, we are aware that a number of banks are providing loan data to the Federal Reserve that will be useful in determining an appropriate spread that would exclude prime loans. Based on discussions with the working group of ABA member banks assembled to discuss the proposal, a spread of five percentage points over Treasury securities for first lien loans and seven percentage points for subordinate liens might be workable; however, additional loan data and analysis would be necessary before we could endorse this alternative with confidence. Members of the working group also stated that a broader spread is necessary in order to take into consideration differences in the mortgage market that vary by geography.

   We reiterate our request that the Federal Reserve use an alternative index for identifying higher-priced loans. In addition, we ask that the Federal Reserve study the data that it receives during this comment period, as well as HMDA data, in order to define higher-

[11] *Banks Fail to Lower Mortgage Rates as Bernanke Cuts*, Bloomberg, L.P., March 27, 2008.

priced loans in a way that: 1) ensures that no prime and fewer Alt-A loans are captured in the higher-priced category; 2) allows borrowers with acceptable risk characteristics to continue to have access to prime lending without triggering features intended to protect subprime borrowers; and 3) addresses the lack of correlation between Treasuries and the mortgage market.

3. "Comparable" Treasury Securities. The ABA appreciates the efforts of the Federal Reserve to 1) minimize the number of loans that would be classified as higher-priced loans as a result of the changed relationship between short-term and long-term rates and 2) provide greater certainty earlier in the application process as to whether a particular loan would be required to comply with the requirements for higher-priced loans.

   However, the variation between the yield on Treasury securities and mortgage rates is so pronounced that the proposed matching methodology would not sufficiently reduce the number of prime loans that would be included in the higher-priced category. That is why we continue to advocate a benchmark other than Treasuries for purposes of identifying higher-priced loans. In the event that the final rule does, in fact, rely on Treasuries, we make the following recommendations for purposes of determining comparable Treasuries and the timing of the match.

   Matching Methodology. The Federal Reserve has attempted to minimize the rule's burden by using the same 300 and 500 basis point spreads over Treasury securities as are used under Regulation C, which implements HMDA. However, the proposal would use a different approach for matching the comparable Treasury securities to particular loan terms. Regulation C compares the APR on a loan to the yield on Treasury securities having a period of maturity comparable to the maturity of the loan, while the proposal would match loans to Treasuries based on whether the loan is adjustable or fixed; the term of the loan; and the length of any initial fixed-rate period if the loan is an adjustable-rate mortgage. The proposed methodology is intended to reduce the "yield curve effect" that results from changes in the interest rate environment.

   ABA members report that creating an additional matching standard would increase the complexities of compliance without providing any substantial benefit in terms of minimizing the yield curve effect. Therefore, we recommend that the Federal Reserve not adopt a separate methodology for determining the comparable Treasury security for purposes of identifying higher-priced loans. In addition, there is merit in issuing an Advance Notice of Proposed Rulemaking to determine whether it would be worthwhile to have one standard for identifying higher-priced/higher-cost loans for purposes of HMDA and HOEPA.

   Timing of the Match. We also have concerns regarding the proposed timing for matching the comparable Treasury security. Loans would be matched to the applicable Treasury as of the 15th day of the preceding month if the creditor receives the application between the 1st and the 14th day of the month and as of the 15th day of the current month if the creditor receives the application on or after the 15th day.

   We are concerned about market shifts and changes in the yield curve that may occur between the date of application and the date that the interest rate is locked or that the loan documents are drawn. While the rate-lock date (which is the date established under HMDA for comparing the applicable Treasury) would provide a more accurate way of

determining whether a loan should be classified as a higher-priced loan, we do not believe that this approach would provide lenders with sufficient time to ensure that a higher-priced loan meets all of the applicable consumer protection requirements. Therefore, we do not oppose the application date approach even though we have concerns about the accuracy and the added compliance complexities associated with this matching methodology.

B. Examples of Prime Mortgage Products That Could be Classified as Higher-Priced Loans in Many Environments.

Financial institutions commonly price a risk premium into loan products based on many factors, including the amount of the loan, the amount of the borrower's down payment, the term of the loan, and whether the loan will be held in portfolio. However, risk-based pricing should not be automatically equated with subprime or higher-priced lending. Some popular loan products, each of which are priced to reflect the type and associated risk of a given loan product, would likely be classified as higher-priced loans under the proposed amendments. The loan products described below illustrate the need for crafting a definition of higher-priced loans that is based on a market rate.

1. Adjustable Rate Mortgages. A significant percentage of prime adjustable rate mortgages (ARMs) would be classified as higher-priced loans under the proposed rule under certain circumstances. This would be particularly true when the yield curve is inverted. At such times, the ARM price for 6-month, 1-year, and 2-year adjustable ARMs will be high relative to the benchmark for 30-year fixed mortgages because the short end of the yield curve is high relative to longer maturities. Since shorter maturity ARMs will be priced relative to short-term funding costs in order to manage interest rate risk, the inverted yield curve will cause an increased proportion of prime ARMs to be classified as higher-priced loans.

   ABA surveyed the members of our mortgage issues working group in order to obtain a sense of the effect that the proposal would have on the loan originations of depository institutions. The responses to the survey are noteworthy. It was not uncommon for the APR of prime ARM loans originated in November 2007, December 2007, and January 2008 to exceed 300 basis points over the comparable Treasury security based on the matching methodology set forth in the proposal. Several respondents reported that more than half of the prime 7/1, 5/1, and 3/1 ARMs that they originated during this period would be classified as higher-priced loans under the proposal.

2. Jumbo Loans. Jumbo loans typically carry higher interest rates than conforming loans that are eligible to be purchased by the housing GSEs, such as Fannie Mae and Freddie Mac. Historically, jumbo loans had interest rates that were 25 to 50 basis points higher than the rate for conforming loans. However, recent tightening in the credit markets has resulted in jumbo loan rates that are 100 to 125 basis points higher than the rates charged on conforming loans. Because jumbo loans generally are ineligible to be purchased by Fannie Mae or Freddie Mac, an institution that originates jumbo loans faces the possible risk of being unable to free up capital for future loans by selling jumbo

mortgages to the investment community.[12] After pricing for this risk, it would be common for jumbo mortgages to be considered higher-priced loans under the proposal.

Indirectly including jumbo loans within the definition of a higher-priced mortgage would not remedy the lending abuses that have been the real source of problems in the mortgage market. The vast majority of jumbo loans are made to borrowers with prime credit, and applying the higher-priced loan requirements to this mortgage product would result in added regulatory and compliance costs for financial institutions and increased closing costs for prime consumers. This undesirable result would be particularly harsh in high-cost areas, such as Washington, D.C., California, New York, and Florida where jumbo loans are common.

3. Small Mortgage Loans. Small mortgage loans are another example of products that could be improperly categorized as higher-priced loans. As explained below, small loans often are priced higher to reflect circumstances that have nothing to do with whether the borrower is subprime. The proposal risks limiting the availability of flexible loan products and would increase closing costs for prime customers that reside in low- and moderate-income areas or rural parts of the country.

   Between 2003 and 2006, real estate prices surged a total of 34 percent nationally and much more in many regions of the country. But not all areas experienced dramatic appreciation. In some locations, real estate prices remain below the national average. For example, ABA members located in the nation's mid-section and in parts of the southern U.S. report that they commonly originate mortgage loans ranging between $50,000 and $75,000. In addition, many banks provide loans for the purchase of mobile homes. The cost of mobile homes can range from several thousand dollars to $15,000 or $20,000. They are an affordable housing option in many parts of the country and are usually retained in the lender's loan portfolio.

   Small mortgage loans are commonly held in portfolio and often have pricing structures that are different than other mortgage products. Lenders incur comparable costs for originating and servicing mortgage loans, regardless of the size of the loan. Institutions sometimes charge a higher rate of interest on a smaller loan in order to recover overhead costs and to ensure that the loan is profitable.

   Likewise, pricing for small loans can be affected by characteristics that are unique to the collateral that secures the loan or by specific loan terms that may not be available for larger mortgage loans. The small mortgage products that have been developed by financial institutions provide choice and flexibility for consumers. In many cases, consumers can select from loan terms ranging from 5, 10, 15, or 20 years due to the small loan amount. Some institutions offer flexible payment terms, such as bi-monthly payments.

   The final rule should not impede an institution's flexibility to provide these kinds of loan products that are tailored to the unique needs of their customers and communities. The proposed rule would hinder the ability of an institution to make pricing decisions based

[12] The Economic Stimulus Act of 2008 temporarily increases the conforming loan limit for Fannie Mae and Freddie Mac. The companies may purchase loans with a maximum original principal obligation of up to 125 percent of the area median home price in high-cost areas, not to exceed $729,750 except in Alaska, Hawaii, Guam and the U.S. Virgin Islands, where higher limits may apply.

on unique loan products because of the added layer of regulatory burden, internal compliance oversight, and litigation risk that would accompany the higher-priced loan designation. We are concerned that the attempt to protect subprime borrowers could, unintentionally, make it difficult for lenders to provide profitable small mortgage loans in the rural marketplace. Moreover, lenders that opt to continue to provide small mortgage loans would pass added compliance costs on to borrowers, thereby increasing closing costs of this affordable housing alternative for credit-worthy customers.

4. Zero Upfront Closing Costs. Loan products with no upfront closing costs (such as loan application fees, title insurance costs, appraisal fees, or credit report fees) are a popular way for consumers to reduce the initial costs associated with purchasing or refinancing a home. Lenders that provide zero closing cost loans charge a higher rate of interest in order to recoup their origination costs on this product. However, the higher interest rate on zero closing cost loans should not be equated with subprime lending. These products can be very helpful to young families with good credit that are trying to purchase their first home. The wrong definition of higher-priced loans could encompass zero closing cost loans and could potentially limit the availability of this product that has been helpful to many first-time homebuyers and refinance borrowers.

5. Home Equity Loans. Treasuries are not a good measure of a bank's cost of funds for home equity loans. As witnessed in the current market, an inverted yield curve, volatility, and liquidity issues will skew the spread and cause prime home equity loans to be categorized as higher-priced loans. Home equity loans are fixed for a specific term, typically ranging from 60 to 360 months. A bank's cost of funds for these loans can vary by over 200 basis points. In some cases, this leaves little room for an institution to price for risk and make a profit without crossing the proposed higher-priced threshold.

   We would also point out that home equity loans that are first liens would have an increased likelihood of being higher-priced loans under the proposal.[13] First lien home equity loans have funding, origination costs, and loan terms that differ from other first mortgages (such as a home purchase loan), even though they are in the same loan position and are secured by the same collateral. Due to these pricing factors, first lien home equity loans could easily trigger the requirements for higher-priced loans when market conditions are similar to those that we are experiencing at this time. Further tightening in the credit markets by banks that wish to avoid the compliance requirements, litigation risk, and the possible stigma associated with higher-priced loans would not be a desirable effect of the Federal Reserve's mortgage reform initiative. Therefore, we request that the test for higher-priced loans 1) reflect market pricing and 2) ensure that prime home equity loans, including first lien home equity loans, would not be considered higher-priced loans. We recommend that the Federal Reserve consider treating all home equity loans as second liens for purposes of determining whether a loan is higher-priced.

C. Specific Requirements Pertaining to Higher-Priced Loans.

The proposed additional consumer protections, while seemingly unobjectionable on their face, raise some significant concerns for our members. Significantly, many of these issues would be addressed if the Federal Reserve were to adopt a definition of higher-priced loans that takes into

[13] A home equity loan can be in first lien position when the initial mortgage on the property is paid in full.

account actual mortgage market pricing and other economic conditions. However, if the proposed threshold is adopted, or if there is a substantial likelihood that prime loans would be affected, we urge the Federal Reserve to adopt the following recommendations.

1. Ability to Repay. The proposed §§226.34(a)(4) and 226.35(b)(1)-(2) would prohibit lenders from engaging in a pattern or practice of making higher-priced mortgage loans based on the collateral without regard to a consumer's repayment ability, including the consumer's current and reasonably expected income, current and reasonably expected obligations, employment, and assets other than the collateral. Lenders would be required to document a consumer's ability to repay the loan.

   We agree that lenders should evaluate a consumer's ability to repay a loan based on the borrower's circumstances at the time of origination. Evaluating a consumer's repayment ability is a key principle of safe and sound lending.

   Underwriting Standards. Federally insured depository institutions already determine their underwriting criteria and establish levels of tolerance based on their risk management principles. If the Federal Reserve moves forward with a final rule, we request that the rule and its accompanying commentary provide clear guidance regarding what an institution must do in order to "consider" income, debt, ordinary living expenses, and residual income. In addition, the Federal Reserve should clearly define the meaning of these required underwriting terms so that the level of underwriting discretion available to the lender is clear. Lenders are reminded on every fair lending exam and in agency guidance that the use of vague or subjective terms in underwriting policies may lead to disparate treatment of or have a disparate impact on applicants in a protected group. It is important that any final rule also avoid ambiguous terms.

   Income Verification Requirement. Proposed §226.34(a)(4) would create a rebuttable presumption that a lender failed to consider a borrower's repayment ability if the lender engages in a pattern or practice of failing to verify and document repayment ability. As discussed more fully below, we are concerned about the ambiguity of the "pattern or practice" standard. Furthermore, applying the documentation requirement to prime customers would bog down the underwriting process for borrowers that have solid, well-established credit histories based on a previous or an existing relationship with the lender.

   Litigation Risk. ABA members are very concerned about the litigation risk that may accompany the underwriting of higher-priced loans. The Truth in Lending Act and its implementing regulations have been highly litigated, and lenders expect that new regulations governing higher-priced loans would be similarly tested by the plaintiffs' bar. We are particularly concerned that the proposed ability to repay requirement would lead to situations in which borrowers whose loans are delinquent or are about to go into foreclosure would file suit against the lender, arguing that the borrowers were put into loans that were unaffordable, and that the lender should not be permitted to foreclose on the properties. This part of the rule potentially sets creditors up for a challenge every time a borrower defaults: The fact of default means that the creditor obviously did not adequately consider the borrower's ability to repay (the argument would go). The potential for protracted, expensive litigation is enormous.
   Lenders will analyze the likelihood and the expense of such lawsuits when examining the costs and benefits of providing higher-priced loans.

Moreover, the potential liability would likely impact the availability and pricing of funding from the secondary market. As the current environment demonstrates all too well, investors hate uncertainty. If a category of loans carries with it significantly higher litigation risk, the value of the assets is placed in considerable doubt and the market for those loans is likely to evaporate.

One option that would lessen the litigation risk would be to include a provision in the final rule stating that compliance with a comparable standard imposed by a lender's primary regulator would satisfy compliance with the ability to repay requirement. Thus, for instance, a national bank that makes a loan that satisfies the requirement in 12 CFR 34.3(b) would be deemed to satisfy the ability to repay requirement in the Federal Reserve's rule. If there are no standards imposed by the lender's primary regulator, or if the standards provide less protection for borrowers, then the lender could remain obligated to comply with the Federal Reserve's requirement.

"Pattern or Practice" Standard. While litigation risk remains a significant concern, we believe that the "pattern or practice" standard set forth in the proposal is an appropriate approach for determining an originator's civil liability for failure to consider a borrower's ability to repay a mortgage loan. However, creating civil liability for an originator that does not assess repayment ability on an isolated loan would severely curtail the availability of mortgage credit to consumers.

In order to provide additional clarity to the industry, we request that the Federal Reserve define what constitutes a pattern or practice of failing to determine repayment ability. Additional specificity would clarify the intent of this standard in the underwriting context and would ensure that the same standard would be applied in all jurisdictions.

Violations that involve a small percentage of an institution's total lending activity should not be construed to constitute a pattern or practice. Therefore, we request that the Federal Reserve provide examples in the commentary to §226.34(a)(4) of what would constitute a true pattern or practice of failing to consider a borrower's ability to repay a loan. It is important that the Federal Reserve clarify the intent of this standard in the underwriting context.

In addition, the proposed commentary to §226.34(a)(4) states that "a creditor might act under a lending policy (whether written or unwritten) and that action alone could establish a pattern or practice of making loans…" without regard to a consumer's repayment ability. We are very concerned that there would be a substantial risk of a per se pattern or practice violation in situations where a lender applies the same criteria or uses the same underwriting software for its mortgage loans. This also raises the question of the extent to which automated underwriting programs would affect a lender's liability.

For example, lenders large and small rely on automated underwriting systems. Some large banks have developed their own automated underwriting systems. Community banks commonly use these underwriting systems when originating loans that they sell to aggregators. Similarly, institutions of all sizes that wish to sell loans to Fannie Mae or Freddie Mac are required to use Desktop Underwriter or Loan Prospector, which are the automated underwriting systems that banks are required to use when making loans that will be sold to the GSEs.

The GSE models are commonly referred to as a "black box" because the systems are proprietary and individual lenders do not know how the GSEs weigh various borrower characteristics. Individual lenders that must rely on the Desktop Underwriter or Loan Prospector should not be held liable if loans originated using the GSEs' underwriting systems are found to constitute a pattern or practice of failing to consider a borrower's repayment ability. The GSEs should be given ample time to audit and revise these systems if necessary in order to ensure that the systems would not violate the rule's repayment requirements.

A determination that use of automated underwriting systems could constitute a pattern or practice of making higher-priced loans without regard to repayment ability would expose creditors to enormous legal risk under the penalty provisions of section 129 of TILA. Therefore, we request that the Federal Reserve specify that lenders that use automated underwriting systems that are developed by a bank, a bank aggregator, or a GSE are not considered to engage in a pattern or practice for purposes of the regulation as long as the creditor is regularly examined by a Federal regulatory agency for compliance with fair lending laws and regulations.

2. Prepayment Penalties. Prepayment penalties that are clearly disclosed can benefit both borrowers and lenders. Consumers benefit from receiving a lower interest rate or lower closing costs, while lenders benefit from increased predictability for loan duration. This loan feature provides consumers with additional choices when selecting the loan product that is best for their circumstances. This choice should be preserved. However, we support putting rules around these kinds of agreements in order to protect borrowers that are vulnerable to lending abuse.

   There were products in the market that effectively prohibited consumers from refinancing hybrid ARM loans that had low teaser rates for an initial period (typically two or three years) but had a significantly higher rate after the initial period. These kinds of loans were not fair to consumers. To address this practice, the proposed amendments would prohibit prepayment penalties on higher-priced mortgage loans unless certain circumstances are met. Specifically, prepayment penalties would be prohibited unless the borrower's debt-to-income ratio at consummation does not exceed 50 percent; prepayment is not made using funds from a refinancing by the same creditor or its affiliate; the penalty term does not exceed five years from loan consummation; and the prepayment penalty expires at least 60 days before the first date on which the principal or interest payment amount may increase under the terms of the loan contract.

   Many of the benefits from the use of prepayment penalties could be obtained and the abuses associated with these clauses could be avoided if prepayment penalties were not permitted to extend beyond 60 days before the first payment reset in cases in which the payment reset is substantial (e.g., greater than 15 percent compared to the original payment). The proposed 60-day rule is appropriate for loans such as 2/28s or 3/27s where there is a fixed payment period followed by a significant payment increase. However, for some ARMs, the 60-day requirement would effectively limit prepayment penalties to ten months. In these cases, the payment increase often will be modest. The proposed limitations on prepayment penalties would be unlikely to provide consumers with significant additional benefits, but the restrictions would complicate a bank's ability

to manage interest rate risk. As a result, we recommend that the 60-day rule be limited to cases where the payment would increase significantly.

The ABA is concerned that this loan feature would be restricted for prime borrowers if the Federal Reserve adopts a definition of higher-priced loans that is too broad. For example, high net worth, prime borrowers that take out a higher-priced loan would not be able to obtain a lower rate by agreeing to a prepayment penalty if their debt-to-income ratio exceeds fifty-percent, notwithstanding that the borrower may be relying on other assets to repay the loan. This unintended result is one more reason that the Federal Reserve should reconsider how higher-priced loans are defined. Limiting the ability of prime borrowers to select a loan with a prepayment penalty would result in higher costs to consumers and could restrict the availability of credit by increasing a lender's risks and costs.

3. Escrow. The proposed rule would require lenders to establish an escrow account for higher-priced mortgage loans that are secured by a first lien. Creditors would be permitted, but not required, to allow borrowers to opt out of the escrow account twelve months after the consummation of the loan.

   Clearly, lenders should consider the ability of a borrower to pay taxes and insurance when evaluating creditworthiness. Moreover, homebuyers need to be adequately informed about the costs of homeownership, including the obligation to pay property tax and premiums for homeowners insurance. These obligations are often significant additional costs that can turn a seemingly affordable loan into one that is unaffordable in reality. Thus, no loan should be made unless the borrower is informed of the obligation to pay taxes and insurance and the borrower has demonstrated an ability to pay all the costs associated with the mortgage loan.

   This does not mean, however, that escrows of taxes and insurance should be mandated for all higher priced loans. Requiring financial institutions to establish escrow accounts for borrowers whose mortgages are classified as higher-priced loans would impose a significant cost and an ongoing compliance burden on institutions that have chosen not to establish departments within their banks for purposes of collecting and paying taxes and insurance premiums on behalf of their borrowers. Accordingly, we request that the Federal Reserve adopt a disclosure alternative to the proposed escrow requirement.

   To ensure that consumers are able to pay their obligations associated with a mortgage, federally regulated financial institutions qualify borrowers for a loan based on the principal and the interest that must be paid on the loan, as well as the taxes and insurance for the property. Some financial institutions have established escrow programs that they view as an important service that they provide to their borrowers. However, not all institutions require borrowers to set aside funds each month in an account for purposes of paying taxes and insurance.

   Some lenders do not escrow due to the costs and compliance requirements associated with these accounts. State laws have different requirements regarding the interest rate that institutions must pay on escrow accounts. In addition, compliance requirements mandated by the Real Estate Settlement Procedures Act make it very expensive for institutions to service escrow accounts. These costs likely will be passed along to the borrower, thereby raising the price of credit. Furthermore, lenders that escrow for taxes

and homeowners insurance must also escrow for flood insurance if the property is located in a floodplain, thereby adding to the compliance burden that is associated with these accounts. Other institutions choose not mandate escrow accounts in order to accommodate customers who simply prefer to manage their own taxes and insurance. The flexibility to permit borrowers to opt out of escrowing after the first year, while helpful, does not change the fact that some banks will have to change their systems or implement new systems in order to accommodate even the first year's taxes and insurance.

The circumstances of two ABA members illustrate the expense that can be associated with establishing an escrow program. A $165 million community bank with two branches estimates that it would have to hire a new staff person to work ½ - ¾ time in order to administer an escrow program. In addition, the institution would incur costs associated with conducting vendor due diligence and purchasing new computer software to help manage the program. The salary and benefits for such an employee would create a significant expense for the institution in a regulatory environment that is already imposing a heavy toll on community banks. The escrow requirement would impact large banks as well. One large ABA member recently established an escrow program for its subprime loans at a cost of over $1 million, excluding ongoing staffing costs. This institution spent one year to hire a vendor and implement the program.

For the reasons explained above, we do not believe that the costs of establishing escrow systems from the ground up would always be outweighed by the benefits that consumers, lenders, and investors would receive. Much of the benefit of the proposal could be obtained in a less burdensome way by requiring a) that creditors consider taxes and insurance when reviewing the borrower's ability to repay and b) that creditors clearly disclose the obligation to pay taxes and insurance.

The need for mandatory escrows is even less compelling in the case of refinancings. The escrow requirement is unlikely to provide a significant benefit to consumers that are refinancing their home. Borrowers that are refinancing already know what the taxes and insurance on the property will be. Therefore, we recommend that the TILA disclosures be amended to include a disclosure of estimated taxes and insurance that is based on the previous year's assessment. Any such changes to the TILA disclosures should be coordinated with initiatives that are currently underway by the Department Housing and Urban Development to reform the disclosures that borrowers receive under the Real Estate Settlement Procedures Act.

If the final rule requires lenders to establish escrow accounts for higher-priced loans, the Federal Reserve should allow adequate time for institutions to conduct due diligence on vendors and software providers and to take other steps necessary to implement the escrow system. We recommend that institutions be given 18 months to come into compliance with any escrow requirement.

D. Impact of Adopting the Amendments as Proposed.

1. Increased Litigation Risk. The Federal Reserve is proposing the higher-priced loan regulations pursuant to §129(l) of the Truth in Lending Act. This provision allows the Federal Reserve to prohibit acts or practices in connection with unfair and deceptive

mortgage loans. Section 130 of TILA permits individual or class action litigants to recover the following damages from creditors that violate §129(l)(2):

- Actual damages.
- Statutory damages in an individual action of up to $2,000 or, in a class action, total statutory damages for the class of up to $500,000 or one percent of the creditor's net worth, whichever is less.
- Special statutory damages equal to the sum of all finance charges and fees paid by the consumer.
- Court costs and attorney fees.

In addition, state attorneys general may bring an action to enforce a violation of §129.

The potential for litigation is the most significant factor weighing on the minds of lenders as they consider whether they will make higher-priced loans. The damages are severe for violations of the requirements for higher-priced loans. In addition, we are very concerned about the potential for class action litigation and actions by attorneys general who are not responsible for the safety and soundness of financial institutions. Monetary damages aside, financial institutions would be forced to spend large sums of money just to defend such actions.

Including prime loans within the scope of loans that could be subject to civil damages for failure to comply with the requirements for higher-priced loans would not accomplish the intent of the proposed rule. The enormous legal risk for banks that make higher-priced loans is one more reason why the Federal Reserve should ensure that the definition of higher-priced loans does not include the prime market.

2. Other Implications. The combination of a) a threshold for defining "higher priced loans" that is too low and b) new consumer protection rules that lack bright-line clarity have caused many of our members to be concerned about the impact that the proposed rules for higher-priced loans could have on their businesses, customers, and communities. A few banks have said that they will exit the mortgage lending market if the proposal were to be adopted as proposed. Others have noted that their compliance and legal costs are likely to increase which, in turn, means that the costs of obtaining higher priced loans will increase. However, one thing remains certain: the prospect of having a large swath of the prime market classified as higher-priced imposes burden that is unnecessary and detrimental for all concerned.

   Such an outcome would be particularly undesirable at a time when regulators and policymakers are looking to regulated financial institutions to provide needed liquidity in the credit markets. Federally regulated institutions can help restore confidence in our country's credit system. An overly broad definition of higher-priced loans could frustrate the intent of the proposed amendments by restricting the availability, or increasing the cost, of credit for many prime borrowers. As some policy makers have noted, a key function of consumer protection is to ensure that consumers have access to responsible credit products.

   Reputation Concerns. Numerous ABA members are troubled by the prospect of being perceived as a predatory lender by virtue of making higher-priced loans. Because the media, activist groups, and others have equated subprime loans with predatory lending practices, it would not be a stretch to imagine an environment in which higher-priced

loans would be viewed as a bad deal for consumers. A related factor is the negative publicity that could result from the litigation risks associated with higher-priced lending (see our comments in section III(C)(1)).

As a result, banks and savings associations will examine whether making higher-priced loans would affect their reputation as responsible lenders in the communities where they do business. Financial institutions may opt to scale back community development and community reinvestment projects in order to minimize the risk of being labeled as high-cost lenders.

Consequences for Consumers. Adopting an overly broad definition of higher-priced loans would have consequences that go beyond increased compliance costs and reduced margins for financial institutions. Young families and others trying to purchase their first home would find mortgages more difficult and more expensive to obtain. Expanding the compliance requirements that would apply to parts of the prime market would increase the cost of consumer credit. The extent to which these adverse consequences occur will depend in large part on the threshold adopted by the Federal Reserve for identifying higher-priced loans.

Compliance and Regulatory Concerns. ABA members have expressed concern that if the rule for higher-priced loans is adopted as proposed, examiners could criticize institutions for spikes in higher-priced loans even though an institution's credit risk exposure would not have changed. Therefore, if the parameters for higher-priced loans are not adjusted in the final rule, we request that the Federal Reserve reassure the industry that institutions will not be criticized for what may appear to be changes in their loan portfolio due to the implementation of the new higher-priced loan regulation.

IV. Provisions Applicable to All Mortgage Loans

Part of the proposed amendments would apply to only higher-priced mortgages, while other sections of the proposal would provide additional consumer protections for all mortgage loans, regardless of a loan's APR. For all mortgage loans, the proposed rules would regulate the compensation of mortgage brokers, prohibit creditors and brokers from coercing a real estate appraiser to misrepresent a home's value, and would establish rules to prevent servicers from engaging in unfair fee and billing practices.

The ABA supports these amendments in proposed §226.36, subject to the suggested changes noted below. Buying a home is one of the most complex and life-changing financial transactions that a consumer will undertake. Therefore, it is appropriate that the Federal Reserve establish basic disclosure, appraisal, and servicing practices that would apply to all mortgage loans.

Most of the proposed provisions are standard practice for insured depository institutions. As pillars of their communities, banks and savings associations serve as trusted financial partners that have a vested interested in ensuring the integrity of the lending process from the time that a loan is originated until it is paid in full. Solid lending practices, combined with good customer service, help depository institutions maintain long-term relationships and secure repeat customers.

Below is a more detailed discussion of our position on the proposed broker compensation, appraisal, and servicing provisions. In addition, we have a number of recommendations that would clarify these sections in order to take into account existing systems and industry practices.

A. Creditor Payments to Mortgage Brokers. Proposed §226.36(a) aims to increase the transparency of a mortgage broker's compensation. Under the proposed amendments, a mortgage broker could not be paid a yield spread premium unless the consumer agrees in advance to the dollar amount that the broker will receive as compensation. The broker and the consumer must enter the agreement before the consumer pays a fee to any person or submits a loan application. This rule would apply even if all or part of the broker's compensation is paid directly by the creditor.

The ABA agrees that consumers should receive information that is more specific about a broker's role and compensation in a mortgage transaction. Consumers, particularly first-time homebuyers, are not always well-informed about the mortgage process or the varying roles of the parties that are involved in the transaction. In many cases, consumers are not aware that the interest rate on a loan affects the amount of compensation that a broker receives.

Yield spread premiums are disclosed on the HUD-1 Settlement Statement, but it is not clear that the broker is receiving the compensation. Disclosing a broker's interest in the transaction will help consumers understand how to better use a mortgage broker. Moreover, providing specific information about a broker's role could make brokers less likely to steer consumers into a more expensive loan product in order to increase their own compensation.

While ABA supports the proposed broker fee agreement, we are concerned that depository institutions, through no fault of their own, would be liable for violating this provision if such an agreement were not signed in a timely manner. As a practical matter, the ultimate creditor will have no way of knowing whether a broker fee agreement was timely signed. Accordingly, we request that the Federal Reserve 1) specify that creditors may rely on the face of the broker compensation agreement for purposes of complying with proposed §226.36(a); 2) impose a direct obligation on the mortgage broker to provide the broker disclosure/fee agreement; and 3) expressly prohibit mortgage brokers from accepting any fees or the consumer's loan application until the consumer signs the fee agreement.[14] These requirements should be in addition to the limitations that would apply to creditors.

The proposed requirement to disclose a broker's compensation would not apply to payments that creditors make to their own employees. We agree with this approach. Consumers simply do not view brokers and loan officers in the same manner. Borrowers understand that loan officers are employees of the institution and that they represent the interests of the bank. However, there is not a similar understanding that a broker is likewise motivated to act in his or her best interest. Therefore, the proposed broker fee agreement would address a transparency problem in the marketplace without imposing unnecessary regulation on other parts of the mortgage industry.

While we support increased transparency regarding broker compensation, we believe that new rules regarding broker compensation should be adopted in conjunction with the Department of Housing and Urban Development's (HUD) initiative that is underway to reform the disclosures for broker compensation under the Real Estate Settlement Procedures Act (RESPA). Like the Federal Reserve, HUD recently published for public comment new requirements regarding the disclosure of mortgage broker compensation. However, HUD's proposal is different as to the timing, form, and content of the disclosures. We strongly urge the Federal Reserve to work with

[14] While we recognize that the civil liability provisions for §130(a) of TILA are limited to creditors, § 130(e) would enable state attorneys general to bring an action to enforce a broker disclosure obligation issued under §129(l)(2).

HUD to issue regulations and disclosures that are the product of a coordinated effort to improve the mortgage process and to provide useful information to consumers. It would be costly and confusing for the banking industry if the two agencies issued varying rules, revisions, and disclosures independently. Similarly, we are aware that the Federal Reserve is in the process of reforming the closed-end credit disclosures that are required by Regulation Z. We strongly urge the Federal Reserve to work with all relevant agencies, including HUD and the Federal Trade Commission, to adopt a simplified and improved disclosure package for consumers. Piecemeal or inconsistent disclosure provisions would not be helpful to consumers and would be unnecessarily expensive for the industry to implement.

B. Appraisals. Reliable appraisals are key to safe and sound lending practices and the functioning of the mortgage markets. Property valuations must be free from improper influence in order to protect the investment of lenders and other investors. Accordingly, ABA supports the proposed provisions that would prohibit creditors and mortgage brokers from coercing appraisers to misrepresent the value of a consumer's dwelling.

The proposed amendments would prohibit creditors and brokers from:

- Implying that retention of the appraiser depends on the amount at which the appraiser values the property.
- Failing to compensate or retain an appraiser in the future because the appraisal comes in too low.
- Conditioning compensation on the loan closing.

In addition, a creditor could not extend credit if it knows or has reason to know that a broker has coerced an appraiser.

These provisions are consistent with existing regulations that apply to federally insured depository institutions as well as the Interagency Appraisal and Evaluation Guidelines. Banks and savings associations are required to implement prudent safeguards to isolate the collateral evaluation process from interference or influence from the loan production process. Due to the important role that accurate appraisals play in safe and sound lending practices, it is appropriate to expressly prohibit all mortgage market participants, including mortgage brokers, from improperly influencing an appraisal.

While there should be basic parameters to help ensure that appraisals will be reliable, we are concerned that the proposed §226.36(b)(2) would hold creditors liable for the actions of mortgage brokers. This provision would prohibit a lender from extending credit if it knows or "has reason to know" that a broker improperly influenced an appraiser. The "reason to know" standard is broad, ambiguous, and subject to multiple interpretations. Incorporating this standard into Regulation Z would increase a creditor's legal risk by holding it responsible for the actions of independent businesses that it does not control.

The proposed appraisal regulations are based on the Federal Reserve's authority under §129(l)(2) of the Truth in Lending Act. Consumers who bring timely actions against creditors for violations of these restrictions may be able to recover actual damages, statutory damages, court costs, and attorney fees. We do not believe that it would be good public policy to subject a lender to such significant liability under a broad, "reason to know" standard. As with several other provisions in the proposal, this provision exposes a creditor to an argument that is a) likely to be made only after the borrower fails to repay the loan and b) probably without merit. A borrower could bring an action (or defend a foreclosure action) based on the creditor's having a reason to know that an appraiser was coerced, as "evidenced" by the fact that an objective

appraisal would have protected the borrower from obtaining a loan that was unaffordable. This puts a creditor in the very difficult position of having to prove a negative. Moreover, the rule as proposed is likely to create increased risk of nuisance suits that are settled in order to avoid the expense of a trial and the possibility – however remote – of a judgment that is far more punitive than the facts would suggest is appropriate.

Therefore, we request that the Federal Reserve delete the "reason to know" standard and replace it with a standard that prohibits a lender from making a loan if the lender had actual knowledge that the appraisal was inflated.

C. Servicing. Prior to the evolution of the secondary mortgage market and the securitization of mortgage loans, individual lending institutions originated loans and processed loan payments. Today, however, it is common for separate servicing companies to oversee account maintenance activities, including the collection of payments and the handling of interest rate adjustments. These outside servicers can be the primary point of contact for consumers. We would note, however, that some institutions, including many community banks, elect to hold their loans in portfolio and service their loans in-house.

Proposed §226.36(d) would prohibit specific loan servicing practices that are deemed to be unfair to consumers. These practices include:

- Failing to credit payments as of the day that they were received (unless a delay in crediting does not result in a finance or other charge or in the reporting of negative information to a credit reporting agency).
- Imposing a late fee on a consumer for making an otherwise timely payment that would be the full amount currently due, but for the payment's failure to include a previously assessed late fee (aka pyramiding fees).
- Failing to provide a fee schedule to the consumer upon request.
- Failing to provide an accurate statement of payoff within a reasonable time after the request.

The ABA supports the adoption of general rules that would govern mortgage servicing practices. The proposed servicing standards are generally consistent with the business practices of depository institutions. Requiring all servicers to adhere to these industry standards would provide more complete protection for consumers.

We are concerned, however, that the new restrictions or requirements for mortgage servicing would be adopted under TILA §129(l)(2). This provision authorizes the Federal Reserve to prohibit unfair or deceptive practices in connection with mortgage loans as well as to prohibit abusive practices or practices not in the interest of the borrower in connection with refinancings. The penalties for violating this provision include statutory damages, finance charges and fees paid on the loan, and attorney's fees unless the creditor demonstrates that the failure to comply "is not material." The penalties that could be imposed for violating one of the proposed servicing provisions are not proportionate to the harm that these violations would cause to the consumer. Therefore, we request that the Federal Reserve specify that a violation of the servicing requirements in proposed §226.36(d) is not "material" for purposes of the civil liability provisions of §130(a)(4) of TILA.

The ABA also requests that the Federal Reserve make the following clarifications regarding specific servicing practices. These clarifications would make the proposed servicing standards more workable.

Fee schedules. We agree that consumers should receive a fee schedule within a reasonable time after requesting information about a servicer's fees. However, the rule should provide servicers with sufficient flexibility to provide information to the best of the servicer's ability, recognizing that some fees will be difficult to know with certainty. Otherwise, this provision – like so many others discussed above – would appear effectively to create a strict liability under §129(l) for conduct that may be neither unfair, deceptive, nor designed to evade the provisions of §129.

The proposed commentary would state that fees imposed by the servicer include third party fees that the servicer passes on to the consumer. Charges by third parties differ across the country, thereby making it difficult to provide precise information to a specific consumer. For example, the fee schedules adopted by state and county governments vary by jurisdiction and can be wide-ranging. It would not be practical for a servicer to disclose all applicable fees that are charged by these government agencies. Therefore, we request that servicers be required to disclose only standard fees or common fees such as non-sufficient funds fees or duplicate statement fees. If it appears that a servicer is attempting to evade the rule by persistently charging fees that are not disclosed in advance, then the appropriate regulatory agency can, and should, address that situation individually.

Pyramiding. The ABA supports the proposed prohibition on late fee pyramiding. This provision is consistent with the practice of insured depository institutions and we believe that it would be beneficial for all servicers to adhere to this standard. In addition, we understand that some states have laws that prevent servicers from pyramiding fees.

V. Advertising Rules

The Federal Reserve is proposing advertising rules that would apply to open-end home equity plans and closed-end credit. The rules are intended to ensure that advertisements provide accurate and balanced information about rates, monthly payments, and other loan features. The new rules would:

- Require additional disclosures for advertisements with introductory or discounted rates.
- Specify how the "clear and conspicuous" standard would apply to advertisements for open-end home-equity plans and closed-end mortgage products that include rate and payment information.
- Require lenders to disclose that a loan will result in a balloon payment (if applicable) and that interest on the loan is tax deductible only to the extent of the fair market value of the dwelling, if the loan or plan permits extensions of credit above the fair market value.
- Ban specific deceptive or misleading advertising practices.

A. Advertising Disclosures. We appreciate that the Federal Reserve is working to address misleading and deceptive advertising practices in the marketplace. The proposed advertising rules are intended to provide greater transparency about advertised mortgage products. The Federal Reserve has undertaken a very challenging task. It will be difficult to craft regulations that enable consumers to understand and compare credit products while ensuring that such rules do not turn advertisements into quasi-legal notices. We are unsure whether requiring a creditor to include detailed loan information in an advertisement is the best approach for preventing misleading advertisements. Indeed, more information may be too much. At some point, the reader or listener is likely to become overloaded and fail to focus on, much less understand, the terms that the proposal identifies as important.

Therefore, we request that the Federal Reserve study whether the proposed advertising disclosures would be useful to consumers or whether such detailed information would be more helpful if it were provided in other disclosure contexts. The Federal Reserve's recent work in studying privacy disclosures[15] provides a useful template for conducting consumer testing in order to determine which disclosures are helpful in the advertising context and which ones are not. This study could be included in the consumer testing of TILA mortgage disclosures that the Federal Reserve will conduct later this year.

B. Electronic Advertisements. The proposed commentary to the advertising rules would specify how the "clear and conspicuous" standard would apply to advertisements for open-end home equity plans and closed-end products that include rate and payment information. The proposed commentary would explain how disclosures about rates or payments in advertisements for home-secured loans would meet the test for being prominent and in close proximity to triggering terms about rates or payments in an advertisement.

The Federal Reserve seeks comment on whether the close proximity requirements for triggered terms should apply to electronic advertisements, such as radio, television, and Internet advertising for closed-end and open-end plans. The Federal Reserve has specifically inquired whether advertisements should be permitted to require consumers to click on an Internet link in order to access the required advertising disclosures.

ABA supports flexible alternatives for providing disclosures in radio and television commercials. These mediums are time-limited and are simply not conducive to providing disclosures of triggered terms as would be required by the proposed rule. Therefore, we support the Federal Reserve's proposed disclosure alternative that would permit advertisements to provide a toll-free telephone number that consumers could call in order to receive more information about the product.

We also urge the Federal Reserve to provide similar flexibility for Internet advertisements. Online consumers are familiar with using links to obtain additional information. This is customary practice for how information is organized in the digital world. Lenders should be permitted to use links in Internet advertisements in order to meet mortgage disclosure requirements. We do not believe that there is evidence that consumers would be harmed by including disclosures within Internet links. We request that the Federal Reserve specify that compliance with its recently amended rule for electronic advertisements under §226.16(c) would continue to satisfy the clear and conspicuous standard for disclosures that are required to be included in mortgage loan advertisements.

There are two types of advertisements that can be purchased for the Internet – search marketing and banner advertising. Paid search marketing is conducted when an advertiser is sold limited characters in order to generate potential interest from a prospect to learn more about the product when certain keywords are searched. The proposed close proximity requirements could generate confusion, not clarity, for the consumer if the additional disclosures are attempted within these limited characters. The current linking structure allows the consumer to view all relevant information on the landing page and is a common interaction with search results.

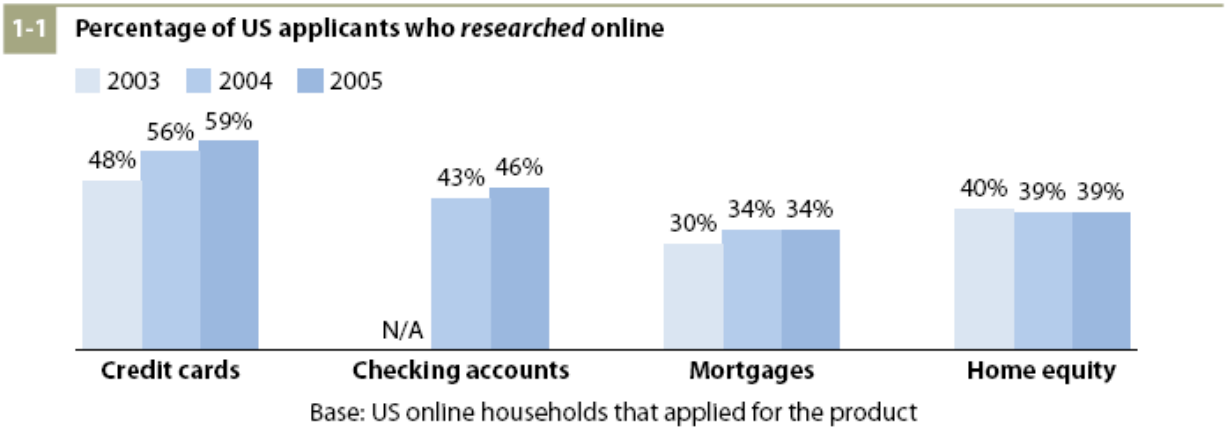
In a similar scenario, banner advertising is sold in small units with the intent to have consumers click through to learn more information regarding a product. Fitting in additional disclosures

[15] *See* http://www.ftc.gov/privacy/privacyinitiatives/financial_rule_inrp.html.

would not be an effective way to educate consumers about the features of an advertised loan product. In addition, purchasing larger ad unit sizes would result in additional costs, as well as costs and time to reprogram the bank's website to accommodate the larger banners.

Rather than complying with the proposed rules, some institutions may consider removing advertising from the Internet entirely in order to avoid the additional advertising costs as well as the costs of adjusting their websites. However, this would not be a desired outcome. According to Forrester Research, slightly over one-third of consumers utilize the Internet in order to conduct research about mortgage products.[16] Requiring banks that have acted responsibly to change their advertising practices due to the deceptiveness of unregulated lenders would result in harm to both consumers and responsible lenders by potentially restricting consumer access to information about various lending products.

Figure 1 Most Credit Card Applicants Research Their Purchase Online



C. Prohibition on Certain Acts or Practices. The proposed rules for closed-end credit would also prohibit specific acts and practices in connection with advertisements. Creditors could not:

- Use the word "fixed" to refer to rates or payments when the rate or payment would be "fixed" for a limited time unless certain conditions are satisfied.
- Compare a consumer's actual or hypothetical current payments or rates and any payment that would apply under the advertised product unless the advertisement includes all applicable rates or payments and states that the advertised payments do not include amounts for taxes and insurance.
- Display the name of the consumer's current lender in an advertisement unless the ad also prominently discloses that it is not associated with the consumer's current lender.
- Claim that the advertised product will eliminate debt or result in a waiver or forgiveness of a consumer's existing loan obligations with another creditor.
- Give the false impression that a broker or lender has a fiduciary relationship with the borrower.
- Provide information about trigger terms or required disclosures only in a foreign language, but provide other trigger terms or disclosures only in English.

[16] *How Consumers Buy Banking Products*, Forrester Research (August 7, 2006).

ABA supports these prohibitions. These practices are not fair and have been used by unregulated mortgage market participants to mislead consumers. Lenders should not be permitted to make statements about loan products that are not true.

In addition, advertisements by some mortgage brokers and mortgage companies have taken advantage of the good name of specific banks and savings associations by prominently displaying the name of the consumer's bank on an advertisement while failing to disclose that the advertisement is by a mortgage lender that is not associated with the consumer's current bank. These advertisements have implied that the consumer's bank is offering the loan advertised or that the loan terms stated in the advertisement constitute a reduction in the consumer's payment amount or rate, rather than an offer to refinance the current loan with a different creditor. These advertisements are misleading to consumers and exploit the reputation of regulated depository institutions as honest and respectable corporate citizens. Therefore, we strongly support the prohibition of this misleading practice.

VI. Early Mortgage Disclosures

The proposal would require creditors to provide consumers with transaction-specific mortgage loan disclosures before they pay any fee, except a reasonable fee for reviewing a consumer's credit history. This rule would extend the early mortgage loan disclosure requirement to other types of closed-end transactions, including mortgage refinancings, home equity lines of credit, and reverse mortgages. ABA members generally report that they require their employees to provide the mortgage loan disclosures within three days of application for all mortgage loans in order to simplify and ensure compliance with the current rules that apply to residential mortgage transactions. Accordingly, we do not oppose the Federal Reserve's proposed disclosure requirement. However, the inability to collect a fee prior to providing the disclosures would be problematic.

We request that, in addition to credit report fees, creditors be permitted to collect appraisal fees and rate-lock fees. Some of our members report that although a signed rate-lock and advance fees agreement will be obtained with the customer's signature at the time of application, the TILA disclosures are mailed within three business days of the consumer's application. If the signed agreements would not be enforceable prior to the disclosure receipt date, institutions would need to either incur the cost for expenses associated with the processing of the loan or delay the processing of the loan. In addition, institutions that lock the interest rate without a fee are exposed to interest rate risk from the time of application until the disclosures are provided. If the institution hedges the lock-in and interest rates drop, the borrower may be able to find another lender offering a lower rate. The initial institution, meanwhile, is left with no fee to offset the hedge cost. This cost is particularly difficult for community banks to absorb.

As with other proposed mortgage disclosure provisions, we request that the Federal Reserve coordinate with HUD and the FTC to ensure that any amendments to the disclosure requirements are consistent with any revisions that other regulators are preparing and that the new disclosure information is helpful to consumers.

VII. Conclusion

The ABA reiterates our support for addressing regulatory and oversight gaps for non-bank lenders and mortgage brokers. In addition, we believe that the Federal Reserve is on the right track by trying to apply the requirements for higher-priced loans to those consumers who need additional protections. Nevertheless, we are troubled by the proposed triggers for higher-priced loans as well

as the potential litigation risk for lenders that extend credit that is classified as "higher-priced." Many of these concerns would be addressed, however, if the test for a higher-priced loan were to be crafted in a way that clearly excludes the prime market.

In addition, we appreciate the Federal Reserve's efforts to make the mortgage shopping, closing, and servicing processes more transparent and easier for consumers to understand. We urge the Federal Reserve to ensure that the broker compensation, appraisal, servicing, and advertising provisions 1) are genuinely helpful to consumers; 2) do not hold regulated depository institutions responsible for the acts of third parties; and 3) take into account well-established businesses processes established by responsible mortgage lenders.

Thank you for the opportunity to comment on this important matter. Should you have any questions, please contact the undersigned or Krista Shonk at 202-663-5547 or kshonk@aba.com.

Sincerely,

Robert R. Davis