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August 13, 2007

Hon. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Docket Number OP-1288

Dear Chairman Bernanke:

We, the undersigned Attorneys General, commend you for conducting hearings and for considering regulations to strengthen consumer protections under the Home Ownership and Equity Protection Act (HOEPA). We strongly urge the Federal Reserve Board to exercise its statutory mandate to protect vulnerable homeowners from the well-documented abuses in the subprime mortgage lending arena. The problems are serious and ongoing, and the need for effective action by the Board is pressing.

It is important that federal consumer protection regulation cover all lenders and loan originators to the maximum extent possible. We believe that the Board is therefore the most appropriate entity to take prompt action to address these abuses. While federal banking agencies have recently adopted the Nontraditional Mortgage Guidance and the Statement on Subprime

Mortgage Lending to deal with some lending abuses, and some states have adopted parallel guidelines, these guidelines do not uniformly apply to all categories of lenders in all states, do not have the same force of law as formal regulations, and are not uniformly enforceable by aggrieved homeowners. Furthermore, due to recent aggressive preemption interpretations by the OCC and OTS, any effort by the States to regulate mortgage lending practices by federally-related banking institutions or their subsidiaries is likely to be resisted on jurisdictional grounds.

The Board, by contrast, has the ability to promulgate rules applicable to all mortgage lenders. The statutory structure is already in place. HOEPA directs the Board, by regulation or order, to "prohibit acts or practices in connection with (A) mortgage loans that the Board finds to be unfair, deceptive or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower." 15 U.S.C. § 1639(l)(2).

As the chief consumer protection officials of our states, we are well aware of the unfair and deceptive lending practices that have become all too prevalent in the subprime lending marketplace in recent years. These practices include aggressive and misleading marketing of inappropriate loan products; the loosening of loan qualification and underwriting standards; outright fraud facilitated by the prevalence of "stated income" and "no doc" loans; bait and switch sales tactics; inflated appraisals; and unaffordable payments caused by rapidly escalating adjustable rates. The result is a rising tide of delinquency and foreclosures. While the foreclosure problem is worse in some sectors of the country than others, the increase in the foreclosure rate is universal, and its effect on individual homeowners and communities can be devastating. Of course, the increase in the default rate for subprime loans has also had a substantial negative impact on banking institutions and other investors as well.

Beginning with North Carolina in 1999, at least 13 states have enacted predatory lending laws to address unfair mortgage lending practices. These state laws typically follow the HOEPA approach of identifying and targeting loans with excessive fees and rates. These "high cost" loans are then subjected to stringent consumer protection requirements, while the mainstream competitive mortgage market is unaffected. The problem practices covered by these laws include: (1) excessive origination and junk fees; (2) loan flipping (which results in compounding of loan fees, thus stripping equity); and (3) "packing" loans with single-premium credit insurance. The state predatory lending laws have been effective in curtailing these abusive practices. Despite the dire predictions by some elements of the lending industry, subprime credit did not dry up in the states that have enacted predatory lending legislation.

The States, acting through the combined efforts of Attorneys General and banking commissioners, have collectively attacked unfair lending practices in major court-approved settlements with national subprime lenders. Our settlement with Household International paid out $490 million in consumer restitution while our more recent settlement with Ameriquest resulted in $295 million in consumer relief. More importantly, the settlements imposed comprehensive consumer protection requirements on the lenders, and set standards that have been adopted by other subprime lenders.

However, despite the successes of these efforts by the States and despite the laudable goals of HOEPA, predatory mortgage lending continues to be a major problem. Although some of the earlier predatory practices are now history, bad actors have developed new practices that are largely unaddressed by current laws or regulations.

The Board has requested comment on four major current consumer protection problem areas in the home equity lending market. We believe that the Board should take strong regulatory action in all four areas. We specifically urge the Board not to rely on further disclosure requirements as the exclusive remedy for any of these problem areas. Mortgage lending is already a disclosure-laden process, and disclosures have been of minimal utility in deterring abusive practices. While we support continuing efforts to improve and streamline disclosures, we recognize that these efforts do not adequately address the core unfair and deceptive lending problems.

We will briefly summarize our position on each of the topics identified by the Board:

1. Unaffordable Loans and Ability to Pay Standards. It should be a fundamental principle that no lender or broker should put a borrower in any home loan that the borrower does not have a realistic capacity to repay. Such a loan may generate fees for the originator but it is harmful to the longer term interests of both the borrower and the eventual holder of the loan. Yet these unaffordable loans are made with shocking regularity.

We would recommend that the Board adopt a general affirmative standard for all home loans that (1) requires the loan originator to evaluate the borrower's ability to repay; and (2) prohibits the lender from making the loan unless the borrower has the ability to make the scheduled payments on the loan, including real estate tax and property insurance obligations, and including payment obligations on any contemporaneous second mortgage loans. No responsible lender should oppose a uniform loan affordability standard.

Many of the abuses we have seen have involved what are commonly known as 2/28 ARMs. In many of these loans, the lender qualifies the borrower based on the initial teaser rate even where it is clear that the payments will become unaffordable when the rate inevitably jumps significantly after the first two years. Therefore, we support a regulation stating that a failure to qualify a borrower according to the borrower's ability to make future payments on an adjustable rate loan is an unfair, deceptive, or abusive practice that is not in the interest of the borrower. At a minimum, consistent with the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortgage Lending, the Board should require that all adjustable rate loans be underwritten at the fully indexed rate based on a fully-amortized payment schedule.

2. <u>"Stated Income" and "Low Doc" Loans</u>. In our experience, loan qualification without verification of income has been a major contributing factor to the increased incidence of mortgage fraud. There are estimates that in 2006, more than 40% of subprime borrowers were qualified for mortgage loans on a stated income basis. The use of stated income or "low doc" qualification used to be limited to borrowers who were self-employed or who had irregular income. However, it is now frequently used for borrowers who have regular salaried jobs and can easily document their income. Given the current prevalence of mortgage fraud, there is no justification to allow for stated income qualification when substantiating documentation is readily available, as it is for most borrowers.

It is worth noting that in our experience, the fraudulent use of stated income is typically initiated by the loan originator, not the borrower. In addition to the opportunity for fraud, stated income loans carry a higher interest rate. It is clearly not in the interest of borrowers to be qualified for loans based on income they actually do not have. We therefore recommend that the Board restrict the use of stated income loans to very narrow, appropriate circumstances.

3. <u>Prepayment Penalties</u>. The large majority of subprime loans have prepayment penalties, while such penalties are infrequently included in prime loans. It is our experience that subprime borrowers do not bargain for prepayment penalties or receive any pricing benefit from their inclusion. Rather, prepayment penalties are simply part of the boilerplate terms of the loan.

Prepayment penalties serve to keep borrowers bound to undesirable loans even when the borrower has the ability to refinance into a more favorable loan. This is particularly unfair for those borrowers who were steered into subprime loans although they qualified for prime loans. Prepayment penalties are also unfair to borrowers who are seeking to refinance escalating rate ARMs before their payments become unaffordable.

We recommend that the Board flatly prohibit as an unfair or abusive practice the imposition of prepayment penalties in subprime loans. As noted above, we believe that further disclosures will not solve this problem.

4. Escrow Requirement for Taxes and Insurance in Subprime Loans. As with prepayment penalties, there is disparate treatment between prime and subprime borrowers in the area of escrowing tax and insurance payments. Almost all prime loans have escrow requirements while most subprime loans do not. The practice of non-escrowing allows subprime lenders to deceptively promote monthly payment amounts that may be lower than the prospective borrower is currently paying. Many subprime borrowers are unaware that their loans do not include escrow accounts, and face payment shock when the tax and insurance bills come due. Of course, if the borrower is unable to pay the property insurance premium, the lender will add force-placed insurance to the loan, in effect creating a high-cost escrow requirement after the fact.

To curtail deceptive practices in payment quotations, and to protect against the potential for default, we would urge the Board to require escrow accounts in all subprime loans. Since the escrow practice is almost universal among prime loans, this requirement should not impose any undue burden on lenders.

Deceptive and abusive lending practices have had a devastating effect on too many American families and communities. There can no longer be serious disagreement about the existence and severity of the problems in the mortgage lending marketplace. While HOEPA and state predatory lending laws, as well as federal and state enforcement initiatives, have had positive effects in combating mortgage lending abuses, they have not been adequate to keep up with the changes in predatory practices. We urge the Board to use its broad authority to address these problems, and to move promptly and comprehensively.

Respectfully,

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[1] Of the states listed, Hawaii is not represented by its Attorney General. Hawaii is represented by its Office of Consumer Protection, an agency which is not a part of the state Attorney General's Office, but which is statutorily authorized to represent the State of Hawaii in consumer protection actions. For the sake of simplicity, the entire group will be referred to as the "Attorneys General," and such designation as it pertains to Hawaii, refers to the Executive Director of the State of Hawaii Office of Consumer Protection.

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