UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of the Secretary

March 9, 2001

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

Re: Docket No. R-1090

Dear Ms. Johnson:

The Federal Trade Commission (Commission) appreciates the opportunity to provide comments on the amendments proposed by the Federal Reserve Board (Board) to the provisions of Regulation Z that implement the Home Ownership and Equity Protection Act (HOEPA). With one exception specified below, the Commission strongly supports the proposed amendments. The Board's proposals to expand and to strengthen HOEPA are necessary and appropriate given the serious problems many consumers still encounter in the subprime home-equity market.

As the Board notes in its proposed rule, lending in the subprime market has escalated dramatically since the enactment of HOEPA in 1994.(1) The Board's hearings this past year on HOEPA allowed representatives of the consumer, industry, and law enforcement communities to offer their perspectives on how to address concerns that have arisen about the predatory practices of certain subprime lenders. The Commission welcomed the opportunity during the course of those hearings to provide its comments on predatory lending practices and its recommendations for curbing such conduct.(2)

The Board requests comments on a number of proposed revisions to Regulation Z, including adjusting the HOEPA price triggers, prohibiting certain acts and practices in connection with HOEPA and other loans, and strengthening the disclosures required for HOEPA loans.

I Expanding the Scope of HOEPA

A. Price Trigger Revisions

The Board recommends amendments to both the rate-based and fee-based standards that trigger the protections of HOEPA. Specifically, the proposals would lower the annual percentage rate (APR) trigger from the current 10% to 8% (above the rate for Treasury securities with a comparable maturity) and expand the points-and-fees trigger to include the cost of optional single-premium credit life insurance and other credit-protection products. The Board also requests comment on certain alternative, more complex modifications of those triggers.

1. Lower the APR Trigger

The Commission supports the Board's proposal to lower the APR trigger to 8%. This measure will apply HOEPA's protections to more high-cost loans and therefore protect more borrowers in the highest-cost segment of the subprime market. According to the report issued last June by the U.S. Departments of Housing and Urban Development and Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000 (HUD/Treasury

Report), there is a compelling need for this regulatory adjustment. According to that study, with the current 10% trigger HOEPA's protections only apply to a very limited number of subprime mortgage loans.(3)

As the Board observes, lowering the trigger by two percentage points would expand HOEPA's protections from an estimated one percent of subprime loans to five percent,(4) still covering only a very small portion of this market.(5) An expansion of HOEPA's reach by the Board in this manner would provide a modest, yet meaningful benefit by shielding more borrowers of very high-cost loans from the particularly onerous loan terms and unfair practices prohibited by HOEPA. The Commission is aware that some parties argue against expanding HOEPA coverage on the grounds that this would limit the availability of credit to subprime borrowers. Although we recognize the theoretical possibility of such an effect, we see no evidence of it at this time, nor do we have any reason to believe that any effect would be significant.

The Board also solicits comment on whether a two-tiered rate trigger should be adopted, pursuant to which first-lien mortgages would be subject to a new 8% trigger while the trigger for second liens would remain at 10%. The Commission urges the Board to adopt a uniform rate trigger. Home-equity loans secured by second liens pose similar risks of abusive practices as first-lien loans. Moreover, this approach would add unnecessary complexity to both compliance and enforcement efforts in an already complicated area. In light of these concerns, the Commission recommends against the adoption of different APR triggers based on lien status and supports the adoption of an 8% APR trigger for all HOEPA loans.

2. Expand the Points-and-Fees Trigger

The Board proposes to include in the "points-and-fees" trigger for HOEPA all single-premium credit life insurance and similar credit protection products paid at or before closing. This modification would include the costs of optional credit life, accident, health, or loss-of-income insurance, as well as debt-cancellation coverage and other extras, in determining whether the points and fees associated with a loan exceed the greater of 8% of the total loan amount or $451,(6) and is therefore subject to HOEPA. The Commission supports the Board's proposed change to the points-and-fees trigger.

As explained in its prior testimony to the Board, the Commission has a long enforcement history in the area of loans sold with credit insurance and other "extras."(7) This practice, known as "packing," involves the addition of credit insurance or other "extras" to increase the lender's profit on a loan. Typically, the insurance or other extra is included automatically as part of the loan package presented to the borrower at closing, and the premium is financed as part of the loan. The lender often fails to provide the borrower with prior notice about the insurance product and the additional costs, and then rushes the borrower through the closing.(8)

Given this background, there are two important reasons why the cost of single-premium insurance should be included in the HOEPA fees-trigger. First, it will eliminate the incentive for lenders to shift fees to insurance (and other extra products) to stay below the HOEPA trigger. That incentive will only increase if the APR trigger is lowered. Second, comparable treatment of insurance costs with other fees in calculating the HOEPA fees-trigger will ensure that consumers who pay high costs for home-equity loans receive equivalent consumer protections.

The Board also asks whether the consumer's ability to cancel coverage and obtain a "full refund" would justify the exclusion of the cost of such coverage from the points-and-fees test. This exception would effectively swallow the rule and inappropriately place the burden on consumers to affirmatively assert their rights with respect to what are often hidden costs.(9) In the Commission's experience, given the way insurance is often deceptively packed into the loan, consumers may not realize they have purchased insurance, or may not realize the cost or coverage of the insurance, and are therefore unlikely to cancel even if technically they have that right.(10)

B. Including Open-End Credit

The Board proposes to clarify that a loan documented as open-end that has the features and terms of closed-end credit is subject to HOEPA and other regulations, if otherwise applicable, governing closed-end credit. Further, the Board solicits comment on whether it should adopt any specific rules to prevent evasions of HOEPA, including a "rebuttable presumption" that if a borrower seeks a closed-end loan but receives a line of credit or similar open-end loan that is priced above HOEPA's triggers, the creditor intends to avoid HOEPA's obligations.

The Commission has encountered the problem of "spurious open-end credit" in its enforcement of HOEPA. The two cases noted by the Board(11) that were part of the Commission's "Operation Home Equity" involved allegations that a lender had falsely represented to consumers that the credit offered to those consumers was open-end, when in fact it was closed-end credit subject to HOEPA's protections.(12) Although the Commission was able to address these instances of deception under section 5 of the FTC Act, additional clarity with respect to when such credit would be subject to HOEPA would be helpful. The Commission also endorses the adoption of the rebuttable presumption proposed by the Board, because it would facilitate HOEPA enforcement by the Commission and others.

II Limiting or Prohibiting Practices that are Unfair, Deceptive, or Abusive

A. Loan Flipping

The Board proposes a variety of measures designed to limit the ability of a lender to refinance repeatedly its HOEPA loans. This practice, commonly referred to as loan "flipping," can be harmful to borrowers because typically each time a loan is refinanced, or flipped, new points and/or fees are charged, often without regard to the borrower's ability to repay the additional amount. As the Board notes, victims of flipping are typically borrowers who already are having difficulty repaying their original loan.(13) Although these refinancings often result in little, if any, additional cash to the borrower or other significant benefits, points and fees are often imposed on the entire amount of the new loan, not just on the incremental amount added to the loan principal through each successive refinancing.

1. Limitations on the Refinancing of HOEPA Loans

The Commission supports the Board's proposal to restrict the refinancing of HOEPA loans within the first twelve months.(14) The Board would permit such refinancing if it would provide a "tangible benefit" to borrowers. The Commission suggests that the Board provide in the Final Rule, for both compliance and enforcement purposes, additional guidance concerning the "tangible benefit" standard.

2. Limitations on the Refinancing of Certain Low-Rate Loans

The Commission also supports the Board's proposal to prohibit for five years the refinancing of certain low-rate loans with higher-costs loans unless the refinancing is in the interest of the borrower. The prohibition would apply to such loans, regardless of whether they are covered by HOEPA. As the Board observes, abuses have been documented with respect to the refinancing of loans issued through mortgage-assistance programs serving low- or moderate-income borrowers. This is of particular concern because those programs, typically sponsored by government or not-for-profit entities, often offer these borrowers their first opportunity for homeownership. As a result of refinancing, these borrowers may be required to pay higher, unaffordable rates and/or fees that can result in foreclosure and the loss of the borrower's first home. The Board would permit refinancing determined to be the "in the interest of the borrower." The Commission suggests that the Board provide in the Final Rule, for both compliance and enforcement purposes, additional guidance concerning the "in the interest of the borrower" standard.

B. Call Provisions

The Board proposes to prohibit "payable on demand" or "call" provisions in HOEPA loans that allow the creditor to demand repayment of the loan principal at any time unless invoked in connection with a borrower's default. The Commission supports this common-sense proposal. Like the current limitations on balloon notes, which HOEPA already prohibits if the loan term is less than five years,(15) this proscription helps avoid forced refinancing in short-

term loans in order to satisfy the demand clauses. As the Board observes, these provisions raise similar concerns as balloon notes, which require lump-sum repayment of the principal at the end of the loan term, and thus warrant comparable protections.(16) This amendment would also be consistent with the TILA's treatment of home-equity lines of credit, and for that reason as well should be implemented.

C. Asset-Based Lending

The Board's proposal would require that creditors generally document and verify consumers' current or expected income, existing obligations, and employment, to the extent applicable. Further, it would amend the commentary to establish a rebuttable presumption of a violation of that rule if the creditor engaged in a pattern or practice of extending loans without complying with the documentation and verification requirements. It would also amend the commentary to refer to external legal standards to help determine whether a pattern or practice of lending without regard to creditworthiness exists.

Asset-based lending is among the most harmful of predatory lending practices. A loan based on the borrower's equity in the home and not the borrower's ability to repay the loan is more likely to result in foreclosure, which injures not only the homeowner but also the surrounding community. Statistical evidence noted by the Commission in its prior testimony to the Board demonstrates the link between subprime lending and foreclosure rates, the latter of which have increased more than the market share of subprime loans.(17) For example, in Chicago between 1991 and 1997, the subprime share of the mortgage origination market increased from 3 percent to 24 percent, but between 1993 and 1998, the percentage of foreclosures attributable to subprime loans rose from 1.3 percent to 35.7 percent.(18)

The Commission has specifically addressed the practice of asset-based lending as part of its HOEPA enforcement agenda.(19) In its investigations of predatory lending practices, the Commission has frequently encountered either missing or extremely poor documentation by lenders regarding what factors were considered in determining ability to pay; in some cases, lenders have failed to verify income. While Regulation B, which implements the Equal Credit Opportunity Act, requires a creditor to retain "written or recorded information used in evaluating the application," it does not generally require that such information be created in the first instance.

In light of this enforcement experience, the Commission strongly supports the Board's proposal to require that lenders generally document and verify consumers' present or anticipated income, current indebtedness, and employment status, to the extent applicable.(20) This change would provide more certainty to creditors who endeavor to comply with the law and to entities that seek to enforce it. The Commission also supports the Board's proposed commentary that references external civil rights standards for establishing a "pattern or practice" of asset-based lending.(21)

D. Notice to Assignees

The Board proposes a new comment that would "clarify" that assignees of HOEPA loans are subject to all claims and defenses, including but not limited to violations of TILA and HOEPA, that the borrower could bring against the originating creditor. However, because the Commission believes that the existing law clearly establishes this principle, it is an unnecessary addition to the HOEPA commentary. The statutory language is unambiguous -- an assignee is subject to "all claims and defenses." Moreover, the legislative history of HOEPA makes clear that this provision was intended to have an effect similar to that of the FTC's Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, also known as the "Holder in Due Course" Rule.(22) As stated in the House Conference Report,

[This provision] eliminates holder-in-due-course protections for purchasers and assignees of [HOEPA] mortgages. Consumers maintain all claims and defenses in connection with such mortgages against assignees that can be asserted against creditors. With this provision, the conferees intend to insure that the market polices itself in order to eliminate abuses. Similar liability has been previously extended by the FTC to consumer installment paper, including automobile loans, without a significant impact on credit availability.(23)

Moreover, the proposed "clarification" could potentially complicate the Commission's efforts to enforce HOEPA against secondary market purchasers. Assignees might argue that the Board's action suggests that, prior to the "clarification," the law was unclear on this issue and, thus, assignees who previously purchased HOEPA loans should not be held liable.

III Enhancing Disclosures

The Board addresses a number of changes to the disclosure requirements for HOEPA loans set forth in 12 C.F.R. § 226.32 (c). The Commission's comments on these proposals are based on issues that have arisen repeatedly in its enforcement of HOEPA.

A. Affirmative Consent to Purchase of Voluntary Items

HOEPA currently requires that consumers be provided with a notice three days in advance of the transaction that discloses, among other things, the amount of the consumer's monthly or other periodic payment. The Board solicits comment on amending the disclosure obligations for HOEPA loans to include a requirement that creditors obtain the affirmative written consent of borrowers to purchase voluntary items prior to including those items in the regular payment disclosed under § 226.32(c). Without such a requirement, a creditor may quote a monthly payment that accurately reflects the loan terms contemplated by the creditor, but that includes charges never agreed to by the consumer.

The Commission supports amending the commentary to require written consent. However, in order to bolster its effectiveness, the Commission recommends that the Board specify that the consent be specific as to the items to which the consumer has consented and that the items required to be disclosed in connection with obtaining consent correspond to those required when consent is obtained at closing. Further, the Board should require that the request for such consent be clear and conspicuous, which is consistent with other requirements imposed by TILA.

B. Total Amount Borrowed

Under the Board's proposal, the HOEPA advance disclosures would include a new item, the "total amount borrowed." As the Commission has learned through its enforcement work, notwithstanding the disclosures otherwise required under TILA, deceptive sales techniques may successfully confuse borrowers about the TILA-required terms.(24) Currently, when the consumer pays points and fees, the amount financed is typically lower than the amount borrowed. Most recently, the Commission challenged such tactics in its suit against the First Alliance Mortgage Companies.(25) The defendants, a subprime lender based in Orange County, California, its parent company, and a Minnesota affiliate, allegedly marketed high-cost home-equity loans to vulnerable borrowers through misleading statements and aggressive sales tactics that were designed to obfuscate the true meaning and significance of TILA-required disclosures. In the experience and opinion of the Commission, the addition of the total amount borrowed as a discrete term included in the HOEPA advance disclosures will at least alert borrowers to the fact that the financing of high points and fees may add substantially to the loan amount,(26) information that the monthly payment amount may not convey.

IV. Conclusion

The Commission appreciates the Board's efforts to expand HOEPA's protections to enhance consumer protections in the subprime mortgage market. Due to the sharp increase in subprime lending, it appears that predatory lending practices are also on the rise, making the Board's proposed steps especially critical at this time. With its enforcement authority under HOEPA and other laws, the Commission will continue to work to protect borrowers from these abuses.

The Commission appreciates your consideration of these views. If any other information would be useful regarding these matters, please contact Joel Winston, Associate Director, Division of Financial Practices at (202)326-3224.

By direction of the Commission.

Donald S. Clark
Secretary

Endnotes:

1. The Board observes that "the number of subprime loans made by lenders that identify themselves primarily as subprime lenders increased about six times -- from 138,000 in 1994 to roughly 856,000 in 1999." 65 Fed. Reg. 81438, 81439 (2000).

2. See Prepared Statement of the Federal Trade Commission before the Board of Governors of the Federal Reserve System on Predatory Lending Practices in the Home-Equity Market, delivered by Peggy Twohig, Assistant Director for Financial Practices, San Francisco, California, Sept. 7, 2000 http://www.ftc.gov/os/2000/09/predatorylending.htm (Board Statement).

3. For example, the Report notes that from July through September 1999, only 0.7% of all subprime loans would be covered by HOEPA. HUD/Treasury Report at 85. Although the actual number may be slightly higher because the example relies upon note rates and not APRs, it nonetheless demonstrates that the current APR trigger brings few loans under HOEPA.

4. The Board cites data compiled by the Office of Thrift Supervision. 65 Fed. Reg. at 81441. While the Board's estimate may be conservative because that data is based on note rates and not APRs, the Commission believes that the number of high-cost loans that would be covered by HOEPA after the APR-trigger was lowered to 8% would still be a relatively small share of the subprime market.

5. The Commission has found that many current lenders price their loans just below the HOEPA triggers, and that such loans often are accompanied by abusive lending practices. Lowering the trigger could bring many of these loans under HOEPA's protections.

6. 12 C.F.R. § 226.32(a)(1)(ii). The dollar amount trigger is adjusted annually, and is set at $465 for 2001.

7. See Board Statement, supra note 2, at 10-13.

8. The lender may employ a variety of tactics to misrepresent the inclusion of the credit insurance in the loan, such as implying that the insurance is free by telling the borrower that it "comes with the loan." See Prepared Statement of the Federal Trade Commission before the House Committee on Banking and Financial Services on Predatory Lending Practices in the Subprime Industry, May 2000, delivered by David Medine, Associate Director for Financial Services http://www.ftc.gov/os/2000/05/predatorytestimony.htm.

9. Such "negative options" plans can operate in ways that are unfair or deceptive to consumers, as is evidenced by the Commission’s trade regulation rule governing such practices. See Use of Negative Option Plans by Sellers in Commence, 16 C.F.R. Part 425.

10. Even if the borrower asserts that right, he or she may not actually obtain a "full refund." In the Commission’s enforcement experience, lenders may only credit consumers’ accounts with the amount of the insurance premium, and not rebate the interest that has already accrued on the premium, the financed points charged on the premium, or the interest that has accrued over the loan term on those points.

11. 65 Fed. Reg. at 81446.

12. See Federal Trade Comm'n v. CLS Fin. Servs., Inc., Civ. No. C99-1215Z (W.D. Wash. 1999); Federal Trade Comm'n v. Wasatch Credit Corp., Civ. No. 2-99 CV579G (D. Utah 1999).

13. 65 Fed. Reg. at 81444.

14. This restriction would not limit a consumer's ability to obtain refinancing of a HOEPA loan from another lender.

15. 12 C.F.R. § 226.32(d)(1)(i).

16. See 65 Fed. Reg. at 81444.

17. See Board Statement, supra note 2, at 16.

18. Id. (citing HUD/Treasury Report, supra note 3, at 49).

19. For example, in conjunction with the United States Departments of Justice and HUD, the Commission brought an action last year against Delta Funding Corporation. In that case, Delta allegedly extended high-cost loans to borrowers based on the borrower's collateral, failing to consider indicia of the borrower's ability to repay the loan, such as current and expected income, other outstanding debts, and employment status. In addition, Delta failed to consider whether the borrower had sufficient residual income after repayment of the obligation to meet ordinary living expenses.See United States v. Delta Funding Corp., Civ. Action No. 00 1982 (E.D.N.Y. filed March 30, 2000).

20. The Commission also agrees with the Board's recommendation to add a comment providing that in evaluating a borrower's ability to repay an adjustable rate mortgage, the creditor may not use initial rates and monthly payments. However, the Commission believes that requiring a creditor to calculate increases to the consumer's payments assuming the maximum possible increases in rates in the shortest amount of time may force lenders to deny credit to consumers who in all likelihood would have the ability to repay their loans. Rather, the Board may want to require creditors to use reasonable assumptions about increases in a borrower's monthly payments when evaluating a borrower's ability to repay the mortgage.

21. See Board Statement, supra note 2, at 17.

22. H.R. Conf. Rep. No. 652, 103rd Cong., 2d Sess., at 367-368 (1994); see also Preservation of Consumers' Claims and Defenses, 16 C.F.R. Part 433.

23. H.R. Conf. Rep. No. 652, 103rd Cong., 2d Sess., at 367-368 (1994).

24. Sections 226.17-.18 of Regulation Z set forth the requirements for disclosures for closed-end credit, including but not limited to HOEPA loans. Pursuant to those provisions, lenders offering closed-end credit must provide written disclosures before consummation of the transaction that include the following information about the loan: the amount financed, the finance charge, the APR, and the total of payments. 12 C.F.R. § 226.17-.18.

25. F.T.C. v. First Alliance Mortgage Co., Docket No. SA CV 00-964 DOC (C.D. Cal. filed October 3, 2000).

26. The benefit to consumers of this additional term in the HOEPA-specific disclosure required by 12 C.F.R. § 226.32(c) may, however, be undercut somewhat by the absence of the same term on the disclosure form required by 12 C.F.R. § 226.17, which borrowers of HOEPA loans also receive. To avoid this potential confusion, the Board may want to consider amending the disclosure requirement for all closed-end credit to conform with the proposed changes to 12 C.F.R. § 226.32(c).