Comments of the
Center for Responsible Lending
to the Federal Trade Commission

Advanced Notice of Proposed Rule-Making: Mortgage Acts and Practices
RIN 3084-AB18

July 30, 2009

The Center for Responsible Lending[1] is pleased that Congress has authorized the FTC to use APA rulemaking authority to address the problems in our mortgage market that have wrought such devastation to our economy.

The FTC's ANPRM invited comments on several aspects of the mortgage process. Our comments will focus on origination issues. Although we are not commenting separately on other aspects of the mortgage process, such as servicing, these other stages in the life-cycle of a mortgage are critical. These are addressed in detail in comments submitted by the National Consumer Law Center and others, and we support their recommendations.

Summary of Recommendations

In order to respond to the pervasive, systemic failures that have spilled over from the subprime market, the Federal Trade Commission should take the following actions pursuant to its rulemaking authority under Section 5 of the FTC Act:

- Prohibit the payment of yield-spread premiums on all home loans to all originators subject to FTC jurisdiction, both employees and third-party originators;

- Prohibit steering for all home loans;

- Make applicable to mortgage brokers and non-bank lenders a general duty of good faith and fair dealing to borrowers, in tandem with either a duty of agency or fiduciary duty applicable specifically to mortgage brokers;

- Require originators to evaluate a consumer's ability to repay in accordance with the loan terms; and

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[1] The Center for Responsible Lending (CRL) is a non-partisan, non-profit research and policy organization dedicated to combating abusive financial practices. It is affiliated with the Center for Self-Help, a non-profit community development institution based in Durham, N.C., dedicated to increasing wealth-building opportunities for low- and moderate-income and minority families and communities. Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and non-profit organizations in North Carolina and around the country. It offers affordable loans, suited to the needs and circumstances of the borrower.

- Prohibit the imposition of prepayment penalties on all home loans.

In addition, the FTC should incorporate into a proposed rule the requirements and prohibitions on acts or practices related to mortgage disclosures that the Federal Reserve Board promulgated under its TILA Section 105(a) authority, thereby allowing the FTC to obtain civil penalties for any violation of TILA, HOEPA, or Regulation Z, consistent with the authority conferred on federal banking regulatory agencies.

This comment addresses these recommendations more fully, tailoring our responses to the questions as presented in the ANPRM.

I. YSPs, Steering, and Duties

Questions Posed: What types of unfair or deceptive acts and practices, if any, do non-bank financial companies engage in related to mortgage origination? For any such act or practice, please answer the following questions. Why is it unfair or deceptive under Section 5 of the FTC Act? Should it be prohibited or restricted? If so, how? For all loans or only certain types of loans? What are the costs and benefits of such prohibitions or restrictions? What would be the effect on competition and consumers if the Commission were to prohibit or restrict non-bank financial companies with respect to the act or practice, but banks, thrifts, and federal credit unions were not similarly prohibited or restricted?

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. Federal Reserve Chairman Ben Bernanke has noted that placing pricing discretion in the hands of financially motivated mortgage brokers can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[2] A similar problem can occur with bank-originated mortgages. Together, yield-spread premiums and prepayment penalties create dysfunctional market dynamics that are harmful to consumers and to competition.

The Federal Reserve Board recently proposed a rule that would ban yield-spread premiums and steering under its own unfair and deceptive practices enforcement authority.[3] As both practices satisfy the definition of unfair and deceptive practices under Section 5 of the FTC Act, it is imperative that the FTC exercise its unique jurisdiction over mortgage brokers and non-bank lenders in prohibiting yield-spread premiums and steering for all home loans. We encourage the FTC to join the FRB in proposing that

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[2] Ben S. Bernanke, Federal Reserve Board Chairman, Remarks at the Opportunity Finance Network's Annual Conference, Washington, D.C. (Nov. 1, 2006).

[3] Federal Reserve Board, Proposed Changes to Regulation Z (Truth-in-Lending), Press Release (July 23, 2009)("To prevent mortgage loan originators from "steering" consumers into more expensive loans, the Board's proposal would prohibit payments to a mortgage broker or a loan officer that are based on the loan's interest rate or other terms; and prohibit a mortgage broker or loan officer from "steering" consumers to transactions that are not in their interest in order to increase the broker's or loan officer's compensation"), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm.

these prohibitions apply to all originators subject to FTC jurisdiction.

A. Ban Yield-Spread Premiums for All Home Loans.

Yield-spread premiums qualify as an unfair practice as defined by Section 5 of the FTC Act, which the FTC has a statutory mandate to prohibit by rule. We propose that the FTC ban all YSPs that vary with the terms of the loan.

1. Yield-spread premiums cause substantial consumer injury.

One of the most significant drivers of the subprime mortgage crisis was the institution of yield-spread premiums (YSPs), through which mortgages brokers were able to obtain additional compensation from lenders in return for selling consumers a higher rate loan than that for which they qualified and/or a loan with other risky features such as prepayment penalties.[4] YSPs create a perverse incentive for mortgage brokers to steer borrowers into loans that are more costly and dangerous even though the borrowers could qualify for a more affordable product. The injury to consumers has been further magnified when YSPs are combined with additional compensation for locking borrowers into higher-rate loans with prepayment penalties, ensuring an income stream to pay off the upfront YSP payment.

In the prime market, the YSP was originally used as a trade-off for up-front mortgage origination fees, with the consumer financing upfront costs by agreeing to a higher rate loan. In theory, the yield-spread premium was to be paid at the borrower's choosing to lower closing costs. However, this trade-off has not been substantiated empirically.[5] Furthermore, HUD recently cited extensive evidence suggesting that, even in the prime market, borrowers with YSPs pay more in aggregated fees, interest, and other closing costs than borrowers who do not pay YSPs.[6]

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[4] *See, e.g.,* Testimony of Andrew Celli, Jr., NY Attorney General's Office, Testimony before the House Committee on Banking and Financial Services (May 24, 2000), *available at* http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.htm (Describing 10% broker fees and other abuses by brokers selling loans to Delta Funding). *See also,* Mortgage Bankers Association (MBA), *Subprime Originations Survey Yearend 2006* 2 (July 2007); MBA Research Data Notes, *Residential Mortgage Origination Channels,* (Sept. 2006)(In 2006, mortgage brokers originated 45% of all mortgages and 72% of subprime loans.).

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

[6] *See* Susan Woodward, *A Study of Closing Costs for FHA Mortgages,* HUD Office of Policy Development and Research (May 2008). In the regulatory review accompanying the issuance of their recently-enacted

Federal policy has long recognized that kickbacks increase costs to consumers and are prohibited.[7] If YSPs truly substitute for up-front fees, as is often claimed, they may not violate RESPA. However, as we have explained above, the empirical evidence is that this rationale is more rationalization than reality, leaving the YSP to pay for "simply delivering a loan with a higher interest rate," which is indeed a violation of RESPA.[8]

Lenders may also create internal employee compensation arrangements that create the same dysfunctional dynamic. For example, for a period of time, Ameriquest rewarded its loan officers for generating the loans most profitable for the company. As evidenced by the subsequent states' law enforcement action against Ameriquest for systemic violations of the law, that is a recipe for problems for the homeowners and everyone else in the long run.[9] Therefore, we agree with the Federal Reserve Board that it would be prudent to outlaw any types of incentive payments based on the terms of the loan, including internal lender incentive payments to retail loan officers. Loan officer "overages" can have the same unfair impact on consumers, and prohibiting all such payments leaves the playing field level for brokers and loan officers.[10]

2. Yield-spread premiums are not reasonably avoidable by consumers.

The intermediary function of mortgage brokers has rendered the market incapable of correcting this structural flaw. Lenders who would otherwise refrain from paying YSPs must do so or risk losing business to lenders who will. This situation is further complicated by the fact that most borrowers have a great deal of trouble understanding YSP disclosures.[11] Because YSPs are so confusing, brokers have been able to charge customers up-front for discount points and other fees while also placing them into a

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proposed rule in March 2008, HUD cited extensive evidence to the fact that even in the prime market, borrowers with YSPs pay in the aggregate more in fees, interest, and other closing costs than borrowers who do not pay YSPs. *See also* Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield-Spread Premiums*, 12 Stan. J. L, Bus & Fin. 289, 353 (2007), *available at* http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (hereinafter Jackson & Berry).

[7] 24 U.S.C. 2607.

[8] HUD Policy Statement Regarding Lender Payments to Mortgage Brokers, 66 F.R. 53052, 53055 (Oct. 18, 2001).

[9] *See*, *e.g. Iowa v. Ameriquest Mortg. Co., et al.* Civ.No. EQ CE 53090, Par. IV-G-(4) (consent judgment filed March 21, 2006 (injunction provision to assure no monetary incentives for prepayment penalties)), *available at* http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_CJ.pdf.

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

[11] *See* 73 Fed. Reg. 44563-65 (2008)(stating that borrowers do not understand YSP disclosures).

higher interest rate loan than they qualified for and thereby earning a YSP – essentially being paid for the same loan by both the customer and the lender.

3. Yield-spread premiums confer no countervailing benefits to consumers or competition, but instead contribute to a "race to the bottom."

YSPs distort competitive market forces by creating a reverse competition effect with brokers incented to shop for the best deal for them, not the best deal for the borrower.[12] This structural flaw serves as an obstacle to efficient and effective market operation and thereby increases the cost of credit. In this, it is a quintessential example of a dysfunctional market, precisely the type of practice that is unavoidable by consumers and "properly banned as an unfair practice."[13]

This structural dynamic may help explain why mortgage brokers deny any obligation to advance the borrower's best interest.[14] Banning YSPs on all brokered loans would eliminate this conflict of interest.[15]

B. Prohibit Steering for All Home Loans.

While an efficient financial market theoretically would provide equally qualified borrowers with equally competitive prices, both quantitative research and anecdotal evidence show that some borrowers, particularly minority borrowers, have less access to safer, lower-cost, prime home-purchase loans.[16] Brokers and lenders in the subprime

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[12] For extensive discussion of the history of YSP regulation and the "trilateral dilemma" of financial regulation of the premiums, s*ee* Jackson & Berry, *supra*.

[13] *See Am. Fin. Servs. Ass'n. v. F.T.C.,* 767 F.2d 957, 986 (1985)(discussing FTC Policy Statement on Unfairness).

[14] The National Mortgage Brokers Association's Code of Ethics at one point recognized that their "obligation of absolute fidelity to the client's interest is primary." National Consumer Law Center, The Cost of Credit (First) §11.8.2 n. 286 (1995). This recognition disappeared from its Code of Ethics shortly thereafter, perhaps not coincidentally as legal challenges to the practice of YSP began. *Id.* The first reported decisions challenging YSPs as illegal kickbacks under RESPA were in 1996. *See* The Cost of Credit (Third) § 12.2.1.5.2 (2003).

[15] At least three states have sought to eliminate the conflict of interest created by YSPs: **Massachusetts** (Mass. Gen. Laws ch. 940, § 8.06(17)(Where the financial interest of a mortgage broker conflicts with the interests of the borrower—*e.g.* the broker's compensation will increase directly or indirectly if the borrower obtains a loan with higher interest rates—the broker shall disclose the conflict and shall not proceed with the loan so long as such a conflict exists.); **New York** (N.Y. Banking Law § 6-m(2)(l))(In making or arranging a subprime home loan, no lender or mortgage broker shall accept or give any fee, kickback, split or percentage of charges; payment must reasonably relate to value of services performed), (§ 6-l (2)(p) (high-cost home loans)); **North Carolina** (N.C. Gen. Stat. § 53-243.11)(No lender shall provide nor shall any broker receive any compensation that changes based on the terms of the loan, other than principal.).

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

market have steered borrowers into risky loans with higher costs and unfavorable features that are otherwise inappropriate. YSPs not only encouraged the steering of subprime borrowers into more costly and riskier loans, but also the steering of prime credit borrowers into subprime loans. It is estimated that up to 60% of subprime borrowers could have qualified for prime loans or loans through FHA, Fannie Mae, or Freddie Mac that would have given them interest rates that were lower by 3% or more.[17] A CRL study that analyzed comparable loans closed by brokers versus lenders found that interest payments were significantly higher on broker-originated subprime mortgages: more than $1,000 more in the first year alone and more than $5,000 after four years.[18]

Steering borrowers into worse and riskier loans than those for which they qualify is intrinsically linked to the issue of YSPs. As noted previously, compensation based on the terms or conditions of a credit transaction places the interests of brokers and borrowers at odds. Due to an informational asymmetry inherent in the broker-borrower relationship, the practice of steering is on its face an unfair and deceptive practice. Furthermore, the risk to borrowers is all the more egregious when borrowers' race or ethnicity makes them more likely to be steered. In response to these abuses, both the District of Columbia and the State of Washington have prohibited steering for all home loans.[19]

Steering, particularly given its tie with "reverse redlining," is an equally damaging dynamic in retail originations. The affidavits of former employees submitted in connection with a pending lawsuit against Wells Fargo is dramatic evidence that in-house steering is as problematic as third-party steering.[20]

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

[18] This differential likely is due to the payment of YSPs, which are present in 85% to 90% of brokered loans, and which result in higher interest rates. YSPs are a destructive feature of the subprime market because they give brokers an incentive to act contrary to a borrower's best interest. *See* Keith Ernst, et al., *Steered Wrong: Brokers, Borrowers, and Subprime Loans*, Center for Responsible Lending (Apr. 2008), *available at* http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.

[19] D.C. Code § 26-1152.06 ("A lender shall not steer, counsel, or direct any prospective borrower to accept a loan product with a risk grade less favorable than the risk grade that the borrower would qualify for…"); West's Wash. Rev. Code § 19.144.060 ("A person licensed or subject to licensing, or otherwise subject to regulation pursuant to chapter 19.146, or a consumer loan company licensed or subject to licensing under chapter 31.04 RCW may not steer, counsel, or direct any borrower to accept a residential mortgage loan product with a risk grade less favorable than the risk grade that the borrower would qualify for.").

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

1. Steering causes substantial consumer injury.

Unnecessarily costly loans injure families by making their homes less affordable and by making equity-building substantially more difficult. And, of course, the consequences in terms of increased risk of foreclosure add devastating injury to families, their neighborhoods and their communities.[21] Within the subprime market in particular, African American and Latino borrowers typically pay more for their mortgages than subprime Caucasian borrowers, even when controlling for legitimate credit factors.[22] For example, a 2008 HUD study showed that minorities are more likely to have higher priced mortgages.[23] Discriminatory lending practices such as steering are inherently injurious to borrowers and their communities and run afoul of existing fair lending laws including the Equal Credit Opportunity Act.[24]

2. Steering is not reasonably avoidable by consumers.

Borrowers substantially rely on brokers to present them with loans that they qualify for based on the borrower's credit risk factors. Limitations on price and product transparency in the subprime market, often compounded by misleading or inaccurate advertising, may make it harder for consumers to protect themselves from abusive or unaffordable loans, even with the best disclosure.[25]

In a recent statement addressing proposed rules to ban steering, Federal Reserve Chairman Ben Bernanke stated, "Consumers rely on the professional expertise of brokers

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[21] The products that became the "default" products in the subprime market due to perverse market incentives increase the risk of foreclosure. *See* Testimony of Kathleen E. Keest, Senior Policy Counsel, Center for Responsible Lending, Before the U.S. House of Representatives Committee on Financial Services, Hearing on *"Regulatory Restructuring: Enhancing Consumer Financial Products Regulation,"* pp. 10-11 (June 24, 2009).

[22]*See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Effect of Subprime Mortgages*, Center for Responsible Lending (May 2006), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/rr011-Unfair_Lending-0506.pdf (after analyzing data submitted by mortgage lenders for loans originated in 2004, concluding that, for most types of subprime home loans, African-American and Latino families were at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors).

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

[24] 15 U.S.C.A. § 1691 (Under the Equal Credit Opportunity Act, a creditor may not discriminate against an applicant based on the applicant's race, color, or national origin "with respect to any aspect of a credit transaction."). *See also* Michael M. Greenfield, Consumer Transactions (Fourth) 260 (2003)("Since long-held customs and stereotypes are slow to die, Congress accelerated their demise in 1974 by adding the Equal Credit Opportunity Act as Title VII of the Consumer Credit Protection Act.").

[25] Regulation Z Final Rule, Staff Commentary, Docket No. R-1305 at 7-9 (July 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080714a1.pdf.

and other loan originators and expect that they will act fairly."[26] Bernanke continued by saying that borrowers' expectations are not realized when borrowers "are steered by their loan originator to more expensive loans."[27] Because borrowers generally lack the expertise necessary to fully understand their loan terms, borrowers are ill-equipped to evaluate whether the loan options with which they are presented are the best loan options for which they qualify.

3. Steering provides no countervailing benefits to consumers or competition.

Steering borrowers toward higher cost loans in order to increase a broker's compensation provides no tangible benefit to borrowers. It is *per se* abusive, failing to provide any countervailing benefits and running afoul of the core objective of fair lending laws.[28]

C. Establish Duties for Mortgage Brokers and Non-Bank Lenders.

In addition to prohibiting both YSPs and steering, it is necessary to address the underlying dynamics that have contributed to the proliferation of these and other related abuses. At a minimum, it is critical to establish a duty of good faith and fair dealing to borrowers, applicable to all mortgage brokers and non-bank lenders.[29] Among other things, this standard would require that mortgage brokers and non-bank lenders make reasonable efforts to secure a home mortgage loan that is appropriately advantageous to the consumer with respect to product type, rate, charges, and loan repayment terms.

Independent mortgage brokers should be subject to an additional set of standards. Experts on mortgage financing agree that financial incentives have caused the interests of mortgage brokers to diverge from that of borrowers. More plainly, existing broker compensation structures have pitted the interests of brokers against the interests of

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

[27] *Id.*

[28] 15 U.S.C. 45(n)(Section 5(n) of the FTC Act provides that "in determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence.").

[29] At least sixteen states explicitly impose a duty of good faith and fair dealing on mortgage brokers, supplementing a more generally applicable contractual duty of good faith and fair dealing: **Alaska** (Alaska Stat. § 06.60.340(6)); **Colorado** (Colo. Rev. Stat. § 12-61-904.5); **Connecticut** (Conn. Gen. Stat. § 36a-760h); **Delaware** (Del. Code Ann. tit. 5, § 2114); **Illinois** (205 Ill. Comp. Stat. 635/5-7); **Kansas** (Kan. Stat. Ann. § 9-2212); **Kentucky** (Ky. Rev. Stat. Ann. § 286.8-270(a)); **Maine** (Me. Rev. Stat. Ann. Tit. 9-A, § 10-303-A; **Maryland** (Md. Code Regs. 09.03.06.20); **Minnesota** (Minn. Stat. § 58.161 ("utmost good faith")); **Mississippi** (Miss. Code Ann. § 81-18-27(1)(g)); **Nevada** (A.B. 486 (2009)); **New York** (N.Y. Banking Law § 590-B); **North Carolina** (N.C. Gen. Stat. § 53-243.11); **Ohio** (Oho Rev. Code Ann. 1322.081(A)); **Washington** (Wash. Rev. Code § 19.146.095 ("utmost good faith")).

borrowers. As reports a study from Harvard University's Joint Center for Housing Studies, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[30]

Most mortgage brokers and their trade associations deny that they have any legal or ethical responsibility to refrain from selling inappropriate, unaffordable loans or to avoid benefiting personally at the expense of their borrowers. Borrowers, on the other hand, rely on their brokers to find them the best rate.[31]

Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans to their customers, even when those customers qualify for better loans. There are innumerable unfair and deceptive acts and practices that may flow from this dynamic, many of which have already been deemed violations of the FTC Act.[32] Therefore, in addition to addressing these abuses, it is necessary to comprehensively address the root cause by implementing broker duties that realign the interests of brokers and borrowers.

1. One approach: Duty of Agency

One approach would be to impose a duty of agency on brokers, expressly establishing the relationship between a borrower and its broker as the relationship between a principal and its agent.[33] This standard, which integrates the principles of the law of agency, would be

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[30] Changing Mortgage Banking Industry, *supra*, at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." *Id.* at 42 (citing Alexander, *supra*). *See also* Ben S. Bernanke, Federal Reserve Board Chairman, Remarks at the Opportunity Finance Network's Annual Conference, Washington, D.C. (Nov. 1, 2006) (noting that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws).

[31] *See, e.g.,* Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Borrowers: Broker- and Lender-Originated Loans*, AARP Public Policy Institute, Daily Digest No. 83 at 2, (Jan. 2003)(concluding that 70% of elderly broker-assisted borrowers rely "a lot" on brokers to find the best rates for them); Fannie Mae National Housing Survey, *The Growing Demand for Housing* at 9 (2002)(finding that more than half of African American borrowers surveyed believed that mortgage brokers have a legal obligation to find them the best rate).

[32] *See*, *generally,* Lydia B. Parnes, Bureau of Consumer Protection Director, Prepared Statement of the FTC on Improving Consumer Protections in Subprime Lending before the Senate Committee on Commerce, Science, and the Transportation Subcommittee on Interstate Commerce, Trade and Tourism (Apr. 29, 2008) citing *F.T.C. v. Chase Fin. Funding*, No. 04-549 (C.D. Cal. 2004); *See also F.T..C v. Diamond*, No. 02-5078 (N.D. Ill. 2002)("The FTC has brought enforcement actions against brokers for allegedly deceiving consumers about key loan terms, such as the existence of a prepayment penalty or a large balloon payment due at the end of the loan…[or] falsely promising consumers low fixed payments and rates on their mortgage loans.").

[33] Four states have imposed a duty of agency on mortgage brokers: **Illinois** (205 Ill. Comp. Stat. 635/5-7)(A mortgage broker shall be considered to have created an agency relationship with the borrower and shall...act in the borrower's best interest and in good faith toward the borrower and...use reasonable care in

comprehensive, aligning the incentives of brokers with the interests of borrowers with respect to compensation and loan terms.[34] For example, agents are not permitted to "acquire a material benefit from a third party in connection with transactions conducted . . . on behalf of the principal or otherwise through the agent's use of [his or her] position."[35] However, because agents also have a duty not to act "as or on behalf of an adverse party in a transaction connected with an agency relationship," clarifying the extent to which brokers are acting on behalf of lenders in the mortgage lending transaction would be necessary to avoid problems of dual agency.[36] Care would also have to be taken in shaping such a duty so as not to leave a consumer without meaningful relief for wrongful acts during those portions of the transaction when the broker actually does act as the lender's agent, and the lender is – and should be – liable for the wrongful acts of its agent.

2. Alternative approach: Fiduciary Duty

An alternative approach would be to impose on brokers a fiduciary duty to borrowers.[37] A fiduciary is a person "required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor."[38] Stockbrokers, for example, are the fiduciaries of their customers.[39] Mortgage brokers hold themselves out to consumers as trusted advisers for

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performing duties.); **Minnestota** (Minn. Stat. § 58.161)(A mortgage broker shall be considered to have created an agency relationship with the borrower in all cases and shall…act in the borrower's best interest and in the utmost good faith toward borrowers, and shall not compromise a borrower's right or interest in favor of another's right or interest, including a right or interest of the mortgage broker; **New York** (N.Y. Banking Law § 590-B); **Vermont** (Vt. Code R. 21 01 008)(The mortgage broker shall represent the interests of the prospective borrower rather than those of any lender)).

[34] Restatement (Third) of Agency § 8.10 (2006) (prohibiting agents from engaging in conduct likely to damage the principal's interests).

[35] *Id.* at § 8.02.

[36] *Id.* at § 8.03.

[37] Three states provide that mortgage brokers have a fiduciary duty to borrowers in the mortgage lending transaction: **California** (Cal. Fin. Code § 4979.5)(A person who provides brokerage services to a borrower…is the fiduciary of the consumer…A broker who arranges a covered loan (first home mortgages) owes this fiduciary duty to the consumer regardless of who else the broker may be acting as an agent for in the course of the loan transaction.); **Nevada** (A.B. 486 (2009)(Any person licensed pursuant to this chapter has a fiduciary obligation to a client…which means…a duty of good faith and fair dealing, including…the duty to act in the client's best interest…and to exercise reasonable care…); *See also* *Wyatt v. Union Mortg. Co.* 598 P.2d 45 (Cal. 1979); **Washington** (Wash. Rev. Code 19.146.095)(A mortgage broker has a fiduciary relationship with the borrower... A mortgage broker must act in the borrower's best interest and in the utmost good faith toward the borrower... A mortgage broker must use reasonable care in performing duties.)).

[38] *Black's Law Dictionary* (8th ed. 2004).

[39] *See also,* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending,* 80 Tex. L. Rev. 1255, 1317-63 (2002); Kathleen C. Engel & Patricia A. McCoy, *A Tale*

navigating the complex mortgage market. Like stockbrokers, that is the value-added service they sell, and it is the service consumers assume they are buying.

II. Non-traditional Loans, Ability-to-Repay, Prepayment Penalties

Questions Posed: Are there features of any non-traditional, or alternative, mortgage loans that are unfair or deceptive? Identify any such feature, and for each, please answer the following questions: Why is it unfair or deceptive under Section 5 of the FTC Act? Should it be prohibited or restricted? If so, how? For all loans or only certain types of loans? What are the costs and benefits of such prohibitions or restrictions? What would be the effect on competition and consumers if the Commission were to prohibit or restrict non-bank financial companies with respect to the act or practice, but banks, thrifts, and federal credit unions were not similarly prohibited or restricted?

In the past few years, non-traditional mortgage products were poorly underwritten and were mass-marketed to home owners and home buyers for whom they were ill-suited, and by whom they were poorly understood. At the root of these irresponsible products lie two key unfair and deceptive practices: a) disregard of consumers' ability to repay the loan according to its terms; and b) the imposition of prepayment penalties.

It is critical that the FTC exercise its authority under Section 5 of the FTC Act in requiring consideration of ability to repay and prohibiting prepayment penalties for all home loans. Such action would be meaningful in setting expectations for the market as a whole moving forward, incorporating the lessons learned from alternative mortgage products, while extending protections to non-bank lenders and brokers who have operated outside the jurisdiction of the other federal regulators.[40]

While our analysis will focus on the impact of these practices on the more recent examples of nontraditional mortgage loan products, the ever-evolving nature of the mortgage lending industry mandates that a clear standard be set to protect all consumers and ensure the sound distribution of credit. Thus, we recommend that both practices be prohibited for all loans.

A. Prohibit Disregard of Consumers' Ability to Repay for All Loans.

The FRB, FDIC, OCC, OTS, and NCUA (the "Agencies") have long made clear that they expect institutions' lending programs to require analysis of a consumer' ability

of Three Markets Revisited, 82 Tex. L. Rev. 439, 440 (2003)(discussing the suitability standards in the securities framework and their adaptability to the mortgage context).

[40] 73 Fed. Reg. at 44542 (stating that relaxed standards, such as those that pervaded the subprime market, may increase the incidence of abusive lending practices by attracting less scrupulous originators into the market, while at the same time bringing more vulnerable borrowers into the market, making it "more difficult for regulators and investors alike to distinguish responsible from irresponsible actors.")

to repay a loan without resort to the consumer's collateral.[41] Concerned with the rapid expansion of the market for nontraditional mortgage products, the Agencies issued specific guidance in 2006 for how the industry should manage the risks associated with these products.[42] First among their recommendations was to ensure underwriting standards "consistent with prudent lending practices," with particular attention to an assessment of ability to repay.[43] "Loans to individuals who do not demonstrate the capacity to repay," the Agencies continued, "are generally considered unsafe and unsound."[44]

Failure to assess a borrower's ability to repay not only threatens the safety and soundness of financial institutions, but poses a significant threat to borrowers and the system as a whole. As such, disregard for a borrower's ability to repay must be prohibited as an unfair and deceptive practice under Section 5 of the FTC Act.[45]

1. Disregard of consumers' ability to repay causes substantial injury.

The negative consequences of disregard for ability to repay are widespread and severe. Over the past decade, rising housing prices created incentives for new entrants to the industry to loosen underwriting standards and market alternative mortgage products

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[41] At least since 2001, the federal banking agencies have put lenders on notice that "loans to borrowers that do not have the capacity to service their loans generally will be classified substandard." *Expanded Guidance for Subprime Lending Program* at 9 (Jan. 31, 2001), *available at* www.ots.treas.gov/docs/2/25137.pdf. *See also* John C. Dugan, Comptroller of the Currency, Remarks Before OCC Credit Risk Conference, Atlanta, Ga. at 8 (Oct. 27, 2005) ("[Nontraditional mortgage products require] meticulous underwriting, including a credible analysis of a borrower's payment capacity beyond the period during which minimum payments are artificially reduced."), *available at* www.occ.treas.gov/ftp/release/2005-107a.pdf; Interagency Statement on Subprime Mortgage Lending, Fed. Reserve. Sys. Docket No. OP-1278 (June 28, 2007) at 10 ("Qualifying consumers based on a low introductory payment does not provide a realistic assessment of a borrower's ability to repay the loan according to its terms."), *available at* www.occ.treas.gov/ftp/release/2007-64a.pdf.

[42] Interagency Guidance on Nontraditional Mortgage Product Risks (Sept. 29, 2006) (hereinafter "Interagency Guidance"), *available at* www.federalreserve.gov/boarddocs/srletters/2006/SR0615a2.pdf.

[43] Id. at 1.

[44] Id. at 4.

[45] At least seventeen states and D.C. require that mortgage originators evaluate the borrower's ability to repay; nine states extend this protection to all home loans. **Colorado** (CO ST § 38-40-105), **Illinois** (205 ILCS 635/5-6), **Maryland** (MD Code, Commercial Law, § 12-127(b)-(c)), **Massachusetts** (940 CMR 8.06(15)("It is an *unfair or deceptive act or practice*…to arrange or...to make a mortgage loan unless the mortgage broker or lender, based on information known at the time the loan is made, reasonably believes at the time the loan is expected to be made that the borrower will be able to repay the loan…")), **Minnesota** (M.S.A. § 58.13 Subdiv. 1(a)(24)), **Nevada** (N.R.S. 598D.100(1)(b)), **New Mexico** (SB 342)(2009), **Ohio** (RC 1345.031(B)(2), (14)), and **West Virginia** (W. Va. C.S.R. 106-5-11).

to the general public as an "affordability product."[46] Consequently, the market for these products expanded rapidly, spanning the subprime, alt-A, and prime markets.[47]

Option ARM defaults have risen dramatically in recent months, and further increases are expected, with option recasts expected to double from $5 billion to $10 billion in the nine month period from April 2009 to January 2010.[48] In an extension of the subprime foreclosure crisis, defaults on these loans are expected to increase drastically over the next several years as the payments options on these loans are recast.[49] Transcending the subprime market, this rise in delinquencies of nontraditional products is indicative of a trend in recent years of widespread disregard for ability to repay and poor-to non-existent underwriting. Stated income lending became more prevalent.[50] Only about 17% of payment option ARMs originated between 2004 and 2007 were fully documented.[51] Countrywide, one of the country's largest originators of POARMs in recent years admitted that about 80% of its loans would not have met the interagency

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[46] John. C. Dugan, Comptroller of the Currency, Remarks before the Consumer Federation of America (Dec. 1, 2005) at 10, *available at* http://www.occ.treas.gov/ftp/release/2005-117a.pdf. *See also* Allen J. Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, Consumer Federation of America at 5 (citing "Financing Options for Home Buyers," KGO-TV San Francisco (ABC7 Apr. 6, 2005) (A mortgage professional recommended, "If you are just getting into a home and you really need every single edge you can get, then an interest rate only loan is the way to go."); Prashant Gopal, The Next Real Estate Crisis, Business Week (June 5, 2008) (hereinafter "The Next Crisis")("Option ARMs, which were originally designed for self-employed people with fluctuating incomes, gained popularity with other workers during the peak of the real estate boom in 2004, when rapidly rising home values would have otherwise kept many buyers out of the market.")

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

[48] *See* The Next Crisis, *supra* (stating that option ARM recasts are expected to bring a fresh wave of foreclosures, as only a fraction of the one million outstanding payment option ARMs have reset).

[49] *Id.* (stating that payment option ARMs are tending to demonstrate high rates of delinquency and rapid rises in foreclosures; of the option ARMs issued in 2006, nearly 13% were 60 days delinquent by the time they were 18 months old. The rate of foreclosures for option ARMs nearly tripled from 0.53% in the first quarter of 2007 to 1.55% just one year later.)

[50] 73 Fed. Reg. at 44524 (stating that this loosening of underwriting standards, in combination with the decline in housing prices, has led to rising delinquencies in the subprime and alt-A market segments). *See also* Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, Fitch Ratings Credit Policy at 4 (Aug. 21, 2006) (hereinafter Fitch 2006 Subprime Performance) (stating that lack of income verification, as opposed to lack of employment or down payment verification, caused 2006 low documentation loans delinquencies to be higher than earlier vintages' low documentation loans.)

[51] *Option ARMs: It's Later Than It Seems*, Fitch Ratings (September 2, 2008), at 5.

guidance for underwriting non-traditional loans.[52] Failure to evaluate borrower's ability to repay has proven especially toxic in the case of nontraditional products, which incorporate an additional element of default risk in the form of negative amortization and payment shock.[53]

Aside from contributing to the risk of default, loose underwriting standards raise the cost of credit. There is generally a premium for a stated income loan, one which originators have little incentive to disclose.[54] This premium, of course, is one the consumer pays in the form of a higher interest rate. As a result, borrowers who are placed into stated income loans, despite being capable of fully documenting their income, pay an increased rate without any corresponding benefit.

The harm to borrowers is further aggravated by a myriad of other abusive lending practices, such as flipping and fee-packing, which are facilitated by lending without regard to repayment ability.

2. Borrowers cannot reasonably avoid injuries from disregard of repayment ability.

Borrowers, unaware of the perverse pricing incentives in the mortgage industry, trust lenders to use sound underwriting practices, reasonably interpreting loan approval as the lender's confirmation of their ability to repay the loan.[55] Limited transparency of

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[52] The federal agencies' guidance instructed lenders to evaluate the borrower's ability to pay based on the fully-indexed, fully-amortizing payment. *Interagency Guidance on Nontraditional Mortgage Product Risks,* 71 Fed. Reg. 58609, 58614 (October 4, 2006). Countrywide's estimate from Countywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

[53] *See* Susan Bies, Federal Reserve Governor Remarks at National Bankers Association National Conference (Oct.12, 2004)(noting that nontraditional mortgage products combined with loosened underwriting standards pose higher risks for default.). *See also,* Merrill Lynch (Dec. 14, 2007)("Even in a period of rising home prices, such loans can cause concern, particularly when a large portion was Alt-A instruments, where often little or no documentation was required and the downpayments on the loans were very low. What makes Alt-A and option ARMs particularly toxic is that in the current environment of home price deflation, many of these borrowers who are currently in a negative amortization position could be facing the horrifying prospect of owing far more on their home than it is currently valued.")

[54] Vikas Bajaj & Christine Haughney, "Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgage*s*," *New York Times* (Jan. 26, 2007)(quoting William D. Dallas, CEO of Ownit Mortgage Solutions, who "acknowledges that [underwriting] standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other subprime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'").

[55] *See* Ben S. Bernanke, Federal Reserve Board Chairman, ''Housing, Housing Finance, and Monetary Policy,'' Remarks at Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyo. (Aug. 31, 2007) (stating that because these brokers and lenders are compensated based on origination of the loan, not its performance, incentives favor maximization of loan volume over sound underwriting), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm.

prices and products exacerbate the informational asymmetry, leaving borrowers ill-equipped to avoid loans that they will struggle or fail to repay.[56]

Stated income and stated asset loans can make it even more difficult for a consumer to avoid an unsustainable loan. Because originators are under no obligation to document ability to repay, even borrowers that furnish documents verifying income and assets can be steered into stated income loans, maximizing their compensation while passing on the additional cost to the borrower.[57] (And it is the case that many borrowers who not only could, but did, furnish income verification, were put into the most costly stated income loans anyway.) Like other forms of steering, injury of this kind is unavoidable, as borrowers may not know that they are even being considered for stated income loans.

3. The injury to borrowers that flows from disregard of repayment ability is not outweighed by countervailing benefits to consumers or to competition.

The Federal Reserve Board recognized a few potential benefits for consumers and competition from stated income loans, including speeding emergency access to credit, reducing the effort of documenting income, and providing credit access to those who cannot document their income at all.[58] The Fed found that the benefits regarding speed and efficiency were "limited relative to the substantial injuries caused by lenders' relying on unverified incomes," while the benefit to those who cannot document their income was also limited in that tax returns can be used in the event that no other income documentation is readily available.[59] The Fed further pointed out that "adopting exceptions for hardship cases would create significant potential loopholes," making the rule unduly complex.[60]

B. Prohibit Prepayment Penalties on All Loans.

As federal policy has long recognized, prepayment penalties trap borrowers in

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[56] *See* Brian Bucks & Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" at 19 (Jan. 2006)(finding that a large proportion of borrowers with ARMs did not understand the reset period, the rate cap, or the terms of their mortgages).

[57] *See Ferguson v. IndyMac Bank* (Filed Feb 14, 2008)(IndyMac's instructions for preparing mortgage applications required that "the file must not contain any documents that reference income or assets."); *See also* Fitch 2006 Subprime Performance, *supra* (reporting that stated income loans with high combined loan to value ratios appear to have become vehicles for fraud).

[58] 73 Fed. Reg. at 44543.

[59] *Id.*

[60] *Id.*

high-cost, disadvantageous loans.[61] Most recently, the Federal Reserve Amendments to Regulation Z (Truth-in-Lending) issued in July 2008 prohibited prepayment penalties under certain conditions, but stopped short of an outright ban.[62] While these efforts represented progress, they did not go far enough. Prepayment penalties qualify as an unfair practice as defined by Section 5 of the FTC Act and must therefore be prohibited for all home loans.

1. Prepayment penalties cause many consumers substantial injury.

Prepayment penalties were a pervasive and insidiously harmful feature of the now-collapsed subprime market, deterring consumers from refinancing high-cost loans and increasing the cost for those who refinance to avoid default.[63] While prepayment penalties are extremely rare in the current origination environment, they remain a prominent feature of the current crisis, trapping many families that might have refinanced before housing values became prohibitively low.

This "exit tax" has proven to be particularly harmful when combined with nontraditional mortgage products.[64] According to the Federal Reserve, "prepayment penalties are likely to cause the most significant, and least avoidable, injuries when

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[61] See, H.R. Conf. Rep. No. 652, 103d Cong., 2d Sess. 147, 160; S. Rep. No. 103-169, 25-26. (1994 USCCAN. 1977, 1990-91; 1995 USCCAN 1881, 1909-10.); 15 U.S.C. §1639(c); Reg. Z, 226.32(d)(6) & (7)(Congress recognized that prepayment penalties functioned this way when it first enacted HOEPA. In 1994, trying a cautious approach, Congress created complicated and narrow restrictions on prepayment penalties in very high-cost loans (Section 32); Joint Report to Congress Consumer Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July, 1998), at 74-75, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf (During a joint HUD-FRB review of the market in 1998, HUD recommended further restrictions on prepayment penalties, and applying reforms to a broader segment of the market); 67 Fed. Reg. 60542, 60548, 60547-48 (mounting evidence that prepayment penalties contributed to the problem of predatory lending led the Office of Thrift Supervision in 2002 to repeal its 1996 regulation that preempted state prepayment penalty laws as applied to non-depository lenders for "alternative mortgages," as "wide-spread use of prepayment penalties not only may deter consumers from seeking to refinance high cost loans that have burdensome provisions, but also may have other adverse consequences for sub-prime borrowers, such as increasing the overall lending cost for a consumer who refinances to avoid default").

[62] 12 CFR Part 226 (Prohibiting a prepayment penalty with a higher-priced mortgage loan or HOEPA loan if payments can change during the four-year period following consummation. For all other higher-priced mortgage loans and HOEPA loans—loans whose payments may not change for four years after consummation—the final rule limited prepayment penalty periods to a maximum of two years.)

[63] Office of Thrift Supervision, 67 Fed. Reg. 60542, 60548; 60547-48, *supra* note 61.

[64] The Next Crisis, *supra*, (quoting *Business Weekly* interview of Chandrajit Bhattacharya, vice-president and mortgage strategist at Credit Suisse Securities: "Most of the public is thinking that the subprime thing is over, but this is another thing waiting. The problem for [POARM] borrowers is that once you go underwater, it's very hard to refinance, and if you cannot refinance there is very little option for you.")

coupled with loans designed to have short expected life spans, which have proved to be the riskiest loans for consumers."[65]

The costs associated with prepayment penalties are not, however, limited to the inability to exit the loan. Interest rates on loans with prepayment penalties are often 40 basis points higher than on loans without prepayment penalties.[66] This counterintuitive result is a product of a perverse market compensation structure that incentivizes the steering of borrowers into loans with prepayment penalties. While borrowers may have to pay an increased rate for loans without prepayment penalties, the yield-spread premium paid for loans *with* prepayment penalties is often significantly larger.[67]

2. Borrowers cannot reasonably avoid injuries from prepayment penalties.

In 2006, only 2.4% of prime ARMs and 1% of prime fixed rate mortgages contained prepayment penalties, while more than three quarters of securitized subprime loans included the feature. [68] This disparity suggests that it is unlikely that borrowers knowingly and voluntarily opted for these provisions.

Like the subprime market, limitations on price and product transparency of nontraditional and alternative mortgage products work against the assumption that borrowers with prepayment penalties knowingly chose them.[69] The complexity of

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[65] 73 Fed. Reg. at 44554. *See also*, Souphala Chomsisengphet, Timothy Murphy & Anthony Pennington-Cross, *Product Innovation and Mortgage Selection in the Subprime Era*, presented at the Subprime Housing Crisis: Interdisciplinary Policy Perspectives, Univ. of Iowa (Oct. 2008) (referring to loans "designed to terminate" so as to ensure a continuing stream of new originations).

[66] *See* Christopher A. Richardson & Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (Jan. 2005). *See also* CRL *Comments on Home Equity Market*, pp. 13-15 FRB Docket OP-1288 (August 15, 2007), for a more complete explanation of the interrelationship between yield spread premiums and prepayment penalties, *available at* www.responsiblelending.org.

[67] *Id.* (The lender offers the broker the choice of providing the consumer with a loan with no prepayment penalty at a rate bump of 1%, or providing himself with 2 points ($4,000 on a $200,000 loan) at a cost to the consumer of a prepayment penalty (costing the borrower perhaps 3%, or $6,000 in equity) plus a 1.1% rate bump. Given this incentive structure, it is unsurprising that higher interest rates were observed on subprime purchase loans with prepayment penalties.)

[68] *C.f.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business*: *Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (Dec. 11, 2006)(discussing how recent MBA analysis shows that 2.4% of prime ARMs and only 1% of prime FRM originated in 2006 had a prepayment penalty); Inside B&C Lending, *ARMs Dominate Alt A Securitization in 2006* (Feb. 2, 2007)(stating that among subprime securitized loans originated during the same period, nearly three quarters had a prepayment penalty provision).

[69] "In this environment of limited transparency, consumers may reasonably decide not to shop further among originators or among loan options once an originator has told them they will receive a loan, because further shopping can be very costly." 73 Fed. Reg. at 44525.

nontraditional and alternative mortgages renders the process even more challenging, making it less likely that consumers will notice, understand, or consider prepayment penalty provisions.[70] According to the Federal Reserve, “there is a limit to the number of factors a consumer can reasonably be expected to consider, so the more complex a loan is the less likely the consumer is to consider the prepayment penalty.”[71]

Because the complexity of nontraditional products reinforces reliance on brokers, in placing a premium on loans with prepayment penalties, the market has substituted its valuation for that of the borrower. In essence, borrowers do not choose a loan with a prepayment penalty; rather, the loan is chosen for them.

3. The injury to borrowers from prepayment penalties is not outweighed by countervailing benefits to consumers or to competition.

While an $8,000 to $10,000 prepayment penalty may make refinancing cost prohibitive for some borrowers, the fee in and of itself is too small to be the primary motivator for lenders. Rather, the rarity with which prepayment penalties are imposed in prime markets indicates that they are not essential to preserving loan value. Thus, lengthy prepayment penalties and high loan fees merely reward originators by paying them handsomely regardless of the long-term sustainability of the loan. This practice is thus not only anticompetitive, but it prevents borrowers from being able to bridge their way into more sustainable loan products.[72]

Arguments that banning prepayment penalties will restrict access to credit are unfounded. Rather, prepayment penalties have tended to drive out good loans in favor of

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[70] James M. Lacko & Janis K. Pappalardo, Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* at 24–26 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (An FTC staff study found that consumers presented with mortgage loans with more complex terms were more likely to miss or misunderstand key terms.). *See also,* Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?,* Board Fin. & Econ. Discussion Series Working Paper No. 2006–3 at 18–22 (2006) (describing evidence that borrowers with ARMs underestimate caps on the interest rate; the rate of underestimation increases for lower-income and less-educated borrowers), *available at* http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf.).

[71] Lacko & Pappalardo, *supra,* at 74 (‘‘[R]espondents had more difficulty recognizing and identifying mortgage cost in the complex-loan scenario. This implies that borrowers in the subprime market may have more difficulty understanding their loan terms than borrowers in the prime market. The difference in understanding, however, would be due largely to differences in the complexities of the loans, rather than the capabilities of the borrowers.’’)

[72] *See* Richardson & Ernst, *supra* (For the most common product in the subprime market – the hybrid ARM – the rate reduction the study reported was only 18% of the purported reduction commonly associated with a prepayment penalty on the rate sheets; in other words, the possible consumer benefit of the prepayment penalty is less than 1/5th of its purported value. Still further evidence weighing the cost of the prepayment penalty against the gains shows there is no net benefit. Conservative analysis suggests that “borrowers will pay $2 in prepayment penalties for every $1 in interest rate benefits on hybrid ARMs.”)

bad loans. A careful analysis of state anti-predatory lending laws shows that banning prepayment penalties does not cause a restriction in access to credit.[73] States that have tried to curb predatory lending by limiting prepayment penalties have experienced interest rates that have stayed the same or even been lowered compared to states were prepayment penalty protections are absent.[74] Regulation of prepayment penalties would thus be a boon to consumers as well as to competition.

III. Incorporate Federal Reserve Board Disclosure Provisions.

Question Posed: Should the FTC incorporate into a proposed rule any of the requirements and prohibitions on acts or practices related to mortgage disclosures that the Board promulgated under its TILA Section 105(a) authority, thereby allowing the FTC to obtain civil penalties for any violation of TILA, HOEPA, or Regulation Z, consistent with the authority conferred on federal banking regulatory agencies?

Yes. Under current law, the FTC does not have the authority to obtain civil penalties for violations of rules the Board promulgates under its Section 105(a) authority. Moreover, consumers do not have a private right of action to enforce the early disclosure requirements under federal law.[75] This means that the enforcement mechanism for violations of these disclosure requirements vis-à-vis non-bank entities such as non-bank mortgage lenders, mortgage brokers and finance companies are weak. This gap would be narrowed, although not entirely closed, if the FTC incorporates into a proposed rule all of

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[73] Wei Li & Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending at 2-3, 13-17 (Feb. 23, 2006).

[74] *Id. (*At least thirty-five states regulate prepayment penalties, including eleven states that have prepayment penalty bans on broad categories of mortgage loans. There is no evidence that consumers feel deprived of "choice" in these states.) **Alabama** (Ala. Code § 5-19-31; § 5-19-4(c))(banned unless approved mortgagee under National Housing Act or where creditor is exempt from licensing); **Alaska** (Alaska Stat. § 45.45.010(g))(except federally insured loans requiring prepayment penalty); **Indiana** (prepayment penalty banned for a consumer loan (key requirement: secured by an interest in land or by personal property that is the borrower's principal dwelling) that is not "*primarily* secured by an interest in land" (i.e., that is not a first lien mortgage) as well as for a refinancing or consolidation (junior lien)) (Ind. Code Ann. § 24-4.5-3-209 (limitation on penalty), § 24-4.5-3-104 (definition of "consumer loan"), § 24-4.5-3-105 (explanation of "primarily secured by land", also banned on first-lien adjustable rate mortgages, as well as for refinancing and consolidation, § 24-4.4-2-201)); **Iowa** (Iowa Code Ann. § 535.9.2)(purchase money or refinance of purchase money loan secured by 1- or 2-family dwelling or by agricultural land), (§ 528.4)(reverse annuity or graduated payment mortgage loans), **Minnesota** (Minn. Stat. §58.137(2)(c))(prohibited in residential mortgages under Fannie Mae conforming limit); **New Jersey** (N.J. Stat. Ann. § 46:10B-1, B-2)(for loans with interest rates exceeding 6%); **New Mexico** (N.M. Stat. Ann. § 56-8-30); **North Carolina** (N.C. Gen. Stat. § 24-1.1A(b)(1))(banned on first mortgage loans below $150,000); **Ohio** (Ohio Rev. Code § 1343.011(C)(prohibited in residential mortgage under $75,000); **South Carolina** (S.C. Code Ann. §§ 37-23-80, 37-10-103) (banned on loans below $150,000); **Vermont** (Vermont Stat. Ann. tit. 8 § 2232a, tit. 9 § 45).

[75] Under RESPA, there is no private right of action for violations of the requirements to provide either the Good Faith Estimate or the HUD-1. TIL remedies for early mortgage disclosures are not certain, *see, e.g.* National Consumer Law Center, *Truth in Lending*, Sec. 8.6.5.7 (6th Ed. 2007). And, of course, there is no private right of action under the FTC Act.

the requirements and prohibitions on acts or practices related to mortgage disclosures that the Board promulgated under its TILA Section 105(a) authority, thereby allowing the FTC to obtain civil penalties for any violation of TILA, HOEPA, or Regulation Z, consistent with the authority conferred on federal banking regulatory agencies.

Non-bank financial institutions sold an increasingly large portion of subprime loans during the housing boom. Reports indicate that by 2006, mortgage brokers or other third-party originators were responsible for 63% to 81% of all subprime loans.[76] Moreover, non-bank mortgage lenders (such as Ameriquest, New Century, Countrywide (before switching to a federal charter) also had a significant role in the housing and mortgage boom, with 48.2% of HMDA high-cost loans between 2004 and 2007 originated by such lenders.[77]

Although the composition of the mortgage market has changed, there is no guarantee that we will not see a resurgence of such non-bank lenders in the future. Oversight and enforcement should be parallel across both bank and non-bank lenders, to make compliance more consistent throughout the mortgage market.

Although CRL has never viewed the provision of disclosures as sufficient to prevent abusive practices in the market, they can be useful to consumers, and more importantly, lenders who fail to provide disclosures or who provide fraudulent or untimely disclosures can facilitate fraud and abusive conduct through such failures.

At least one study has shown that the strength of enforcement of TILA disclosures impacts the cost of credit to consumers, with consumers paying more where enforcement is lacking.[78] Victor Stango and Jonathan Zinman studied consumers' "cognitive bias" towards assuming a lower-than-actual APR for a given loan, and discovered that this bias only resulted in consumers getting higher cost loans when dealing with non-bank lenders who face less enforcement around existing TILA disclosures, and therefore have less regular compliance.[79]

In order to increase disclosure compliance among *all lenders*, CRL recommends that the FTC incorporate Regulation Z's disclosure rules into its own rulemaking.

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[76] *Inside B&C Lending,* "Retail Share of Subprime Originations Jumps in 1Q07" at 4 (June 15, 2007); *Inside B&C Lending,* "Subprime Lenders to Face Increased Legislation" at 4 (Feb. 29, 2007).

[77] CRL calculations based upon HMDA data 2004-2007.

[78] *See* Victor Stango & Jonathan Zinman, "How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets" at 3-4 (Sept. 5, 2006), *available at* https://www.dartmouth.edu/~jzinman/Papers/Stango&Zinman_CognitiveBias&Competition.pdf (finding that, where TILA disclosures are made reliably, consumers who most underestimate APRs do not overpay on credit, while where TILA disclosures not made reliably, the same consumers pay 200-400 basis points more for interest compared to consumers who have less "cognitive bias" related to APRs).

[79] *Id.*