**Comments**
**to the**
**Federal Trade Commission**
**16 CFR Parts 321 and 322**
**[RIN 3084-AB18]**
**Advance Notice of Proposed Rulemaking: Mortgage Acts and Practices Rulemaking**
**Rule No. R911004**

**by the National Consumer Law Center[1]**
**on behalf of its low-income clients**
**and for**
**the National Association of Consumer Advocates[2]**

## I. Introduction

In the process of proposing and writing the Advance Notice of Public Rulemaking relating to mortgage acts and practices, the FTC has already recognized the myriad of unfair and deceptive practices facing homeowners in the origination, servicing and foreclosure process. The FTC has already identified many of the practices that need to be prohibited. The FTC now has the unquestionable authority to identify and ban these shameful and illegal practices on a market-wide basis.

While prohibiting many of the origination practices that facilitated the unaffordable and confusing mortgages that are currently in foreclosure may appear to be like closing the barn door after the horse has escaped, an unequivocal prohibition of these practices will a) prevent many of them from being repeated, and b) assist in the process of stopping the

---

[1] The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by Alys Cohen , John Rao, Margot Saunders, and Diane Thompson.

[2] The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

foreclosures of the homes secured by mortgages in which originators engaged in those practices.

Prohibiting the identified mortgage servicing practices from continuing will have a direct and immediate impact on the millions of mortgages currently being serviced. *None of the prohibitions that we propose are particularly new.* Servicers never have had the express right to misapply payments, overcharge on fees, or force-place insurance in improper circumstances. Yes, a specific prohibition will more effectively deliver fair and reasonable mortgage servicing.

Perhaps the single most important proposal on which the FTC can take immediate action, where an FTC rule would have an immediate beneficial impact on hundreds of thousands of individual families, hundreds of communities and the economy of the entire nation, is – as we describe in response to Question 20 – to **make it an unfair trade practice to proceed to foreclosure without offering affordable loan modifications to those homeowners for whom the modification provides more income to the investor than foreclosure.**

Below we have endeavored to answer all of the Questions posed in the FTC's ambitious ANPR *except* those relating to advertising.

## II. Mortgage Origination—Underwriting, Loan Terms, & Disclosure Issues

*Background*

The foreclosure tsunami that is devastating our nation is rooted in a massive failure of mortgage underwriting. The initial waves of foreclosures on subprime loans with little or no documentation and unaffordable payments are being followed by skyrocketing defaults in the Alt-A market of Payment Option ARMs and other exotic mortgages. While much has been discussed in Washington about how to stop this from happening again, little has been done. While the Federal Reserve Board issued a final rule under its HOEPA authority (which we recommend that you incorporate into the FTC's rules) there are substantial gaps in the rule that need to be addressed in order for the rules to have their intended effect.

The Commission's rulemaking is a real opportunity to step into the abyss and take bold action. Some of the most egregious mortgage lending excesses came from non-depository institutions—not only brokers but also lenders. While FTC rules that go beyond the Board rules would not apply to the whole market, they would reach significant portions of the market and compel other agencies and Congress to act to raise the bar for everyone. This rulemaking is a real opportunity for the Commission to lead on mortgage origination; we hope the Commission will take advantage of this.[3]

### ***<u>Question 6 – Unfair or Deceptive Mortgage Origination Practices</u>***

### Underwriting Without Regard to Ability to Repay, and Without Adequate Income Verification

[3] While we do not address steering issues here, we support the comments of the Center for Responsible Lending.

The Federal Trade Commission should address lending without regard to ability to repay under the terms of the loan, and lending without income verification, because these practices are both deceptive and unfair. A loan's underwriting is unfair or deceptive where it does not include analysis for the maximum payment under the loan for the first seven years **–** or under both loans if the homeowner is taking out two loans simultaneously, such as the "80/20" situation where a homeowner takes out a second mortgage to avoid paying PMI – taxes and insurance (including any private mortgage insurance (PMI)), and a consideration of a consumer's residual income after making scheduled payments.

Consumers do not understand the risks of changing interest rates, different margins, increasing balances, changes from teaser rates to base line rates, in their mortgage agreements. Consumers cannot be expected to underwrite themselves for their mortgage lending. Indeed, leaving to consumers the essential analysis of whether they can afford a mortgage loan is part of what has created the mortgage disaster facing the nation currently.

The central thread connecting abusive mortgage loan originations over the past decade is the unaffordability of those loans.[4] Unaffordable loans are loans that are designed to fail, either from the outset,[5] or as soon as the fixed-rate period ends and the payment begins to adjust upward. These loans are made because the individuals and entities involved in the lending process make enough money from the loans so that it does not matter whether the borrower ultimately is forced to refinance or face foreclosure.

The extent to which making unaffordable loans came to dominate mortgage lending is shown most tellingly by subprime lenders' own words: "[M]ost subprime borrowers cannot afford the fully-indexed rate, and . . . it will hurt liquidity for lenders and effectively force products out of the marketplace."[6] Of course, it also is reflected in the magnitude of today's foreclosure crisis. Goldman Sachs estimates that, starting at the end of the last quarter of 2008 through 2014, 13 million foreclosures will be started.[7] The Center for Responsible Lending, based on industry data, predicts 2.4 million foreclosures in 2009, and a total of 9 million foreclosures between 2009 and 2012.[8] At the end of the first quarter of 2009, more

---

4 *See, e.g.,* Written Statement of Jean Constantine-Davis, Senior Attorney, AARP, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on Preserving the American Dream: Predatory Lending Practices and Home Foreclosures (Feb. 7, 2007), *available at* *http://banking.senate.gov/public/index.cfm?Fuseaction'Hearings.Detail&HearingID'2053fdd2-9832-4731-802d-fa9c18772267*.

5 In particular, many borrowers are defaulting prior to loan reset dates or early on in fixed rate loans. These borrowers apparently were not even qualified for the loan at the initial payments and will benefit from an ability to repay standard.

6 Wright Andrews, representing the subprime mortgage lenders, complaining about a Freddie Mac policy, as quoted in *American Banker,* February 29, 2007, at 4.

7 Goldman Sachs Global ECS Research, *Home Prices and Credit Losses: Projections and Policy Options* (Jan. 13, 2009), at 16; *see also* Rod Dubitsky, Larry Yang, Stevan Stevanovic & Thomas Suehr, Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* 1 (Dec. 4, 2008) (predicting 9 million foreclosures for the period 2009-2012).

8 Center for Responsible Lending, Soaring Spillover 1 (May 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf.

than 2 million houses were in foreclosure.[9] Over twelve percent of all mortgages had payments past due or were in foreclosure and over seven percent were seriously delinquent—either in foreclosure or more than three months delinquent.[10] Realtytrac recently reported that an additional 300,000 homes go into foreclosure every month.[11] These numbers are significantly elevated compared to more normal times.[12] Such lending practices cannot be preserved in the name of access to credit. Borrowers need access to affordable, constructive credit not just *any* credit.

Legal services and other consumer attorneys have been flooded with clients seeking protection from unaffordable loans that never should have been made. The following are three examples that we previously shared with the Federal Reserve Board when it undertook the HOEPA rule, finalized in July 2008. We repeat them here because they are clear examples of the need for strong rules – stronger than the rules we have now.

> **Example 1:** Ms. Nessia Jones is a 56-year old African-American who has lived in her home in Decatur, Georgia for 28 years. Ms. Jones has received Social Security widow's and/or disability benefits since 1988. Her mental and physical health is poor and requires an extensive medication regime. Ms. Jones's adult daughter, who lives with her, has been disabled since infancy, is profoundly mentally retarded and suffers from seizures. In 2006, GreenPoint Mortgage Funding made two mortgage loans to her that should never have been made. The combined payments on these loans total 200% of her income.[13]

> **Example 2:** Ms. Avonia Carson is a 68-year-old African- American. She has lived in her home in southeast Atlanta since 1971. Her adult son, who had lived with her since 2001 after an accident that rendered him blind and in need of 24-hour care, recently moved into a personal care home. Ms. Carson has custody of her four-year-old

---

[9] Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009) (reporting that 3.85% of 44,979,733, or 1.7 million, mortgages serviced were in foreclosure). Roughly half of these were serviced by national banks or federal thrifts. *See* Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 8 (June 2009), *available at* http://files.ots.treas.gov/482047.pdf (reporting that 884,389 foreclosures were in process by national banks and federal thrifts at the end of the first quarter of 2009). The estimate of more than 2 million homes in foreclosure is achieved by extrapolating from the MBA numbers. The MBA survey only covers approximately 80% of the mortgage market. Thus, (44979733*3.85%)/0.8=2.16 million.

[10] Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009).

[11] Realtytrac**,** 1.9 Million Foreclosure Filings Reported On More Than 1.5 Million U.S. Properties in First Half of 2009, *available at* http://www.realtytrac.com/ContentManagement/PressRelease.aspx?channelid=9&ItemID=6802.

[12] *See* Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12 (noting that the number of foreclosures has more than doubled from pre-crisis levels). While a substantial portion of the homeowner whose loans will not be modified by HAMP may be unemployed or have reduced paychecks, some portion of these homeowners will be able to support a loan modification or qualify for other temporary assistance.

[13] *See* Appendix A for the details of Ms. Jones' loans. This example was provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

great-granddaughter, for whom she has been caring since birth. Ms. Carson is on a fixed monthly income of $1,233.00 from Social Security. In 2006, Wachovia Bank made her a mortgage loan she could not possibly afford. Five months later, JPMorgan Chase Bank made her a second mortgage she had no way of paying. The combined payments on Ms. Avonia Carson's two loans consumed 99% of her income.[14]

**Example 3:** Ms. Mary Overton is an elderly African-American widow who has owned her Brooklyn home since 1983. Although she suffers from serious health ailments that limit her mobility and practically confine her to the ground floor of her home, she manages to care for her teenage grandson, who lives with her. Ms. Overton did not finish high school and has difficulty understanding numbers.

In mid-2005, Ms. Overton met with representatives of Ameriquest Mortgage Company and explained that she needed a reverse mortgage so that she could make repairs to her home. At the time, Ms. Overton lived on a fixed income of $825 per month and did not have any debt on her home. Ameriquest led her to believe that she was signing a reverse mortgage, but instead gave her a 2/28 loan with initial monthly payments that were nearly 300% of her income.[15]

Underwriting is abusive where it does not examine fully amortizing payments as part of the affordability analysis, including taxes and insurance, with PMI. The advent of credit scoring in PMI pricing has resulted in many borrowers showing up at closing, only to find that the PMI obligation increases the monthly payment by several hundred dollars.[16]

*Residual Income and DTI Analyses Are Both Essential to Fair and Honest Underwriting*

Residual income is an essential component of an affordability analysis, especially for lower-income families.[17] After making housing-related monthly payments and all other regularly scheduled debt payments, families must have sufficient residual income available to cover basic living necessities, including but not limited to food, utilities, clothing, transportation and known health care expenses.

It is essential that any rule include a specific reference to residual income and DTI . Specificity will result in higher compliance rates and more performing loans. Many subprime lenders have already purported to consider residual income and to set DTI limits.

---

[14] See Appendix B for the details of Ms. Carson's loans. This example was provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

[15] See Appendix C for the details of Ms. Overton's loans. This example was provided by Jessice Attie, co-director, Foreclosure Prevention Project, South Brooklyn Legal Services.

[16] For a discussion of credit scoring and its effects on PMI payments, see National Consumer Law Center, *The Cost of Credit: Regulation, Preemption, and Industry Abuses,* § 8.3.2.1 (3d ed., 2005).

[17] *See* Michael E. Stone, *What Is Housing Affordability? The Case for the Residual Income Approach,* Housing Policy Debate, Vol. 17, Issue 1 (Fannie Mae Foundation, 2006), *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_stone.pdf.

Nonetheless, in many cases the loans originated were obviously not affordable by any realistic assessment of residual income. We have seen cases where lenders approved loans with a DTI of 52% but looking only at the borrowers' mortgage payment and excluding car payments, taxes and insurance, student loans, and other fixed debt. Seldom, if ever have we seen a lender at origination look carefully at the necessary components of residual income—utilities, food, clothing, repairs.[18]

The most appropriate way to incorporate DTI and residual income is to recognize the relationship between them and develop a tiered or teeter-totter approach. Obviously, higher income borrowers can generally afford to carry a higher DTI than can lower income borrowers without putting themselves and their families at imminent risk of foreclosure. As residual income increases, borrowers in general can safely tolerate a higher DTI. Conversely, as residual income decreases, permissible DTI should also decrease. The Department of Veterans Affairs (VA) has long used a specific set of guidelines that are widely recognized as useful and appropriate. To our knowledge, the VA guidelines have not resulted in widespread denial of credit to veterans nor the unavailability of VA guaranteed loans. Specific guidelines such as these will provide substance to a residual income standard.

Whether or not the Commission adopts such an approach, the teeter-totter method is appropriate. The VA guidelines combine specificity and flexibility. They allow loans to be approved without special supervisory approval if the veteran has a DTI of 41% or less *and* meets a residual income test. The DTI takes into account the monthly PITI of the loan being sought, assessments such as homeowners' association and condo fees, and any other long-term obligations. The residual income test is used to determine whether the veteran's monthly income, after subtracting monthly shelter expenses and other monthly obligations, will be sufficient to meet living expenses. The VA has fine-tuned the residual income standards to reflect family size, regional differences, and loan amount.

A critical feature of the VA guidelines is the flexibility they provide to make exceptions based on documented facts, and the manner in which DTI and residual income relate to each other. If the veteran meets the DTI standard but not the residual income standard, or if the DTI is greater than 41%, the underwriter must justify the loan in accord with detailed guidelines, and the underwriter's supervisor must approve the loan.[19] If, however, the veteran has residual income substantially in excess of the guidelines, the loan can be approved without special justification.[20] This rule recognizes that the importance of DTI recedes if the borrower has larger residual income.[21] Without specific requirements,

---

[18] By contrast, most servicers impose inflated residual income standards when a consumer seeks a loan modification. So, a lender can structure a loan that is predictably unaffordable with an unrealistically low residual income threshold, and then, when the loan fails, deny a modification because the borrower lacks residual income.

[19] 38 C.F.R. § 36.4840(c)(4), (5).

[20] 38 C.F.R. § 36.4840(c)(3) (special justification unnecessary if residual income exceeds guidelines by at least 20%).

[21] As an illustration, a borrower with a million dollars in annual net income might be able to afford a $800,000 housing expense, an 80% DTI ratio, because that borrower would have $200,000 in residual income for other annual expenses. On the other hand, if a borrower paid 80% of an annual net $20,000 for housing expenses, that borrower would have only $4000 for all other annual expenses, and the loan would clearly be unaffordable.

enforcement personnel—and for that matter, assignees—have no guideposts against which to measure compliance or safety and soundness.

It should be stressed that the VA guidelines were adopted by an agency whose mission is to help veterans obtain stable housing. These guidelines therefore are concerned with ensuring that the borrower benefits from the loan, while at the same time avoiding rigid exclusion of veterans who may be able to sustain homeownership despite lower incomes. If these goals had informed mortgage lending during the past decade, it is unlikely that the current mortgage crisis would ever have developed.

If the Commission chooses not to adopt the VA's detailed regulations or develop detailed guidelines of its own, the FTC should limit DTI (including all long-term debt, principal, interest, insurance and taxes) to 50% for all borrowers as long as residual income also is found to be sufficient and there is no reasonable expectation of a reduction in income.

*An Underwriting Rule Must Specify That It Is Based on the Rate Increases Described in the Loan's Terms, Not the Legal Construction Known as the Fully-Indexed Rate.*

A rule requiring lenders to underwrite for ability to pay should specifically state, for ARMs, the ability-to-pay analysis shall be based on the maximum possible payment allowed under the note during the first seven years of the loan. Using the fully-indexed rate, instead of the maximum possible payment will not give borrowers adequate protection from payment shock.

The Federal Reserve Board's underwriting mandate in its HOEPA rule falls short because it only requires underwriting for the maximum scheduled payment (essentially another term for the fully-indexed rate). The maximum scheduled payment, however, is not the maximum *actual* payment because it is impossible to predict what interest rates will be in the future. Instead, the maximum scheduled payment is based on the fictional notion that interest rates will remain exactly as they are at closing, without either increasing or decreasing. Thus, the Board's maximum scheduled payment standard significantly understates the interest rate risk that borrowers face. It also permits creditors to continue to use an artificially low and excessively optimistic yardstick for evaluating a borrower's ability to repay.

The only way it is possible for an underwriter to determine whether a borrower truly has the ability to repay a loan over the long-term is to compare the borrower's income to the maximum possible payment as calculated using the rate and payment caps and change dates described in the note along with any other relevant loan terms.

The fully-indexed rate is purely fictional. In contrast, the maximum possible payment is a more likely eventuality expressly written into the terms of the loan. The fully-indexed rate is based on the application of the index at or shortly before origination plus the margin that will apply at the end of the fixed-rate period (which could be one or more years long). If, as is almost certain to be the case, the index rate changes during the fixed-rate period, the rate that will apply at the end of the fixed-rate period will be different from the "fully-indexed rate" that was calculated at origination. Assessing the affordability of a loan based on a rate that will never actually be applied to it makes little sense.[22] Assessing affordability based solely on the fully-indexed rate does not protect homeowners from the risk of increasing payments when the underlying index increases.

For example, almost all 2/28 and 3/27 loans included terms specifying that initial rate during the fixed period of the loan was the *lowest* rate that could ever be charged. In other words, the interest rate could climb, but even if the index upon which the interest rate was based dropped, the rate charged to the borrower could never go below the initial rate. And, as recent events have shown, the interest rates and thus the payments did rise on these loans. If interest rate increases on adjustable rate loans are not considered in underwriting, borrowers will continue to feel pressured to return to the closing table for a refinancing, where their equity may be used for closing costs, and where their wealth will continue to dwindle. Others will be unable to refinance, and will lose their homes.[23]

*Adequate Underwriting Includes Income Verification*

Stated income loans are called "liar loans." That name connotes that it is the *borrower* who is doing the lying, that it is the *borrower* who wants to qualify for a higher payment loan than the income on the tax return will justify. The predominant problem, however, comes from the loan originator, not the borrower. The loan originator creates the fictional income to qualify the unsuspecting homeowner into a loan which is destined to fail because the homeowner generally cannot afford the payments. Many cases have documented falsification of borrowers' qualifications by loan originators.

If the borrower detects the unaffordable payment amount at closing (not an easy task given the great number of documents presented at closing and the speed with which the borrower is often urged to sign them) and complains about it, the originator typically promises that the loan will be refinanced after some short period of on-time payments. (Indeed, for many borrowers it was impossible to ascertain the monthly payment, even at closing, due to the adjustable rate loans that came to dominate the mortgage market.) [24]

---

[22] Another problem is that the fully-indexed rate is often not even the payment that would be required if the index rate remained unchanged during the fixed rate period. In years when the LIBOR rate was low, loans were often made where the initial rate of the loan was *higher* than the fully-indexed rate. This has been true in instances when the initial indexed rate was very low. For example, in loans which were initiated between early 2002 and late 2004, when the six month LIBOR varied from 1.99 (in January, 2002) to 2.78 (in December, 2004), typically initial rates were at 8 or 9%, with margins of 5 or 6 over the index.

[23] Another approach, which has been raised by Rep. Ellison's bill, H.R. 3018, is to qualify borrowers at the fully-indexed rate plus additional basis points.

[24] With the Mortgage Disclosure Improvement Act (Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, §§ 2502(a)(6), 2502(c)(2), 122 Stat. 2654, 2856 (codified at 15 U.S.C. §1638(b)(2)(C))), Congress mandated improved payment schedule disclosures, including the disclosure of the maximum payment. The Federal Reserve Board has until February 2011 to conduct the required consumer testing and implement the improved disclosure (Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2502(c)(2), 122 Stat. 2654, 2857). The Board also has proposed some additional disclosure improvements in its recent Notice of Proposed Rulemaking.

Typical stated income loans have included: homeowners who live exclusively on Social Security, yet their applications include falsified income from babysitting, an export business, or the like; homeowners whose income is entirely derived from wages reflected on a W-2, yet the amount of the wages is inflated on the loan application; and homeowners whose income is solely derived from public benefits but the amount of those benefits is inflated.

As the Federal Reserve Board recognized in its HOEPA rule, the failure to verify income harms consumers. The HOEPA rule, however, has significant limitations that the FTC should address. As the FRB observed, failing to verify income is harmful because the practice:

- Presents the opportunity for originators to mislead consumers who could easily document their incomes into paying a premium for a stated-income loan – making the loan unnecessarily expensive.
- Provides originators with incentives as well as opportunities to inflate the applicant's income, by rewarding the originator for providing a stated-income loan with a higher premium.
- Allows originators to hide the inflated income in the rush and confusion of the loan application and closing process.
- Results in loans to consumers with payments that are unaffordable, leading to default, foreclosure, loss of the home and home equity,
- Causes increases in foreclosures which, in turn, harms neighborhoods, communities and cities.[25]

The Board articulated several potential benefits from stated-income lending, including speeding access to credit by several days for emergency situations; saving some consumers from expending "significant effort to document their income;" and providing access to credit for some consumers who would otherwise not have access because they cannot document their income.[26] However, the Board notes that "where risks to consumers are already elevated, the potential benefits to consumers of stated-income/stated-asset lending may be outweighed by the potential injury to consumers and competition."[27]

Even though the Board recognized these problems with stated-income lending, the HOEPA rules allow no-doc lending to continue. The Board specifies that a lender will face no liability for making a no-doc loan where the originator's loan decision would not have been materially different had the proper information been available. This affirmative defense may serve as an invitation to originators to circumvent proper underwriting procedures and to continue to rely instead on the representations and warranties of brokers. This flaw also encourages lenders to gamble that their potential benefit from no-doc lending will exceed the risk of getting caught by an injured borrower. Especially for non-depository institutions that are not examined, liability under this rule will depend entirely on enforcement by borrowers, who may have difficulty ascertaining before suit what the originator's

[25] 73 Federal Register 1672, January 9, 2008 at 1691.

[26] *Id.*

[27] *Id.*

underwriting standards were and whether the borrowers' actual, undocumented income met those underwriting standards.  Accordingly, it is essential that the Commission prohibit failure to verify income by the institutions who most significantly engaged in this practice.

Subordinate lien loans should be fully covered by the requirement to verify income.   Just as the non-payment of a first mortgage loan can lead to a foreclosure and the loss of the home, so can the non-payment of a subordinate lien loan. Generally, there is no justification to treat subordinate lien loans differently from first mortgages.

Requiring verification of subordinate lien loans does not mean that if a lender simultaneously makes a first mortgage and a subordinate lien loan, the verification process for both loans cannot be accomplished simultaneously. This is not so much of an exception as an explanation of the process. Both loans made at the same time would be required to be based on verified income. Yet, if the verified income supported the payments for both loans, there would be no need for separate verifications of income for both loans.

*An Underwriting and Income Verification Rule Should Apply to Assignees as well as Originators*

All players involved in a bad mortgage loan must be part of the solution, just as they are now part of the problem. Wall Street's investment in subprime lending transformed the industry from a modest player into a significant portion of the market. The securitization process also resulted in product development aimed at secondary market sales, rather than at homeowners. Market incentives and interests must be aligned with those of the homeowners.

Opponents of assignee liability claim that a series of terrible events will befall the mortgage industry if full assignee liability is applied. This "sky is falling" list includes: a dramatic decrease in the availability of credit, particularly affecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans, as the process is so routinized and involves so many loans at any one time that a careful review of each loan would be nearly impossible and would dramatically increase the cost of credit.

A key perspective in analyzing these concerns is to look at what happened after the Federal Trade Commission passed the Preservation of Consumers Claims and Defenses Rule (commonly referred to as the "Holder Rule") in 1975. The Holder Rule applies liability for all claims and defenses that could be brought against the seller to assignees of loans used to purchase goods and services. The rule reallocates the cost of seller misconduct from the consumer to the creditor so that a consumer who has been harmed may obtain a remedy by abrogating the Holder in Due Course doctrine.  At the time the rule was proposed, the automobile dealers and other sellers of goods argued that, if the rule passed, the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether. The finance companies and the banks argued that they did not want the responsibility of policing sellers, sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and the rule would interfere with free competition. These nightmare scenarios did not materialize. There was no reduction in available consumer credit; there were no indications that sellers were hurt in any way; there was no increase in defaults.

In 1970, total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s, with not even a blip in 1975 and 1976 when the FTC rule was announced. By December 1980, total non-revolving credit in the United States was approximately $297 billion. In the space of ten years, consumer credit – notwithstanding the announcement and final promulgation of the holder rule halfway through that decade – had more than doubled.[28] The amount of outstanding consumer credit has continued to climb unabated since then: the outstanding amount of non-revolving debt increased over 500% during the seventeen years from January 1980 to December 2007.[29]

***a. Failure to Underwrite for Affordability, Including Failure to Verify Income, Meets the Commission's Standard for Unfair or Deceptive Acts or Practices***

*The Commission's UDAP Standard*

Deception is different that fraud. It is a broader, more flexible standard. The modern concept of deception, as shaped by federal court interpretations of the Federal Trade Commission Act, substantially eliminates the proof requirements for fraud. To show deception under the FTC Act, intent, scienter, actual reliance or damage, and even actual deception, are unnecessary. All that is required is proof that a practice has a tendency or capacity to deceive even a significant minority of consumers. It is important to note that vulnerable consumers are especially protected under the FTC standard of deception. In determining under the FTC Act whether a practice has a capacity or tendency to deceive, federal courts and the FTC historically have considered whether the ignorant, the unthinking, the credulous, and the least sophisticated consumer would be deceived. If a practice affects or is directed primarily to a particular group, the FTC examines reasonableness from the perspective of that group. In addition, the FTC looks at the overall, net impression of a representation to see how it should reasonably be interpreted; including determining if there are implied claims and determining from extrinsic evidence how consumers in fact perceive a representation.

The FTC Act's tri-part test on unfairness requires the following analysis:

1) *Whether the practices in question cause consumers substantial injury.* The Board has already answered this question in the affirmative for all of the practices addressed in the Proposed Regulations.

2) *Whether the harm from these practices is not outweighed by benefits to consumers or competition.* This test is most appropriately employed when applied to the exact practice in question. For example, the question should be whether allowing lenders to

[28] Federal Reserve Statistical Release G.19, 1970 to 1980.

[29] The amount of non-revolving debt (in millions of dollars) was $295,524.23 in 1980 and grew to $1,580,039.43 (in millions of dollars) by December 2007. Federal Reserve Statistical Release G.19, 1980 & 2007, *available at* http://www.federalreserve.gov/Releases/g19/hist/cc_hist_nr.html.

continue making loans without verifying income is a benefit to consumers which outweighs the prohibition of this practice. The secondary, and more global, issue of whether prohibiting stated income loans would limit access to credit is a global issue – one that will be determined by many more issues than a simple regulation addressing several aspects of the origination requirements for mortgage credit. Moreover, even if one were to take on this question, it is clear that specific rules will only quash abusive credit, not all credit. The market in recent years has been rife with externalities, resulting in artificially low costs to some consumers and to investors. The cost of credit did not reflect the burden on some borrowers. Introduction of new rules should have the effect of eliminating these externalities.

3) *Consumers cannot reasonably avoid the injury caused by these practices.* This is the critical test to be applied to each of the practices at issue in these proposals. Recognizing the gross disparity in bargaining power and the significant difference in access to information and ability to understand the complex terms and risks of the new mortgage products, the Board needs to continue to use the potential for injury to consumers as the guiding litmus test for these proposals.

As the OTS itself implicitly found when adopting its version of the FTC's Credit Practices Rule, a practice can be unfair "where the seller takes advantage of an existing obstacle which prevents free consumer choice from effectuating a self correcting market."[30]

*Failure to Properly Underwrite and Failure to Properly Verify are Deceptive or Unfair*

Providing a loan to a borrower without ensuring that the borrower can afford it is deceptive. Homeowners rely on loan brokers and even loan officers at companies to underwrite the loan—not only for the risk to the company but also to check that this complex financial product fits the financial profile of the person seeking it. When a homeowner accepts a loan from an originator, the originator's act of offering that loan is, in the eyes of the homeowner, an endorsement of the loan terms for the borrower's situation. Moreover, providing a loan without income verification—and perhaps charging more for a no- or low-doc loan also is deceptive. Loan originators generally have presented stated income loans as a means of avoiding paperwork, not as a means of avoiding underwriting. The fact that brokers have been paid more for stated income loans than for properly documented loans, even where the properly documented loan origination would involve more work, belies the notion that stated income loans are for the homeowner's benefit; they clearly were for the originator's benefit.

Originating loans without proper underwriting or income verification also is unfair. First, it wreaks significant damage to consumers. Failure to ensure that a homeowner can afford a home loan directly leads to default and potential loss of the home. This may force a family to move, and lose the wealth of equity established through the loan and the wealth of stability and community available to homeowners. Once a homeowner is in an unaffordable loan—which generally has been obtained through deception or other market mischief, the

[30] American Fin. Servs. Ass'n v. FTC, 767 F.2d 957 (D.C. Cir. 1985), cert. denied. 475 U.S. 1011 (1986).

consumer is committed and can not avoid the resulting injury. The consumer is totally reliant on the servicer to make a later accommodation on loan terms. While a consumer can provide documentation to support a loan's underwriting, even the failure to verify income is hard for a consumer to avoid. During the subprime boom, borrowers routinely provided income but were provided with stated income loans for the sake of the broker's profits. Moreover, the market pressure on homeowners to follow a trend is difficult to avoid. Finally, there are no long-term benefits to failing to underwrite loans. Homeowners default, communities are gutted, and, when the practice is as far-reaching as it was recently, the market crashes. While brokers and some others might benefit short term from failure to underwrite or verify income, these benefits will be later eviscerated by the losses to all parties.

***b. Nature and Extent of Rule Needed, and Costs and Benefits of Such Rule***

*The Commission Should Prohibit Abusive Underwriting, Require Income Verification, Establish a Safe Harbor, and Set Out Additional Rules for Loans Outside the Safe Harbor.*

The Commission should establish two layers of rules on underwriting and income verification. Any origination activity outside of these parameters should be prohibited. First, the Commission should establish a rebuttable presumption that a loan is affordable if it is characterized by certain elements. These would include:

- full income verification;
- full underwriting including residual income and DTI analyses (in a teeter totter)that takes into account taxes and insurance, including PMI, and any other loan originated at the same time, including without limitation 80/20 or other arrangements;
- terms that provide for both a fixed-rate and fully amortizing fixed-payment over the entire loan term; and
- all remuneration paid to originators (including brokers) from the payment stream, rather than at the closing or from the loan amount (i.e. homeowner cash or home equity).[31]

Above, we discuss the importance of underwriting based on the factors noted here, and the necessity of full income verification. Here, we propose two additional factors for this safe harbor structure: First, a fixed rate and a fully amortizing, fixed payment; and, second, that all remuneration is paid to the originators from the payment stream.

The predictability of static loan payments—of a fixed rate and fixed payments—is the best way to assure that homeowners can participate in reasonably assessing a loan. While ARM loans may be appropriate for certain borrowers, these loans should be the exception and not the rule, because of the unpredictability that they bring, even with an attempt to underwrite to the maximum payment. Inclusion of only fixed-rate and payment loans in the safe harbor has the advantages of transparency and simplicity—two key factors missing from the mortgage market in the last decade.

[31] We recommend banning prepayment penalties. However, to the extent that the final rules permit prepayment penalties, they should not be allowed for loans within the scope of the safe harbor.

Including only loans for which remuneration comes from the payment stream will promote consideration of externalities in originator decision making. If the originator can get paid up front for the loan and then sell it, the incentive to originate a performing loan is too limited. Although mass defaults of late have caused some originators to buy back loans and thus to face massive financial failure, substantial subprime defaults of the past decade proceeded without sufficient consequences for originators. It is the payment stream that will assure that originators make loans in a process without deception or unfairness.

For loans outside the safe harbor, additional rules should be established. First, for adjustable rate mortgages, underwriting should be based on the maximum payment, not the fully-indexed payment. As described above, the fully-indexed payment is unrelated to the actual loan payments a homeowner will be obligated to make and the maximum payment is clearly defined in the contract. To the extent that maximum payment terms in contracts now are unrealistically high, this merely highlights the lack of bargaining power of homeowners and the need to level the playing field.

In addition, loans outside the safe harbor should bring with them a requirement to inquire and reasonably verify the benefit of the loan to the borrower. The operative question should be: *Does the loan preserve and facilitate affordable and sustainable lending?* The originator would review and document special circumstances and evaluate the overall reasonableness of plan.

*The Underwriting and Income Verification Rules Should Apply to the Whole Market.*

Most subprime borrowers will be covered by the Board's HOEPA rule. However, the ability to repay rule and other higher-cost restrictions do not apply to the many borrowers with nontraditional prime mortgages and other abusive bank loan products. Failure to consider a borrower's ability to repay has been endemic in parts of the prime and Alt-A market not covered by the rule. The HOEPA rule is narrower than the federal guidance on nontraditional mortgages and sends the wrong message about underwriting in the majority of the mortgage market. The Commission should go beyond the scope of the Board's rule by covering the whole market. The discussion below regarding Payment Option ARMs paints a clear picture of why the whole market must be regulated. These abusive prime loans are a major cause of today's foreclosure crisis.

*Abuses Migrate to the Least Regulated Portions of the Market*

Experience has shown that regulating smaller slices of the market does not prevent abuses from migrating to the less regulated segments. The rise of the subprime market compared to HOEPA's effectiveness demonstrates the problem of regulations that only affect a small portion of the market.

In the thirteen years since its effective date, HOEPA has nearly eliminated the origination of these very high-priced, abusive loans. The 2006 HMDA data shows that the reporting lenders made only 14,730 HOEPA loans secured by owner-occupied residences.[32] This is

[32] This number includes both one-to-four family dwellings and manufactured homes. Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *The 2006 HMDA Data*, Table 4, Fed. Res. Bull. (Dec. 2007). We believe these numbers do not include all HOEPA loans made in 2006 because the data covers about 80% of all

down from 2004, when the HMDA data first collected HOEPA information.[33] Contrast this with one industry-commissioned study reporting that 12.4% of first-lien loans and 49.6% of second-lien loans made by nine large lenders between July 1, 1995 and June 30, 2000 were HOEPA loans.[34]

In contrast to the clear decline in the number of HOEPA loans, concurrent with the passage of HOEPA, the number of subprime originations took-off for a variety of reasons, one of the most important being the lenders' ability to obtain capital from investors by pooling, packaging, and securitizing their loans. Subprime securitization volume rose from $17.771 billion in 1994 to $448.598 billion in 2006.[35] Abuses in the subprime market have become apparent over the years due to consumer complaints, lawsuits, investigations by public agencies, and testimony presented to the Board at hearings in 2000, 2006, and 2007.[36]

It is evident that abuses migrated to the subprime market at the same time that lenders began to face the liability risk from making abusive HOEPA loans. In other words, they made loans below the HOEPA triggers to avoid stringent regulation and the risk of significant liability.[37]

The prime market is not exempt from abuses either. Lenders in the prime market have paid brokers yield spread premiums for years without transparency or consent from borrowers .[38]

---

home lending nationwide. *Id.* at A73. In addition, we believe that many HELOCs are truly closed-end transactions masquerading as open-end and should be covered by HOEPA, which presently exempts HELOCs from its protections. Nevertheless, relative to the market as a whole, the numbers are small.

33 Robert B. Avery, Glenn B. Canner, & Robert E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement,* Table 7, Fed. Res. Bull. (Summer 2005)(reporting 19,751 HOEPA loans).

34 Michael E. Staten & Gregory Elliehausen, *The Impact of the Federal Reserve Board's Proposed Revisions to HEOPA on the Number and Characteristics of HOEPA Loans,* Credit Research Center (2001).

35 The 2007 Mortgage Market Statistical Annual, Vol. II, p. 15, Inside Mortgage Finance Publications (2007). These numbers capture non-agency MBS issuances. The totals are a bit higher when agency MBS issuances are included. *Id.* at Vol. I, p. 3.

36 *See* 73 Fed. Reg. at 1677-78 (summarizing testimony presented to the Board at the 2006 and 2007 hearings). Some of the public investigations of subprime lenders include the largest companies, *e.g.,* Household Finance Corp. (2002) and Ameriquest Mortgage Co. (2006). Journalists reported on practices of other large subprime lenders, *e.g.,* Citifinancial (Michael Hudson, *Banking on Misery: Citigroup, Wall Street, and the Fleecing of the South*, Southern Exposure 31.2 (Summer 2003), http://www.southernstudies.org/reports/bankingonmisery.pdf); and Countrywide (Gretchen Morgenson & Geraldine Fabrikan, *Countrywide's Chief Salesman and Defender*, N.Y. Times, Nov. 11, 2007, at 1 (Sunday Business)(origination issues); Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. Times, Sept. 2, 2007, at 1 (Sunday Business)(servicing issues); Gretchen Morgenson & Jonathon D. Glater, *The Foreclosure Machine: An Industry Thrives on Housing Woes,* N.Y. Times, Mar. 30, 2008, at 1 (Sunday Business)(servicing issues).

37 For example, Household Finance made loans just under the HOEPA points and fees trigger. *See* Washington Department of Financial Institutions, "Expanded Report of Examination of Household Finance Corporation III As of April 30, 2002" on file at NCLC. Consumer advocates report that state laws passed to regulate some of the subprime market prompted the same reaction: lenders made loans below the state higher-priced loan triggers to avoid regulation.

38 The Department of Housing and Urban Development has been struggling with this type of compensation since at least 1992. See Supplementary Information, Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080, 10,080 (Mar. 1, 1999)(reporting that it conducted rulemakings on three occasions in the previous seven years;

Lenders in that market also made no documentation loans. For example, in one case, a bank instructed loan brokers to "black out" any income information on social security letters and on IRS Schedule B forms in its Stated Income Loan Origination Guidelines. In another instance**,** a bank's instructions stated: "Completed typed 1003 Application with no reference to income or assets. The file must not contain any documents that reference income or assets."

When lenders in any part of the market shrug-off prudent banking practices, such as verification and assessment of ability to repay, grave consequences will result, as shown by the impending foreclosure disaster in the Alt-A market. The three examples highlighted below constitute compelling evidence of why the Commission should issue rules that go beyond the limitations of the FRB's HOEPA rule. The practices described below violate prudent underwriting standards yet they are not covered by the HOEPA rule because the loans represent prime products.

*Prime Loans Raise Significant Verification and Ability to Repay Concerns*

> **Example 1:** Ms. Avonia Carson, whose situation was previously described above, received a first and second mortgage over the course of five months from two different lenders. The loans themselves are reasonably priced and did not include high points or closing costs. However, both Wachovia and Chase made mortgage loans without regard to Ms. Carson's ability to pay. At the time of each closing, Ms. Carson's monthly income was about $1,135. The debt-to-income ratio in the first mortgage is 78%. When the first and second mortgage payments are combined ($1,265.49), the debt-to-income ratio is 112%.
>
> Wachovia's loan file contains no loan application and no documentation of Ms. Carson's income. JPMorgan Chase Bank's loan file also contains no loan application and no documentation of her income. Wachovia extended the first mortgage based on the value of the home, not on Ms. Carson's ability to pay. An appraisal report in Wachovia's file states the property was valued at $167,000. Neither Wachovia nor Chase included an escrow account for taxes and insurance.
>
> Neither loan is prohibited by the HOEPA rule. The APRs for both the first and second mortgages fall below the trigger for "higher priced loans."[39]
>
> **Example 2:** Ms. Josephine Reese is a 55-year-old African American woman. She bought her home in southwest Atlanta in 1982 and has lived there for the past 26 years. Ms. Reese is both mentally and

promulgating a policy statement that applied to the entire mortgage lending market; discussing why these payments were "particularly troublesome" for consumers and industry).

[39] *See* Appendix B for the details of Ms. Carson's situation.

physically disabled. She and her 15-year-old son struggle financially, as their only support is her fixed monthly income of $1,384 from Social Security disability and a pension. On October 13, 2006, Wachovia Bank made her two mortgage loans, a fixed rate loan and a home equity line of credit (HELOC), she could never afford.

Wachovia made both mortgage loans without regard to Ms. Reese's ability to pay. Ms. Reese's monthly income then was about the same as it is now ($1,384). The first mortgage payment alone of $778.18 comprises 56% of her monthly income. Although Wachovia's loan file contains no loan application, Wachovia knew her monthly income because her Social Security and pension checks have been directly deposited into her checking account there for years. Indeed, Wachovia documented her income for its loan file with a printout of Ms. Reese's checking account history for the previous six weeks.

Wachovia made these loans based on the value of her home, not her ability to pay. The Wachovia loan officer apparently conducted a desktop appraisal and told Ms. Reese her home was worth $126,000. Wachovia did not include an escrow for property taxes and insurance in either mortgage loan.

The HOEPA rules do not protect Ms. Reese from either loan. The APR of the first mortgage falls below the trigger for "higher priced loans." The second mortgage is excluded because it is a HELOC.[40]

**Example 3: Oakareta Williams** is a 73-year-old woman who lives in Brooklyn with her 17-year-old grandson. She has owned her home since 1959. She never finished high school and is financially unsophisticated. Before retiring, she held a variety of jobs, including salesperson, laundry hand presser, and babysitter.

On February 28, 2005, Ms. Williams refinanced her home for $335,000 with Delta Funding Corp. in order to make home repairs. At the time of the mortgage, Ms. Williams's income consisted of $709 in social security, $1,600 in rental income for two rental units in her home, and $277 in welfare payments for her grandson, which terminated several months later when her grandson turned eighteen.

The mortgage was unaffordable on its face. With taxes and insurance included, the mortgage created a debt-to-income ratio for Ms. Williams of 88% and left her with $300 in residual income. When the welfare payments for Ms. Williams's grandson ceased, the debt-to-income ratio rose to 99%, leaving Ms. Williams with about $25 in residual income for all household and living expenses. Ms. Williams

[40] *See* Appendix D for the specific details of Ms. Reese's loans. This loan example was provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

> had substantial equity in her home. At the time of the loan, her house was appraised at $525,000.
>
> Ms. Williams's loan would not violate the HOEPA rules because the APR falls below the trigger for "higher priced loans."[41]

*Home Equity Lines of Credit Should Be Covered*

The Commission should include home equity lines of credit in its rule. The Board's HOEPA rule excludes the ever-expanding HELOC market from its purview. It justifies the exclusion of HELOCs from coverage on three grounds.

First, the Board states that most originators of HELOCs hold them in portfolio which aligns the originators' interests more closely with those of the borrowers.[42] Our review of limited public information shows this assertion to be faulty. Non-agency MBS production for HELOCs for the years 2005 and 2006 were $24.62 billion and $23.48 billion, respectively.[43]

Second, the Board argued that TILA provides borrowers special protections for HELOCs. Presumably, this statement means that consumers need no additional protections beyond what already exists in the Act. However, these "protections" boil down to disclosures tailored to open-end credit secured by the home,[44] with the exception of a handful of substantive protections, none of which overlap with the Board's rules.[45] While the Board has recently proposed substantial revisions to the HELOC disclosure rules, they are not yet final, and, in any event, disclosure rules do not supplant the need for substantive protections.

There are several problems inherent in HELOCs. Disclosures for open-end credit do not provide consumers with bottom-line cost figures, as do the closed-end (i.e., fixed term) disclosures, that would give them pause, particularly in loans from high-cost lenders. Lenders prefer to give open-end disclosures to avoid the more onerous requirements for closed-end credit. One major substantive difference between open-end and closed-end disclosures is in the calculation of the APR. In open-end, the APR is simply the loan note periodic rate. In contrast, the APR in a closed-end loan takes into account the periodic interest rate and any loan fees that are "finance charges" under the TILA rules. Effective comparison shopping between HELOCs and fixed-term loans is impossible.

---

[41] *See* Appendix E for the details of Ms. Williams's loan. This example was provided by Jessica Attie, co-director, Foreclosure Prevention Project, South Brooklyn Legal Services.

[42] 73 Fed. Reg. at 1682.

[43] The 2007 Mortgage Market Statistical Annual, Vol. II, p. 16, Inside Mortgage Finance Publications (2007). *See also* Standard & Poors, Trends in U.S. Residential Mortgage Products: Closed-end Seconds and HELOCs Sector Third Quarter 2005 (Jan. 18, 2006)(showing a large and consistent rise in the securitizations by quarter when comparing Q4 2002 through Q3 2005, with the exception of Q1 and Q2 2005 which, nevertheless, were higher than the quarters preceding Q1 2004).

[44] Regulation Z §§ 226.5b, 226.6.

[45] These protections include: limitations on when the creditor can unilaterally change the terms of the HELOC; refunding fees in certain circumstances; limitations on imposing a nonrefundable fee; restrictions on the type of index the creditor can use if the HELOC has a variable rate feature; and the circumstances under which a HELOC or reverse mortgage can be terminated. 15 U.S.C. § 1647.

As previously described, Ms. Reese (Appendix D) and Ms. Jones (Appendix A) are both examples of borrowers who were sold HELOCs that were completely unaffordable. By including HELOCs in any mortgage rule and requiring lenders to apply the same prudent lending principles to this product as they would to its competition--fixed terms mortgage loans--throughout the entire market, the Commission would level the playing field for consumers and honest competition.

*The Benefits Far Outweigh the Costs of a Rule on Underwriting and Income Verification*

Instituting a rule on underwriting for ability to repay and income verification—across the market and with a depth of analysis that ensures real affordability—will produce significant benefits for homeowners, communities and even the lending industry. Affordable lending is sustainable lending and only with such an approach will loans perform. Performing loans lead to accrued home equity for homeowners, greater stakes in communities by those homeowners, and a more solid approach to investment in the lending community. The "quick fix" approach of originating loans to sell rather than to hold, without regard to the ability of those loans to perform, did not serve industry in the end, and of course it wrecked the lives of individual homeowners and communities. While requiring underwriting and income verification will lead to some additional work up front, and will lead to originations only of affordable loans, the additional profits reaped from leaner origination practices and more aggressive loan granting did not in the end turn out to be cost free. The notion that regulation raises concerns about access to credit (which is raised in every public policy debate on lending) is misplaced. The only access to credit that will be affected here will be access to credit that never should have been made.

*c.* ***The Effect on Competition and Consumers***

The greatest overreaching in the mortgage market occurred among non-depository institutions. To date, concerns about the effects of a stringent rule have resulted in a failure to provide adequate protection for consumers obtaining mortgages. The Commission has a real opportunity to step out in front on this, so that the industry's race to the bottom is not replayed. Moreover, to the extent that the Commission issues strong, sensible rules on mortgage origination, or anything else, the other banking agencies will be required to defend any lesser stance they may take.

## ***Question 7 – Unfair or Deceptive Features of Non-Traditional Mortgages***

### Payment Option ARMs

In the past few years, payment option ARM loans ("POAs") became a popular type of mortgage offered to many homeowners. Nearly $750 billion in these loans were issued between 2004 and 2007, and they are a substantial cause of the foreclosure crisis facing the United States.[46] Yet they were largely issued to prime borrowers, and for that reason, they are still considered prime loans.[47]

Like the adjustable rate mortgages that were common in the subprime market since the early part of this decade, POAs include a variable rate component as part of a systematic shifting

---

[46] Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, January 30, 2009.
[47] *Id*.

of risk from lenders to borrowers. The signal factor in POA loans is a set period of time during which the minimum payment is fixed – such as one to several years – but the interest rate varies, which leads to negative amortization and a steady increase in the principal owed on the loan.

Under a payment option ARM a borrower has, in theory, a choice of three payments: a minimum payment based on an initial, low teaser interest rate; an interest only payment that covers the actual interest accruing; and a fully amortizing payment. Three-quarters of all borrowers pay only the minimum payment.[48] The minimum payment is generally sold as a "fixed rate" payment, although the interest rate is usually not fixed for more than a month and may be fixed for only a day.[49] Given the low initial teaser rates (1% to 2%), negative amortization occurs whenever minimum payments are made beyond the initial fixed rate period and the rate becomes adjustable. Most payment option ARM loans limit the negative amortization that can accrue to an amount between 110% and 125% of the original principal.

Once the negative amortization cap is reached, the monthly payments regime is completely changed. There is no longer a choice of payments. Now the borrower must pay an amount sufficient to pay off the loan over the remaining loan term. This means that if the original loan term was 30 years, and the remaining term is now twenty-five years, the – now swollen – principal will be amortized over the remaining twenty-five years of the loan. The combination of negative amortization and low teaser rates results in significant payment shock, often a doubling or tripling of the borrower's payment obligations thirty to sixty months after loan consummation, generally with no more than thirty days notice.

Payment option ARM loans are very problematic for borrowers. They are complex, involve concepts that are unfamiliar and confusing to most, even fairly sophisticated, homeowners.[50] Brokers and lenders can easily take advantage of the complex nature of the products and the lack of specific guidance in the regulations governing disclosures to mislead consumers and make abusive loans.[51]

The dangers of adjustable rate loans for borrowers is considerably exacerbated by additional characteristics on these loans such reduced verification of the borrowers' ability to repay the

---

[48] Joint Ctr. for Hous. Studies, *State of the Nation's Housing 2007*, at 17.
[49] *See, e.g.*, *Andrews v. Chevy Chase*, 240 F.R.D. 612 (E.D. Wis. 2007) (describing payment option ARM sold as "fixed rate" when interest only fixed for one month, although payments fixed for a year).
[50] *See e.g.* Consumer Fed'n of Am. press release, Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages 3, July 26, 2004, (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment) *available at* http:// www.consumerfederation.org/releases.cfm#Consumer%20Literacy.
[51] Fed. Trade Comm'n v. Chase Financial Funding, Inc., No. SACV04-549, Complaint at 4 (C.D. Cal. May 12, 2004), *available at* www.ftc.gov/os/caselist/0223287/040602comp0223287.pdf (describing payment option ARM); Gov't Accountability Office, GAO No. 06-1021, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved 22 (2006) (describing advertisement for payment option ARM that promised 45% reduction in monthly mortgage payments and interest rate of 1.25%, yet interest rate of 1.25% only applied for first month, and this fact disclosed in "much smaller print" on second page), *available at* www.gao.gov/new.items/d061021.pdf.

loan.[52] As more risk factors are piled into the same loans – adjustable rates plus reduced documentation – unsurprisingly, the likelihood of foreclosure rises as well.[53] It is well recognized that particularly the failure to adequately underwrite mortgage loans leads to increased foreclosures creating horrible home losses for homeowners and significant losses for investors.[54]

In 2006 and 2007, federal regulators issued guidance and statements addressing the widespread failure of underwriting in POA loans and other adjustable rate loans.[55] These five federal banking regulators specifically challenged the practice of substituting rate increases for underwriting.[56] They identified three main failures of underwriting typical of these loans: the failure to take into account future rate adjustments and negative amortization in determining ability to repay, the failure to include tax and insurance payments in determining ability to repay, and the widespread prevalence of stated income loans.

The 2006 Interagency Guidance on Nontraditional Mortgage Products issued by these five federal banking regulators focused on the payment shock occasioned by rate resets and periods of negative amortization.[57] The guidance urged lenders to underwrite loans to the fully-indexed rate, as opposed to an initial teaser rate.[58] This focus on the fully-indexed rate was a large step forward from the practices of many lenders – and one which was vigorously objected to by the mortgage industry.[59]

---

[52] *See* Gov't Accountability Office, GAO No. 06-1021, *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved* 3 (2006), *available at* www.gao.gov/new.items/d061021.pdf.

[53] *See* Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12* (Apr. 5, 2007) (increase in early payment defaults within four months of origination, particularly for loans with low documentation and a piggyback loan), *available at* www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf. Thus, balloon payments and ARMs appear to be markers for lack of loan affordability and consequent default risk rather than the cause of default in themselves.

[54] See, e.g., M. Diane Pendley, Glenn Costello & Mary Kelsch, Fitch Ratings, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance* (Nov. 28, 2007), *available at* www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624 (noting the absence of adequate underwriting contributed significantly to the elevated default rates in 2007).

[55] Statement on Subprime Lending, 72 Fed. Reg. 37,569 (July 10, 2007); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

[56] 71 Fed. Reg. 58,609, 58,614 (Oct. 4, 2006) ("While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.").

[57] 71 Fed. Reg. 58,609, 58,613-58,614 (Oct. 4, 2006).

[58] The fully-indexed rate is the interest rate that would be in effect at the time of origination, based upon the index identified in the loan note plus the listed margin, absent a teaser rate. Even the fully-indexed rate does not reflect the possible risk that interest rates will increase; it is not the maximum rate that can be charged under the note. It is only the rate that would be charged on the note had the interest rate calculations under the note been imposed at the outset.

[59] Subprime Mortgage Market Turmoil: Examining the Role of Securitization, Hearings Before the S. Comm. on Banking, Hous., & Urban Dev., 110th Cong. (2007) (statement of Sandor Samuels, Executive Managing Dir., Countrywide Fin. Corp.) (60% of borrowers from Countrywide could not qualify at the fully-indexed rate), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=256; Steven Sloan & Joe Adler, How Freddie Cutbacks in Hybrids May Reverberate, Am. Banker, Feb. 28, 2007 (quoting Wright Andrews, a lobbyist for nonbank lending institutions, as saying that most subprime borrowers cannot

Despite these statements from federal regulators, the loans written after the pronouncements are expected to default at a greater rate than those written before,[60] According to a recent Wall Street Journal article, based on reports issued by Goldman Sachs and Countrywide: As of December 2009, 28% of option ARMs were delinquent or in foreclosure, according to LPS Applied Analytics, a data firm that analyzes mortgage performance. Nearly 61% of option ARMs originated in 2007 will eventually default, according to a recent analysis by Goldman Sachs, which assumed a further 10% decline in home prices. That compares with a 63% default rate for subprime loans originated in 2007. Goldman estimates more than half of all option ARMs outstanding will default.[61] Unfortunately, this only makes clear that non-binding guidance and statements from federal regulators are not sufficient to change the marketplace.

### a. ***Payment Option ARMs, Negative Amortization and Certain Interest Only Loans are Unfair or Deceptive***

As described above, Payment Option ARMs can lull a borrower into believing that low payments are sustainable. Particularly when originated in a market where underwriting and income verification were too often absent, or where underwriting was limited to the initial payments on various types of ARMs, Payment Option Arms and their negative amortization results can push homeowners into higher debt than expected and facing substantially higher payments that those for which they have budgeted or for which they have been underwritten. But Payment Option ARMs also are so complex because of their rate and payment change date rules, and the potential for a principal to increase. These loans are deceptive because, despite representations to the contrary, they are not a path to building equity through homeownership and in general the homeowners who obtained them, and who placed their faith in the originators who provided them, were unable to meet the terms of the loan upon reset. The upcoming wave of foreclosures in 2009 and 2010 will make clear just how broad that reach has been.

Payment Option ARMs also are unfair. By increasing a homeowner's debt, the homeowner actually loses home equity—a substantial injury—as well as being unable to pay down the principal. Because many of these loans have and will lead to foreclosure, the results are clearly devastating. This injury was not reasonably avoidable by consumers because the terms of the loan were not clear to the homeowners and once the contracts was signed, the consumer could not get out of it. The TILA disclosures do not make clear what the effect of the negative amortization will be, and the loan note and other documents are sufficiently complex that average homeowners, and vulnerable consumers, would have been unlikely to identify the danger that lie ahead. The new GFE and maximum payment disclosures will help with this, although Payment Option ARMs are sufficiently destructive that they still

---

afford the fully-indexed rate and requiring underwriting to the fully-indexed rate would prevent adjustable rate mortgages from being made).

[60] *See, e.g.*, American Home Mortgage Assets, LLC Prospectus supplement dated August 29, 2006 (to prospectus dated April 21, 2006), American Home Mortgage Assets Trust 2006-4; Issuing Entity: American Home Mortgage Servicing, Inc.; Servicer: American Home Mortgage Corp. showing that the lender *underwrote these POA loans only for the first year's payments* (at 9), also showing the 73% of the loans covered by this prospectus were refinance loans.

[61] Ruth Simon, *Option Arms See Rising Defaults,* Wall Street Journal, January 30, 2009.

should hold no place in the panoply of financial products available to consumers. Again, these loans provide no benefit to consumers or the market. They provided one of the temporary bases for the housing bubble, but no long term benefits to consumer wealth, homeowner or stability, and the market was unable to sustain these as a prudent product.

Interest only loans with an interest-only period beyond 10 years and loans with negative amortization have similar effects as Payment Option ARMs. Accordingly, the arguments on unfairness and deception equally apply to them.

### b. ***Payment Option ARMs should be banned.***

Payment Option ARMs inevitably lead to negative amortization and often to default. Moreover, their complex nature precludes the ability of consumers to reasonably assess their costs and benefits. Payment Option ARMs do not assist homeowners in accruing equity, and they too often lead to wrecked credit and lost homes. These loans helped fuel the real estate bubble and have left decimated neighborhoods in their wake. Loans that by definition undermine personal wealth and community development have no place in the mortgage market.

Moreover, negative amortization loans with those with an extended interest-only period have similar effects. Accordingly, they also should be prohibited.

### ***Prepayment Penalties***

Over 70% of subprime loans included prepayment penalties.[62] Payment of the yield spread premium is often conditioned on the borrower's acceptance of a prepayment penalty.[63] Thus, brokers have an incentive not only to put borrowers into a high-cost loan in order to receive a YSP, but also to make sure the borrower is locked into the high-cost loan.[64]

Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest. In addition, prepayment penalties are disproportionately imposed on borrowers in minority neighborhoods.[65] Data is accumulating that borrowers in brokered

---

[62] 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), *available at* http://www.ots.treas.gov/docs/4/48978.pdf. *See also* Doug Duncan, *Sources and Implications of the Subprime Meltdown*, Manufactured Housing Institute (July 13, 2007), *available at* http://tondahall.com/tlhdocuments/lagunapresentation.pdf.

[63] *See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (noting that payment of yield spread premiums is often conditioned on the imposition of a prepayment penalty).

[64] An informal oral survey from the dais during the June 2007 HOEPA hearing held by the Board indicated that none of the attendees, presumably borrowers with prime loans, had prepayment penalties on their mortgages.

[65] Debbie Gruenstein Bocian and Richard Zhai, Center for Responsible Lending, Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans (January 2005), *available at* http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf..

loans receive no interest rate reduction from the imposition of a prepayment penalty. For most borrowers, it is a lose-lose proposition.[66]

In 2002, the abuse by predatory lenders, some of which were non-depository "housing creditors," led the OTS to remove prepayment penalties from the designated loan terms under its Alternative Mortgage Transactions Parity Act authority that state housing creditors could place in their loans notwithstanding state law. As of the rule's effective date, any state law limiting prepayment penalties would apply to these creditors. We applauded this decision then. Since these "housing creditors" already operate in many states without the ability to charge prepayment penalties, and since credit unions also are prohibited from charging prepayment penalties, it is clear that the market can function without this device. Thus, it is clear that prepayment penalties are an unfair and deceptive practice.

### *a. Prepayment Penalties are Unfair or Deceptive*

Prepayment penalties are deceptive. As noted above, while originators have claimed that prepayment penalties were bargained for in exchange for a better rate, there is increasing evidence that the opposite is true. Consumer received higher rates and prepayment penalties. Prepayment penalties are unfair. They are associated with an elevated risk of foreclosure.[67] By keeping the consumer in an unaffordable product, the *quid pro quo* between lender and broker has contributed to the foreclosure crisis. Because prepayment penalties are provisions in form contracts, consumers have been unable to bargain them away. Consumers without them are generally those in the prime market, where they have not been existent. Just the fact that they have thrived in a market of consumers who would be mostly likely to want to refinance out of a higher-rate loan is evidence that consumers could not avoid these products. A prepayment penalty is a complex and contingent contract term that would be relatively immune to comparison shopping even if the disclosure regime were drastically improved. This harm is not outweighed by any benefit to consumers or to competition. Instead, prepayment penalties reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders.

---

[66] *See, e.g.,* Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for "borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate," in which case the difference shrank); see also Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pd (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

[67] *See, e.g.,* Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), available at http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation).

### *b. Prepayment Penalties Should Be Banned*

The Board, in a welcome move, limited prepayment penalties in its HOEPA rule for higher-cost loans to a duration of two years or less, and then only when the loan has fixed payments for at least four years. In the subprime market, prepayment penalties generally have been an additional loan burden rather than a fee exchanged for a better rate, and prepayment penalties disproportionately occurred in high-cost loans made to lower-income borrowers and borrowers of color. The rescission remedy available for violations of this rule will help ensure compliance. Borrowers with fixed-rate higher-cost loans, however, still remain subject to prepayment penalties in the first two years, and no limits are put on prepayment penalties in the prime market.

Prepayment penalties are very rare in prime loans. Their absence in a market where borrowers refinance of their own volition combined with the widespread use of them in a market where refinancings are originator-driven makes it clear that prepayment penalties are being abused by the lending industry.

The Commission should adopt a rule that bans prepayment penalties in the entire market.

### *Yield Spread Premiums*

*Lender-Paid Compensation to Brokers Is Confusing to Borrowers*

Lender-paid broker compensation has undoubtedly contributed to the overpricing of many loans and the placement of thousands of borrowers with prime credit into subprime loans.[68] Lender-paid broker compensation often gives brokers incentives to sell consumers higher cost products. Lender-paid broker compensation in its most common form is a simple quid pro quo. The lender pays the broker increasing amounts of money as the interest rate on the loan increases. Lenders may also condition payments to brokers on other features of the loan. For example, lender-paid broker compensation is sometimes pegged to a prepayment penalty being included in the loan, the product sold (fixed-rate versus variable-rate, for example), or the size of the margin or the initial rate for an adjustable-rate mortgage. Occasionally, lenders will even pay brokers additional money for originating a no-doc loan. In all of these cases, the lender pays more as the loan becomes more profitable to the lender, without regard to the benefit or the cost to the borrower, or even the additional risk the higher-cost loan creates for the ultimate holder. In each of these examples, the payment distorts the broker's incentives, is not transparent to the consumer, and is often a source of gouging.

The costs of these tradeoffs can never be adequately disclosed to borrowers. As the Federal Reserve Board has noted, most consumers are unaware of these incentives and believe that the broker is acting in their best interests.[69]

---

[68] *See, e.g.,* Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market,* Wall St. J., Dec. 3, 2007, at A1 (61% of subprime borrowers in 2006 were prime eligible).

[69] 73 Fed. Reg. 1672, 1698 (Jan. 9, 2008).

Most borrowers are confused whenever lender-paid broker compensation is explained to them. Survey respondents often respond to a disclosure of the amount paid by the lender with the question, "Do I have to pay that, too?"[70] Often, when disclosure forms explain broker compensation, borrowers actually do worse at picking the cheaper loan.[71]

Studies of disclosure for mortgage-broker compensation understate the problems real life consumers are likely to have in the real world. First, of course, the studies happen in quiet rooms, away from the pressures many homeowners experience when entering into a mortgage transaction. More importantly, the studies look only at what happens when borrowers are asked to compare two loans identically priced except for how the broker is paid. The other fees, monthly payment, and the interest rate are held constant. But yield spread premiums involve a tradeoff.[72] If the lender-paid broker compensation drops, the interest rate increases. At this point, borrowers are no longer comparing apples-to-apples, but apples-to-oranges. The tradeoff between financed fees, fees paid out of pocket, and the interest rate over time is at best a complicated calculus, and most borrowers cannot do it to any degree of precision.[73]

While the details of the present value of lender-paid broker compensation are intricate, if all the fees and costs are pressed into the rate, borrowers should be able to choose the roughly right loan for their circumstances. In theory, an informed borrower could rely on a generic preference in making the decision on how to pay the broker. The borrower who expected to hold the loan for a relatively short period of time should choose, in most cases, to have the broker paid by the lender in exchange for a rate increase. A borrower who expected to hold the loan for a longer term would generally be better off financing the broker fees or paying

---

[70] *See, e.g.,* Kleimann Communication Group, Testing HUD's New Mortgage Disclosure Forms with American Homebuyers 17-18 (2007), available at http://www.huduser.org/intercept.asp?loc/Publications/PDF/Round_6.pdf (noting that percentage of survey respondents able to identify cheaper loan dropped with addition of a sentence about lender-paid broker compensation).

[71] *See, e.g.,* James M. Lacko & Janis K. Pappalardo, Fed'L Trade Comm'n, The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment 28 (2004), available at .http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf (adding yield spread premium disclosure to prototype disclosures on two loans with the same terms and interest rate resulted in a drop in the identification of the cheaper loan from 94% to 70%).

[72] *See, e.g.,* Kleimann Communication Group, Testing HUD's New Mortgage Disclosure Forms with American Homebuyers 17 (2007), available at http://www.huduser.org/intercept.asp?loc/Publications/PDF/Round_6.pdf (discussing "trade-off bullets" comparing offered loan to one from same lender with hypothetical changes in the interest rate).

[73] Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums,* STAN. J.L. BUS. & FIN. 289, 354 (2007) (broker compensation is at its highest when brokers are paid from multiple sources and at its lowest in no-fee loans, where borrowers need only compare the interest rates); William C. Apgar & Christopher E. Herbert, U.S. Dep't of Housing and Urban Dev., Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis at x (2006) ("[G]iven the . . . complexity of . . . the cost of [mortgages], even the most sophisticated borrower will find it difficult to evaluate mortgage options."); *see also* MACRO International, Inc., Design and Testing of Effective Truth in Lending Disclosures 12, 15, 19, 41 (2007), *available at* http://www.federalreserve.gov/dcca/regulationZ/20070523/Execsummary.pdf (borrowers have difficulty aggregating fees); Mark Kutner, Elizabeth Greenberg & Justin Baer, U.S. Department of Education, A First Look at the Literacy of America's Adults in the 21st Century 1 (2005), *available at* http://nces.ed.gov/NAAL/PDF/2006470.pdf (only 13% of the U.S. population can compare costs if some intermediate calculation has to be performed).

them out of pocket. This simple analysis seldom plays out, however. A consumer is seldom offered a straight choice between all in or all out. In many cases, the broker compensation will be neither all in nor all out of the interest rate and there will be other fees and costs besides the broker's compensation to take into account. Given most consumers' limited ability to manipulate percentages and interest rates, such a task is clearly beyond all but the most financially sophisticated consumers.[74]

Most borrowers cannot compare the cost of two loans when interest and fees are disaggregated. Most consumers cannot calculate interest;[75] even fewer could begin to puzzle out the relative merits of financing a broker fee or paying for it with a yield spread premium. When borrowers are forced to compare loans with disaggregated fees, even when the interest rate is the same, more than a third cannot identify the cheaper loan.[76] Only at the point when all the fees are pushed into the interest rate can most consumers intelligently evaluate the costs of trading fees for interest.

Even if consumers could calculate the tradeoff between the financed fees and higher interest rate, consumers are not given the baseline information they need to evaluate the true costs of that tradeoff. Borrowers are not told, the interest rate for which they actually qualify. [77] Nor are they given, in dollar amounts, the actual increase in interest they will pay in exchange for having the lender pay their broker. Borrowers are instead presented with a done deal from their broker, a broker whom they assume is acting in their best interests, since they are, after all, paying the broker.

---

[74] For a review of the quantitative literacy studies on this point, *see* Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending*, 25 Yale J. on Reg. 181 (2008).

[75] Only 22% of the adult U.S. population in 1992 could even describe how to calculate interest, given a stream of payments, an amount borrowed, and a total loan amount, according to the 1992 National Assessment of Adult Literacy. The question and results are *available at* http://nces.ed.gov/NAAL/SampleQuestion.asp?NextItem'0&AutoR'2. Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationZ/20070523/Execsummary.pdf (borrowers have difficulty calculating interest); Danna Moore, Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes and Experiences 27 (Technical Report 03-09, Soc. & Econ. Sci. Research Ctr., Wash. State Univ., 2003), available at http://www.dfi.wa.gov/news/finlitsurvey.pdf (same); Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, J. MONETARY ECON. (forthcoming) (manuscript at 34), available at http://www.dartmouth.edu/~alusardi/Papers/BabyBoomers.pdf. (same); Annamaria Lusardi & Olivia S. Mitchell, Financial Literacy and Planning: Implications for Retirement Wellbeing 5, 8 (Oct. 2006), http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf (same).

[76] James M. Lacko & Janis K. Pappalardo, Fed'l Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms 81 (2007), available at http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf; *cf.* Susan Woodward, Consumer Confusion in the Mortgage Market 2 (2003), http://www.sandhillecon.com/pdf/consumer_confusion.pdf (consumers who try to combine two or more price components in home mortgage shopping pay more for their mortgages than consumers who are shopping on a single price component).

[77] The rate sheets provided by lenders to brokers that specify the amount of compensation in exchange for the type of loan sold or the interest rate are closely guarded in the industry as trade secrets and are not generally available to borrowers. *See, e.g.,* Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market,* Wall St. J., Dec. 3, 2007, at A1 (New Century rate sheet warns, "Not for distribution to general public").

Sophisticated borrowers may negotiate a tradeoff between lender-paid broker compensation and borrower paid broker compensation and push the entire broker compensation into the interest rate. However, in many cases, brokers receive compensation from both borrowers and lenders, increasing their total compensation from lender payments as the brokers upsell the borrowers.[78] Lender-paid broker compensation, when combined with borrower-paid broker compensation, is pure gravy for most brokers, a lucrative source of extra cash, and a strong incentive to brokers to operate in the lender's interests, not the borrower's. The financial tradeoffs are complicated, hard to disclose adequately, and difficult to calculate even when transparently disclosed.

*Lender Paid Compensation to Brokers Results in Racially Disparate Pricing*

Disparities in the pricing of home mortgage loans between whites and African-Americans and Latinos exist at every income and credit level.[79] The disparities increase as the income and credit levels of the borrowers' increase. In other words, the wealthiest and most credit worthy African-Americans and Latinos are, compared to their white counterparts, the most likely to end up with a subprime loan. One stark example: African-Americans with a credit score above 680 and a loan to value ratio between 80% and 90% are nearly three times as likely as similarly situated whites to receive a subprime loan.[80] As Board researchers have

---

[78] *See, e.g.,* Howell Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums at 8 (Jan. 2002)*, available at* http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (in a survey of mortgage transactions, when yield spread premiums are not paid, brokers received on average no more than 1.5% of the loan amount); *cf.* Jack Guttentag, *Another View of Predatory Lending* 7-12 (Wharton Financial Institutions Center Working Paper No. 01-23-B, Aug. 21, 2000) (reporting on a survey of mortgage brokers showing no correlation between effort as measured by time expended and payment; brokers largely compensated based on size of loan).

[79] *See, e.g.,* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 11 (May 31, 2006), available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf; *see also* Jim Campen, *Borrowing Trouble VII: Higher-Cost Mortgage Lending in Boston, Greater Boston and Massachusetts, 2005* at 8 (Mass. Community & Banking Council, Jan. 2007), available *at* www.masscommunityandbanking.org (highest income Latinos received high-cost home purchase loans at 6 times the rate of the highest income whites; highest income African Americans 7.6 times to receive a high-cost home purchase loan than highest income whites); Geoff Smith, Woodstock Institute, Key Trends in Chicago Area Mortgage Lending: Analysis of Data from the 2004 Chicago Area Community Lending Fact Book 10 (2006) (African-Americans and Hispanics more likely to receive high-cost loan than white borrowers, disparity increases as income increases); Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, *American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States*, 88 Geografiska Annaler, Series B: Human Geography 105 (2006) (finding geographic racial disparities in lending in Baltimore that cannot be explained by income); Stephanie Casey Pierce, Racial Disparities in Subprime Home Mortgage Lending: Can the Difference Be Explained by Economic Factors? (2006) (unpublished M. Pub. Pol'y thesis, Georgetown University), *available at* http://dspace.wrlc.org/bitstream/1961/3612/1/etd_smc54.pdf (a survey of 2004 HMDA data from Louisiana found that blacks were 13.82% more likely than whites to receive a high cost, first lien purchase loan); *cf.* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A138 (2006) (piggyback loans more common in minority census tracts, even holding income constant), available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf .

[80] *See, e.g.,* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 13 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

concluded, the origination channel—whether or not a loan is brokered—accounts for most of the difference in pricing.[81]

Lender-paid broker compensation creates the incentives that drive much of the racially disparate pricing.[82] By encouraging brokers to overprice loans where and when they can, lenders implicitly encourage brokers to target the vulnerable and gullible and those perceived as vulnerable and gullible. Most borrowers naively believe that their lenders will give them the loan they qualify for, and are insufficiently on their guard in dealing with brokers. African-Americans and Latinos are particularly likely to believe that lenders are required to give them the best rate for which they qualify.[83]

The mechanics and extent of lender-paid broker compensation reach beyond simply overcharging African-American and Latino borrowers. Lenders use broker compensation to lock African-Americans and Latinos into downwardly mobile borrowing and destructive products. For example, lender payments to brokers are often conditioned on the borrower's acceptance of a prepayment penalty.[84] Thus, brokers have an incentive not only to put borrowers into a high-cost loan in order to receive additional compensation from the lender, but to make sure the borrower is locked into the high-cost loan. Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest.[85]

---

[81] *See* Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *Higher Priced Home Lending and the 2005 HMDA Data*, Fed. Reserve Bull. A123, A157-58 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (pricing disparities between whites and minorities highest for broker originated loans); Robert B. Avery & Glenn B. Canner, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, Fed. Reserve Bulletin 344, 380, 394 (Summer 2005), *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05/hmda.pdf (same).

[82] Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21-23 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (discussing evidence and analysis that links pricing disparities with broker activity and incentives); *see also* Press Release, Office of the New York State Attorney General, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 5, 2006), *available at* http://www.oag.state.ny.us/press/2006/dec/dec05a_06.html (pricing disparities between whites and minorities highest for broker originated loans).

[83] Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* http://www.trfund.com/policy/pa_foreclosures.htm, *citing* Fannie Mae's 2002 National Housing Survey.

[84] *See* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 21 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (noting that payment of yield spread premiums is often conditioned on the imposition of a prepayment penalty).

[85] Loans with prepayment penalties attached have higher rates of foreclosure, and in brokered loans, borrowers generally receive no interest rate reduction in exchange for the imposition of the prepayment penalty. *See, e.g.,* Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.p

The pernicious racially disparate impact of lender-paid broker compensation on pricing makes it particularly important that the Board's rulemaking is effective in reducing abuse and creating transparency.

### *a. __Yield Spread Premiums Are Unfair or Deceptive__*

Yield spread premiums contribute to borrowers receiving loans that are either unaffordable, or more expensive than those for which they qualify. They are deceptive. Borrowers believe that loan originators, especially brokers, are giving them the best deal for them when in fact the brokers are paid to charge the consumers more. Unknown to most borrowers, the broker's incentive structure is at odds with the borrowers' interests. Yield spread premiums also are unfair. The harm to the consumer is measurable in the higher interest rate paid by the borrower. This is substantial economic injury to the borrower and may contribute to unaffordable payments that the borrower will face.

Moreover, consumers cannot reasonably avoid the injury caused by yield spread premiums, where the process of broker payments is opaque to the borrower. Lender compensation often is the lion's share of a broker's total pay. Usually, the amount of lender compensation to the broker is not disclosed until closing; seldom is the reason for the compensation disclosed; and never do the lender and broker disclose the interest rate bump or other benefit the lender receives as its part of the quid pro quo. Even weak disclosures of the yield spread premiums are often confusing and ineffective to consumers. Compensation structures for internal loan officers are even more opaque and, therefore, possibly more pernicious.

The powerful economic incentives and the enormous imbalance in information between loan originators and borrowers have produced a highly dysfunctional mortgage market and yield spread premiums have been a key driver of that dynamic. The current structure incentivizes the lender and broker to collude in misleading the borrower into a high-priced loan rather than to engage in substantive risk-based underwriting and pricing.

The harm from yield spread premiums is not outweighed by benefits to consumers or competition. There is no benefit to consumers or competition from yield spread premiums. Yield spread premiums cause homeowners to pay more for their loans, not because they don't qualify for better loans, but to inflate the income of brokers making the loans. Moreover, the lack of transparency in the yield spread premium process precludes the ability to consumers to shop on this basis. If anything, yield spread premiums led to a bidding war where brokers were willing to upsell consumers for the highest bidder.

### *b. __Yield Spread Premiums Should Be Banned Except in No Cost Loans__*

---

df. (finding that prepayment penalties were associated with higher interest rates unless they controlled for "borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate," in which case the difference shrank); s*ee also* Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

*Lender-paid broker Compensation Should Only Be Permitted When All of the Closing Costs Are Included in the Interest Rate*

The problem with yield spread premiums is that brokers are paid both out of the interest rate and out of pocket. Most consumers simply cannot aggregate interest and fees to be able to compare the cost of credit of two loans. The problem only gets worse when the settlement statement is cluttered with a myriad of fees, some to the broker, some to the lender, some to a settlement agent. If all of the fees are included in the interest rate, then consumers can shop in a meaningful way on the total cost of the loan.

The Commission should prohibit the practice of paying the broker a yield spread premium, which increases the interest rate, at the same time as the borrower is being charged other up-front fees that purport to reduce the rate. Yield spread premiums should be prohibited unless all other fees (other than escrow fees imposed in accordance with RESPA, actual government fees, and title insurance and title examination fees, if paid to an unrelated party and if bona fide and reasonable) are folded into the interest rate and no discount points are charged. Additionally, no other lender-paid broker compensation should be permitted if the borrower is making any direct payments to the broker.[86]

*All lender-paid broker compensation should be subject to the same rule.*

Lender-paid broker compensation, whether or not it is covered in the interest rate, misaligns the broker's incentives. Lender-paid broker compensation in exchange for loans with a prepayment penalty, a shorter fixed rate term, or a balloon note, to give a few common examples, is no more benign and considerably less transparent than pure interest rate based compensation. There is no reason to exempt even volume based lender-paid broker compensation from the requirements of fairness and transparency. Even volume based payments to the brokers by lenders will ultimately be paid by the consumer through the consumer's interest rate. Borrowers should always be told what the compensation arrangements are; lenders should require brokers to act as the borrower's fiduciary in arranging the loan; all costs should be bundled into the rate to facilitate shopping; and all broker fees must be treated as both higher-priced and HOEPA points and fees. To do otherwise will simply move the gluttony of lender-paid broker compensation from interest to other, less transparent and potentially more harmful, *quid pro quos*.

*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?*

Same as above—see 6c.

---

[86] In this situation, lenders must list all charges incurred in the transaction on the settlement statement but show them as P.O.C., paid outside of closing. *See* HUD Instructions in Regulation Z, 24 C.F.R. 3500 Appendix A. If the lender provides a credit to the consumer to cover closing costs, the credit must appear on lines 204-209 of the settlement statement. See HUD Letter Regarding Disclosures on Good Faith Estimate and HUD-1 Settlement Statement, Q 12, attached to OCC Advisory Letter AL 2000-5.

***Question 8 – Disclosure***

The Federal Reserve Board is taking the lead on revamping mortgage disclosures with its recent issued proposed rule on closed end credit under Regulation Z. The Board's proposal to incorporate almost all loan costs in the APR is a significant step forward in providing transparency on mortgage costs. Importantly, this combines with the recently developed requirements under the Mortgage Disclosure Improvement Act, which requires advance notice to consumers of loan costs and redisclosure of significant changes to those costs. The final piece of this puzzle is the revised Good Faith Estimate issued by HUD. Homeowner now will be able to obtain summary information regarding loan closing costs as well as summary information about the loan, all in one place.

Yet, it is important to remember that disclosure on its own can not stand in for substantive protections. Only ability-to-repay requirements will affect the content of loans for most homeowners. The market is too complex to assume that disclosures can level the playing field between sophisticated corporations and lay homeowners.

Finally, it is essential that no disclosures be developed that would cause a homeowner to waive the rights she has to substantive protections. The reason to require underwriting is because a homeowner is not, on her own, in a position to both assess the loan and demand the right package, without assistance from the law. Bargaining power between consumers and originators is grossly disproportionate. Homeowners should not be required to sign a form disclosure indicating their understanding of particular loan terms or their assent to waive any rights. Simple, transparent, enforceable loan disclosures provided well in advance of closing,[87] combined with strong substantial regulation is the best protection a homeowner can receive.

***Question 9 – Incorporation of Board Rules***

The Commission should incorporate the Board's HOEPA rule under 15 U.S.C. 1639 into the rule. While we ask the Commission to go farther, incorporating the current rules will at least enhance the remedies for violations.

***Question 10 – Recent reports, studies, or research provide data relevant to mortgage origination rulemaking***

*Market Segmentation*

Cassandra Jones Havard, Democratizing Credit: Examining the Structural Inequities of Subprime Lending, 56 Syracuse L. Rev. 233 (2006) (discussing market segmentation and information asymmetries).

Ronald J. Mann, "Contracting" for Credit, 104 Mich. L. Rev. 899, 914/-/915 (2005/-/2006) (describing how complexity, segmentation, and unilateral modification of terms combine to prevent increased consumer sophistication from reducing profits or increasing market efficiency).

[87] Disclosures provided at the closing are too late to serve any purpose.

Ronald H. Silverman, Toward Curing Predatory Lending, 122 Banking L.J. 483, 531/-/544 (2005) (discussing information asymmetries, rent seeking, lack of competition, and adverse selection in predatory home mortgage lending).

Elvin K. Wyly, Mona Atia, Holly Foxcroft, Daniel J. Hamme, Kelly Phillips-Watts, American Home: Predatory Mortgage Capital and Neighbourhood Spaces of Race and Class Exploitation in the United States, 88 Geografiska Annaler, Series B: Human Geography 105 (2006) (arguing that lenders have targeted vulnerable neighborhoods).

Michelle A. Danis & Anthony Pennington-Cross, The Delinquency of Subprime Mortgages 7 (Fed. Res. Bank St. Louis, Working Paper 2005-022A Mar. 2005) (discussing economic theories to explain market segmentation between prime and subprime), *available at* http://research.stlouisfed.org/wp/2005/2005-022.pdf.

*The Problems with Disclosure*

Oren Bar-Gill, The Behavioral Economics of Consumer Contracts, 92 Minn. L. Rev. 749, 796-801 (2008) (discussing needed improvements in TIL disclosures primarily in the credit card context, including the need for binding disclosures and disclosure of use patterns).

Patricia A. McCoy, Rethinking Disclosure in a World of Risk-Based Pricing, 44 Harv. J. on Legis. 123, 128/-/138, 142/-/143 (2007) (discussing limitations of current disclosure regime in providing relevant, binding information in a timely and useful manner).

Elizabeth Renuart & Diane E. Thompson, The Truth, the Whole Truth and Nothing but the Truth: Fulfilling the Promise of Truth in Lending, 25 Yale J. on Reg. 181 (2008)(existing finance charge and APR disclosures do not permit consumers to shop for credit in a meaningful way).

*The Cost of Credit*

Michael LaCour-Little, Economic Factors Affecting Home Mortgage Disclosure 24 (May 18, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992815 (loans originated by brokers were, after controlling for other economic factors, significantly more likely to have increased APRs from 2004 to 2005 than loans originated directly by lenders).

Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, The Age of Reason: Financial Decisions Over the Lifecycle 37 (Feb. 11, 2008), *available at* http://ssrn.com/abstract=973790 (finding that older and younger borrowers pay more for credit than midlife borrowers across a range of credit products, perhaps because older and younger borrowers do not understand "shrouded attributes," such as the relationship between higher LTVs and higher APRs).

Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3-4, Sept. 5, 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956.

*Mortgage Foreclosure Filings*

Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), *available at* www.trfund.com/policy/pa_foreclosures.htm.

*Consumer (Lack of) Understanding*

James M. Lacko & Janis K. Pappalardo, Fed. Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms, at ES-11 (2007), *available at* www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex).

Consumer Fed. of Am., Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages 3 (July 26, 2004), *available at* www.consumerfederation.org/releases.cfm#Consumer%20Literacy (consumers cannot calculate the increase in the payment in an adjustable rate mortgage and minimize the interest rate risk by understating the increase in the payment; problem is present for all categories, but particularly pronounced for younger, poorer, less educated, and non-white consumers).

Brian Bucks & Karen Pence, Do Homeowners Know Their House Values and Mortgage Terms? 18/-/22 (Fed. Res. Bd. of Governors Fin. & Econ. Discussion Series Working Paper No. 2006-3), *available at* www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf (borrowers, particularly low-income borrowers, underestimate caps on life time interest rates in adjustable rate mortgages).

William C. Apgar & Christopher E. Herbert, U.S. Dep't of Hous. & Urban Dev., Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis § 2.2.3, at 1-15 (2006) ("Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage.").

Ren S. Essene & William Apgar, Joint Ctr. for Housing Studies, Harvard Univ., Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans (2007).

*No and Low Doc Loans*

Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (subprime loans with no documentation associated with early payment default).

Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. for Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf. (loans originated with less than full documentation in 2003 had a 63.7% higher risk of foreclosure).

Michelle A. Danis & Anthony Pennington-Cross, Federal Reserve Bank of St. Louis, Delinquency of Subprime Mortgages 20 (Working Paper 2005-022A), *available at* http://research.stlouisfed.org/wp/more/2005-022/ ("Loans with limited documentation also are delinquent and default more frequently than full documentation loans. The impact for loans with no documentation is even larger.").

Morgan J. Rose, Federal Reserve Bank of Chicago, Predatory Lending Practices and Subprime Foreclosures--Distinguishing Impacts by Loan Category 23 (Dec. 2006), *available at* www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (finding in a review of Chicago subprime foreclosures that low or no documentation led to significant increases in the rate of foreclosure for refinance loans but had no statistically significant relationship to foreclosures on purchase loans).

*The Impact on Minorities and Low-Income Borrowers*

Jonathan S. Spader & Roberto G. Quercia, Mobility and Exit from Homeownership: Implications for Community Reinvestment Lending, 19 Housing Pol'y Debate 675 (2008) (finding that African Americans, Latinos, and low-income borrowers who received CRA loans did not exit homeownership at rates higher than the general population, unlike previous studies that found higher rates of exit from homeownership for African Americans, Latinos, and low-income families without distinguishing CRA and non-CRA lending).

Gov't Accountability Office, GAO No. 07-645, Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants 11/-/13 (2007), *available at* www.gao.gov/new.items/d07645.pdf (decrease in FHA market share most pronounced among low income and minority borrowers; subprime market share increased among African Americans, Hispanics, and low-income borrowers in roughly the same amount that FHA market share decreased).

Marsha J. Courchane, The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?, 29 J. Real Est. Res. 399, 415, 417 (2007); Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. for Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3/-/4 (May 31, 2006), *available at* www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

Howell E. Jackson & Laurie Burlingame, Kickbacks or Compensation: The Case of Yield Spread Premiums, 12 Stan. J.L. Bus. & Fin. 289, 350 (2007) (evidence suggests that brokers may charge African Americans and Hispanics more; both groups pay more, on average, in broker compensation than whites).

Carsey Institute, Subprime and Predatory Lending in Rural America: Mortgage Lending Practices That Can Trap Low-Income Rural People, Pol'y Brief No. 4 (2006), *available at* www.carseyinstitute.unh.edu/documents/PredLending.pdf (higher rates of subprime lending in rural areas than urban; rural Latinos, Native Americans, and African Americans all disproportionately receive subprime loans, with African Americans nearly three times as likely as white borrowers to receive a subprime loan).

First Nations Dev. Inst., Borrowing Trouble: Predatory Lending in Native American Communities 14/-/16 (2008), *available at* www.firstnations.org/publications/BorrowingTroubleFinalWebv031308.pdf (American Indians receive subprime loans at roughly twice the rate whites do for the period 1998 - 2005).

Thomas P. Boehm, Paul D. Thistle, Alan Schlottmann, Rates and Race: An Analysis of Racial Disparities in Mortgage Rates, 17 Housing Pol'y Debate 109, 126 (2006) (finding, based on a review of American Housing Survey data from 1991/-/2001, that African Americans in the conventional market pay 20 basis points more for purchase loans, 94 basis points more for refinancing loans, and Latinos pay 12 basis points more for purchase loans than whites with similar income and education).

Kevin Stein, Cal. Reinvestment Committee, Who Really Gets Higher Cost Loans? Home Loan Disparities by Income, Race, and Ethnicity of Borrowers and Neighborhoods in 12 California Communities in 2004, at 8 (Dec. 2005), *available at* www.calreinvest.org/pdf/CRC_highcostloans1205.pdf.

*The Sub-Prime Market and Prepayment Penalties*

Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, Kenan Institute for Private Enterprise, University of North Carolina, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments (Jan. 25, 2005), *available at* www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf (71.8% of loans in the study contained prepayment penalties).

Keith S. Ernst, Ctr. for Responsible Lending, Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages (Jan. 2005), *available at* www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.

*The Sub-Prime Market*

Kathleen C. Engel & Patricia A. McCoy, Turning a Blind Eye: Wall Street Finance of Predatory Lending, 75 Fordham L. Rev. 2039, 2057-60 (2007) (arguing that pricing in the subprime market is above prime in order to compensate investors for risks created by securitization and lax underwriting).

Edward Golding, Richard K. Green & Douglas A. McManus, Joint Center for Housing Studies, Harvard University, Imperfect Information and the Housing Finance Crisis (Feb. 1, 2008), *available at* www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-6_golding_green_mcmanus.pdf (discussing the rent-seeking mechanism that concentrates brokers in the subprime market).

Ira J. Goldstein, The Reinvestment Fund, Lost Values: A Study of Predatory Lending in Philadelphia 66 (2007), *available at* www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf (subprime lenders accounted for 72% of the loans in foreclosure in Philadelphia between 2000 and 2003).

AARP Public Pol'y Inst., A First Look at Older Americans and the Mortgage Crisis 6(2008), *available at* http://assets.aarp.org/rgcenter/econ/i9_mortgage.pdf (having a loan-to-value ratio greater than 100% nearly doubles the risk of foreclosure).

Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. for Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation; loans originated with less than full documentation in 2003 had a 63.7% higher risk of foreclosure).

Morgan J. Rose, Federal Reserve Bank of Chicago, Predatory Lending Practices and Subprime Foreclosures--Distinguishing Impacts by Loan Category 45 (Dec. 2006), available at www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%).

Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (subprime loans with no documentation and piggyback loans showing pattern of default within four months of origination).

Keith Ernst, Ctr. for Responsible Lending, Case Study in Subprime Hybrid ARM Refinance Outcomes (Feb. 21, 2007), *available at* www.responsiblelending.org/issues/mortgage/briefs/page.jsp?itemID=31730766 (less than three years out, 8.5% of 106 hybrid subprime ARMS made by Option One in 2004 had been foreclosed on).

Andrey Pavlov & Susan Wachter, The Wharton School, University of Pennsylvania, Aggressive Lending and Real Estate Markets 13 (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf (each 1% increase in purchase adjustable rate mortgages leads to housing value decline--itself a risk for foreclosure--of 1.3%).

*Mortgage Brokers*

Keith Ernst, Debbie Bocian & Wei Li, Ctr. for Responsible Lending, Steered Wrong: Brokers, Borrowers, and Subprime Loans (2008), *available at* www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf (borrowers in the subprime market pay more when there is a broker).

Susan Woodward, A Study of Closing Costs on FHA Mortgages, U.S. Department of Housing and Urban Development, Office of Policy Development and Research. (2008), *available at* http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf (reporting data showing that borrowers on FHA loans pay more in interest, broker fees, and other closing costs when the broker is paid both by the borrower and the lender, as most brokers in the subprime market are).

M. Diane Pendley, Glenn Costello & Mary Kelsch, Fitch Ratings, The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance 4-5 (Nov. 28, 2007), *available at* www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624 (reviewing 45 origination files and finding that fraud or misrepresentation was apparent in most of the files and would have been apparent to a lender performing "adequate" underwriting).

*Yield Spread Premiums*

Howell E. Jackson & Laurie Burlingame, Kickbacks or Compensation: The Case of Yield Spread Premiums, 12 Stan. J.L. Bus. & Fin. 289, 295 (2007) (in a survey of mortgage transactions, when yield spread premiums are not paid, brokers received on average more than 1.5% of the loan amount).

Howell E. Jackson & Laurie Burlingame, Kickbacks or Compensation: The Case of Yield Spread Premiums, 12 Stan. J.L. Bus. & Fin. 289, 332 (2007) (borrowers in a survey of over 3000 prime loans pay on average $869 more in costs to have a loan brokered).

*Subprimes reach high rates of foreclosure before the reset*

Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination).

Federal Reserve Board, 74 Fed. Reg. 44,522, 44,540-541 (July 30, 2008)("Payment increases on 2-28 and 3-27 ARMs have not been a major cause of the increase in delinquencies and foreclosures because most delinquencies occurred before the payments were adjusted."

"Almost 13 percent of the 2-28 ARMs originated in 2005 appear to have become seriously delinquent before their first reset.").

Joint Center for Housing Studies, State of the Nation's Housing 2007 at 20, *available at* http://www.jchs.harvard.edu/publications/markets/son2008 (subprime ARM 60 day delinquency rates reach 10% to 28%, depending on the origination year, for loans made in 2002-2007, 18 months after origination, at least 6 months before reset).

Anthony Pennington-Cross & Giang Ho, The Termination of Subprime Hybrid and Fixed Rate Mortgages 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock).

Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 25, 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure taking only 12.4 months to enter foreclosure from origination).

State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1, Feb. 2008, at 10-11 http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf (ARMs foreclosing at high rates before reset).

State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3, Sept. 2008, at 4 http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf (one third of suprime ARMs facing reset in the third quarter of 2009 were delinquent in May 2008, more than a year before reset; only 4.15% of subprime and Alt-A loans after reset in May 2008 were delinquent).

*Subprime ARMs foreclose at higher rates than subprime fixed rate mortgages*

Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.; Roberto Quercia, et al. The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments (Jan. 2005), at 28-29 *available at* www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

*Subprime ARMs foreclose at higher rates than prime ARMs*

Sumit Agarwal & Calvin T. Ho, Comparing the Prime and Subprime Mortgage Markets, Chicago Fed. Letter (Aug. 2007), *available at* http://www.chicagofed.org/publications/fedletter/cflaugust2007_241.pdf.

*Subprime ARMs reduce housing values*

Andrey Pavlov & Susan Wachter, Aggressive Lending and Real Estate Markets (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf 13 (each 1% increase in purchase adjustable rate mortgages leads to housing value decline—itself a risk for foreclosure—of 1.3%).

*Borrowers make only minimum payments on payment option ARMs*

Joint Center for Housing Studies, State of the Nation's Housing 2007 at 17 (three-quarters of all borrowers make only minimum payments).

## III. Appraisals

When a loan is made based on an inflated appraisal, the borrower is essentially a captive customer to that bad loan. As the house is worth less than the loan, the homeowner cannot sell to escape the onerous terms without finding the cash to pay off the difference. Nor can the homeowner refinance because the home is "underwater" from the start and will not be sufficient collateral for a new loan from a legitimate lender. The lender who has made this bad loan has the borrower completely at its mercy – the payments must be made, at all costs, to preserve the family homestead. Even leaving and turning the house over the lender often leaves the homeowner subject to a potential deficiency judgment for the balance of the loan (now inflated by foreclosure and sale costs) over the value of the home (now deflated by the forced sale in a foreclosure proceeding).

As the FTC has recognized, inflated appraisals across the nation have caused substantial harm to homeowners, their families and their communities. Inflated appraisals are rampant.[88] Lenders – both brokers and the originating lenders – have incentives to make loans, even if the collateral securing the loan is not sufficient to protect the investor from loss. These incentives have led to wide spread abuses, which not only place substantial risk on the investors, but create devastating traps for consumers.

### ***Question 11 – Examples of Unfair or Deceptive Appraisal Acts and Practices***

As originators do not keep the loans made, yet are responsible for the underwriting of the loan, originators do not have sufficient incentives to ensure that the appraisals supporting the home loans were proper. This is evident in dozens of individual and class action cases across the country.[89] Lenders that encourage or accept inflated appraisals, however, only engage in a short list of unfair or deceptive acts and practices:

---

[88] There are numerous indications of regular and sustained activity among brokers and lenders for accepting and/or facilitating inflated appraisals. For example: As of August, 2007, over 9,100 appraisers had signed a petition to the Federal Financial Institutions Council asking for action to protect them from pressure they feel from lenders, mortgage brokers, and real estate brokers to assess a predetermined value to property. *See,* Concerned Appraisers from Across America Petition, *available at* http://appraiserspetition.com. *Also see,* Wilson v. Toussie, 260 F. Supp. 2d 530 (E.D.N.Y. 2003) (documenting allegations of intentional inflation of appraisals).

[89] *See, e.g. Adkins v Countrywide Home Mortgage et al;* Circuit Court, Lincoln County, Civil Action No. 08-C-28; (Appraisal fraud alleged against lender and cooperating realtor. Settlement included voiding of loan and payment of $95,000 in damages to homeowner, plus attorneys fees and costs. *Anderson v. National City Bank (formerly Provident Bank)*, Circuit Court, Mercer County, Civil Action No. 04-C-199F (Routine acceptance of

1. They provide the appraisers with the expected appraised value.

2. They fail to provide a meaningful underwriting review of the appraisal as required by general industry standards, as well as their own internal guidelines (at least generally).[90]

**Providing appraisers with the expected appraised value**

a. Lenders' provision to appraisers of the expected value causes substantial economic injury to consumers because it undermines the impartiality and independence of the appraiser. Appraisers should not know how much the lender says the home is worth: that is exactly the purpose of the appraisal – to determine the home's value. The only reason for passing this information along is to give the appraiser information which is unnecessary *unless* it is for the improper purpose of establishing the target price. Consumers whose homes are secured by loans based on inflated appraisals are substantially harmed because they often owe more on their mortgage than their home is worth– they cannot escape their mortgage, they cannot sell their house, they cannot refinance. These homeowners are wholly captive to the mortgage's predatory terms.

Consumers cannot escape the inflated appraisals; consumers have no reasonable way of determining whether an appraisal is inflated. Only a lender would have the wherewithal to determine this.

There are no benefits to competition from inflated appraisals.

b. This practice should be prohibited. It is unnecessary except for the improper purpose.

c. By disallowing this practice – and by establishing the loan reformation – as explained more fully in response to Question 13 – requirement for violation of this prohibition – competition between appraisers for appraisal services would be significantly improved. Instead of lenders only using those appraisers who could return the sought after

---

inflated appraisals alleged against bank. Settlement included voiding of sixty mortgages, and payment of damages between $20,000 and $34,000 damages *each* to homeowners who had already lost their homes to foreclosure (between seventy and eighty homeowners); *Lourie Brown and Monique Brown v. Quicken Loans Inc. et al.,* In the Circuit Court of Ohio County, West Virginia, Civil Action No. 08-C-36, (alleging that the lender knew or should have known the appraisal was inflated on loan for $144,800 based on an appraised value of the home of $181,700, when the real value of the home was $56,000); *Harold C. Wallace v. Midwest Financial and Mortgage Services, Inc., MortgageIt, Inc. et al.* United States District Court Eastern District of Kentucky at Covington, Civil Action No. 2:07cv131, (alleging that lender knew of inflated appraisal in making a payment option ARM loan based on appraised value of home of $500,000 20 months after it was purchased for $272,316.

[90] *See, e.g.* Title XI, Financial Institutions Recovery, Reform, and Enforcement Act of 1989, 12 U.S.C. § 3331; "Appraisal Reviews Are Important to Safe Banking", *Financial Update*, Federal Reserve Bank of Atlanta, 4th Quarter, 2004, found at http://www.frbatlanta.org/invoke.cfm?objectid=48322F80-C5A6-D175-9F7DA14278E89F4B&method=display%22%20target=%22_blank..

target price, lenders would have every incentive to engage only the most accurate and most honest appraisers.

**Failing to engage in a meaningful underwriting review of the appraisal**

a. There are numerous industry pronouncements encouraging lenders to engage in a meaningful review of appraisals.[91] Yet, despite these, lenders have repeatedly failed to catch the most obvious of clues that the appraisals purporting to support the loan amount are fallacious. Even though most (if not all) lenders require a careful review of the appraisals, there is no enforcement of this requirement – and no consequences to the lender for failing to engage in it.[92]

The breadth of the inflated appraisal problem is indicative of the lenders' failure to properly review the appraisals. The specific process of reviewing appraisals is neither technical nor difficult, and simply requires a modicum of common sense. Listed below are just a few examples of typical clues that appraisals might be inflated, which should then require additional review to assure that the appraisal is indeed correct:

- An increase in value of the house in the past two to five years at a rate substantially higher than the neighborhood experienced, without an appropriate level of upgrades to the house.
- Inclusion in the appraisal of comparable properties which are not truly comparable, which can be evidenced by long distances from the subject, different neighborhoods or communities, different house types (for example, ranch vs. split level), neighborhoods in which the residents expended considerably more money for landscaping, or in which the utility connections were buried rather than above ground.
- Failure to include in the appraisal itself the basic information required by USPAP[93] standards, such as a sufficient number of comparable properties, the appropriately delineated sketch of the subject property, clear pictures of the front, and back and road view of the subject, the date and amount of the purchase of the subject, a clear explanation of a large difference between the actual age and the effective age of the property.

b. The practice of failing to conduct a proper appraisal review should be prohibited.

c. By disallowing this practice – and by establishing the loan reformation requirement for violation of this prohibition – competition for loans from lenders who were covered by the prohibition would be encouraged. Borrowers would know that these lenders were more likely to engage in lending practices which assure fairer loans, and ones which would not cause the borrowers to owe more on their mortgages than their home is worth.

---

[91] *See, e.g.* guidelines cited in Notes 90 and 97 *supra.*

[92] While some may say lenders will be adequately detered from using inflated appraisals by the risk that they will not be able to recoup the loan balance at foreclosure, the fact that so many loans are sold on the secondary market eliminates any such deterent. Recent history has only confirmed this.

[93] USPAP stands for the Appraisal Foundation's Uniform Standards of Professional Appraisal Practice guidelines.

***Question 12 – Specific Information Required for Disclosure***

No. This is not a problem that can be remedied with disclosures. It requires substantive regulation, as explained in answer to Question 13.

***Question 13 -- Proposed Solution to the Unfair Appraisal Activities by Lenders***

The investigation and legal proceeding settled by the New York Attorney General's office against a large appraisal company for conspiring with a large, nationwide lender provides vivid illustrations of how these incentives play out in the relationship between the originating lender and the appraiser.[94] As is evident from the emails quoted in the pleadings, the large, national, federally regulated savings bank-lender repeatedly and regularly demanded certain appraised values in exchange for its continued business.[95] *Yet, the resolution of the case with Freddie Mac, Fannie and OFHEO[96] -- while helpful – will not provide meaningful, market-based incentives to stop inflated appraisals.*

It is incumbent upon the FTC to *not* limit itself to what has been agreed to by the industry in the past. Instead, the FTC must recognize the dynamics of the mortgage industry and create regulations which use those dynamics to protect consumers. Requirements that simply – and vaguely – prohibit undue influence, and insist upon appraiser independence, will not work if there is no effective enforcement against the lenders who facilitate the inflated appraisals. The buck has to stop at the lender's door – the remedy for an inflated appraisal must be that the lender is required to reform the loan to the proper appraised value of home.

The real problem is the incentive for inflating the value of the property. Meaningful regulation on appraisal fraud needs to be clear and proscriptive. It must flatly lay the blame for an inflated appraisal on the doorstep of the lender. This will be the only way that lenders will develop the essential tools it takes for the lender to ensure that the appraisal is not inflated. Indeed, making the lender responsible for an inflated appraisal is the only way to put a clean stop to this reprehensible practice.

Standard underwriting practices in place for several years require the lender to independently evaluate the appraisal. This evaluation is supposed to be conducted by a part of the lender's business which is separate from the origination arm – an attempt to require some independent judgment to be applied to the process.[97]

---

94 http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html; U.S. Residential Subprime Mortgage Criteria - Standard & Poor, 2006.

95 *See* Complaint filed by NY Attorney General against First American Corporation, *et al.*. http://www.oag.state.ny.us/press/2007/nov/EA%20Complaint.pdf, paragraphs 28 and following

96 *See* New York Attorney General Cuomo Announces Agreement with Fannie Mae, Freddie Mac, and OFHEO (Mar. 3, 2009), (http://www.oag.state.ny.us/media_center/2008/mar/mar3a_08.html).

97 *See*, *e.g.,* Fannie Mae Selling and Servicing Guide, XI, 102: Ongoing Review of Appraisals (11/01/05): "A lender must continually evaluate the quality of the appraiser's work through the normal underwriting review of

The Cuomo settlement with Fannie Mae, Freddie Mac and OFHEO, as laudable as it is, will not solve the problem with the widespread use of inflated appraisals because it will be so difficult to determine compliance failure. As a result, tens of thousands of loans can be made with inflated appraisals, with only a handful problem appraisals coming to light. Then – even when inflated appraisals are discovered – what is the remedy against the originator/lender which encouraged or facilitated or even just allowed the inflated appraisal?

Even if an individual homeowner were to somehow stumble upon the proof of collusion, conspiracy, bribery and fraud, that would essentially be necessary to prove a violation of the Cuomo settlement terms, what penalty would there be?

The FTC should establish a construct that will use the market to ensure that inflated appraisals are not facilitated, and when permitted, are thoroughly punished. The market based prohibition would make the lender/investor responsible for an inflated appraisal. The consequences of facilitating an inflated appraisal should be reformation of the loan.

The FTC regulations should flatly state that when a loan is made which is based on an inflated appraisal, the lender is responsible for that conduct. The remedy should be a rewrite of the loan to be at the same percentage to the *real* appraised value as the original loan was to the inflated appraised value. The real appraised value of the home at the time the loan was written can be determined based on a retrospective appraisal.[98]

For example, assume the original loan in January, 2006, was based on an 80% LTV ratio, and the original appraisal showed the house had a value of $120,000, and the loan was for $96,000. Two years later, after complaints or concerns about an original inflated appraisal, a retrospective appraisal is completed which shows that as of January, 2006, the real value of the home was $85,000. The loan should now be rewritten to be 80% of $85,000, or reduced to a loan amount of $68,000. All payments made on the loan should be applied to the loan as if had been a $68,000 loan all along.[99]

---

all appraisal reports, as well as through the spot-check field review of appraisals as part of its quality assurance system." *Also see,* "The underwriter's role is to review the appraisal report to ensure that it is of professional quality and is prepared in a way that is consistent with our appraisal standards, to analyze the property based on the appraisal, and to judge the property's acceptability as security for the mortgage requested in view of its value and marketability." Fannie Mae Selling and Servicing Guide, XI, Introduction (06/30/02).

[98] A retrospective appraisal is simply an evaluation of the property for a prior time. It is done exactly in the same way as a current appraisal is, using public records and Multiple Listing information, the only difference is the information is obtained as of the earlier date.

[99] Just to continue the illustration: if the original loan had an interest rate of 7.5% and a term of 30 years, the payments would have been $671.25. If the payments had been made on time, through the current month - - March, 2008, presumably 25 payments of $671.25 would have been made. When the loan is rewritten in March, 2008 retroactively to be for 80% of the retrospective appraised amount of $68,000, the current amount due on the mortgage would be $61,071. The remaining payments could be kept at the same level as the original loan required – sufficient to pay off a mortgage of $68,000 in 30 years, which would mean that the loan would actually be paid off more quickly, because of the higher payments made before the inflated appraisal was found and corrected, or the payments could be reduced even further to allow the balance due to be paid off in the remaining months of the original 360 month term.

Inflated appraisals are creating serious problems across the nation, and have fueled, to a significant extent, the current foreclosure problems. If the appraisals had been honest to begin with, many of the loans currently defaulting would not have been made. The only meaningful enforcement mechanism to ensure compliance with meaningful appraisal review requirements is to make the lender's failure to catch the inflated appraisal punishable by a reformation of the loan.

These rules should apply not only to the original lenders, but also to all assignees. Assignees can easily conduct simple file reviews to determine whether the lender engaged in meaningful appraisal reviews. Assignees will not reliably do so, however, unless they—rather than homeowners—suffer the consequences from inflated appraisals. If the rules regarding appraisals--especially including the requirement to reform loans--apply to assignees, the secondary market will establish industry-wide standards to enforce the rules.

By requiring assignees to reform loans when retrospective appraisals indicate the original appraisal was grossly inflated, the FTC would be establishing a market-based solution for the problem of fraudulent appraisals. This is because the market would create the specific mechanisms to police the originators – because the assignees would suffer the consequences for failing to catch the originating lenders who had failed in these duties. Loan files already contain adequate information for assignees to protect themselves without imposing an undue burden on the secondary market.

## IV. Servicing Issues

### *Background on Servicing Issues Prior to Foreclosure or Bankruptcy*[100]

The FTC recognizes that "the relationship between mortgage servicers and consumers is vulnerable to abuse. Mortgage servicers typically do not have a customer relationship with homeowners; rather they work for the loans' owners. Moreover, borrowers cannot shop for a loan based on the quality of servicing, and they have virtually no ability to change servicers if they are dissatisfied."[101] Otherwise put: there are no real restraints on home mortgage servicing abuses. This complete lack of any market mechanism for consumers to employ when their needs are not met calls for comprehensive and enforceable regulation.

The FTC has also highlighted – in a slightly understated fashion – that "servicers have financial incentives to impose fees on consumers."[102] In the interest of maximizing profits, servicers have engaged in a laundry list of bad behavior, which has considerably exacerbated the current foreclosure crisis.[103]

Customarily, the servicer collects a monthly fee in return for the services provided to the trust (or investors). The servicing fee provides the largest income stream for servicers. The

[100] Background information on servicer behavior in foreclosure and in bankruptcy is provided in response to Questions 20 and 21, respectively.
[101] Supplementary Information, Federal Trade Commission, Advance Notice of Proposed Rulemaking. [RIN 3084-AB18], 74 Fed. Register, 26118, at 26126, June 1, 2009.
[102] *Id.*
[103] *See* National Consumer Law Center, *Foreclosures*, Ch. 6 (2d ed. 2007)(describing the most common mortgage servicing abuses).

fee is based on the unpaid principal loan balance and typically ranges from 25 basis points (prime loans) to 50 basis points (subprime loans). In addition, ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events. The most common ancillary fee is a late fee, although a variety of other "servicer" fees exist.[104] Such fees are a crucial part of the servicers' income because servicers are typically permitted under the Pooling and Servicing Agreements (entered into between the servicer and the investor) to retain such fees.

The continued and repeated problems experienced by homeowners whose loans are serviced by Ocwen, a large, nationwide servicer of subprime mortgage loans, illustrates the financial incentives provided by these fees. Late fees and loan collection fees made up almost 18% of Ocwen's servicing income in 2008.[105] Similarly in 2007, Ocwen reported that an additional $29 million in revenue just from float income alone, made up 9% of its total servicing income.[106]

The federal laws and regulations which currently address the activities of mortgage servicers (RESPA[107] and the recent regulations issued by the Federal Reserve Board under its unfairness authority[108]) are woefully inadequate. The FTC enforcement actions against a few of the most notoriously abusive servicers (Fairbanks and EMC Mortgage) were helpful in identifying the type of specific remedies that must be uniformly applied to the entire industry. However, it is unfortunately apparent that fear of an FTC enforcement action does not seem to be a sufficient deterrent to either these servicers or most others in the industry.

## ***Question 15 – Examples of Unfair or Deceptive Acts and Practices Engaged in by Servicers Prior to Foreclosure***

Unfortunately, the list of bad behaviors is not new. The FTC's allegations against Fairbanks and EMC[109] are typical of the continuing troubles that homeowners have with servicers:

1. Failing to credit a consumer's payment as of the date received.
2. Charging consumers for unnecessary casualty insurance (called force placing insurance).
3. Assessing illegal late fees and unauthorized fees such as property inspection and loan modification fees, in connection with alleged defaults.

---

104 For many servicers, a significant part of their income comes from the float interest income derived from the spread between when the homeowner pays and when the servicer turns over the payment to the trust or pays the taxes and insurance, in cases of escrowed funds.

105 Ocwen Fin. Corp., Annual Report (Form 10-K), at 34 (Mar. 12, 2009) (revenue from late charges reported as $46 million in 2008).

106 In 2006, Ocwen reported an additional $48 million in revenue from float income which made up 15% of its servicing income. Due to a decline in both the average float balance and yield, Ocwen's float income went down to $29 million in 2007 and $11 million in 2008. *See* Ocwen Fin. Corp., Annual Report (Form 10-K), at 34 (Mar. 12, 2009).

107 Real Estate Settlement Practices Act, 12 U.S.C. §§ 2605, 2609, and 2610; Reg. X., 24 CFR § 3500.17 and § 3500.21.

108 12 CFR § 226.36.

109 Supplementary Information, Federal Trade Commission, Advance Notice of Proposed Rulemaking. [RIN 3084-AB18], 74 Fed. Register, 26118, at 26127, June 1, 2009. Failing to credit a consumer's payment as of the date received.

4. Using dishonest or abusive tactics to collect debts.
5. Knowingly reporting inaccurate consumer payment information to credit bureaus.
6. Misrepresenting the amounts consumers owed, and the legal status of the debts.

Below, we describe how the worst of these abuses have played out in the market-place and been treated by the courts. Even in those rare situations in which homeowners are able to obtain redress from the courts in their individual cases, the sheer volume of cases is indicative the breadth of the problems, as well as the complete inadequacy of the current system of regulation – or lack thereof.

*Misapplication of Payments.*

One of the most problematic behaviors of servicers which do not appear to be named in the FTC's actions involves servicers' misapplication of payments. Some servicers improperly take fees from payments which are intended by the homeowner – and required by the contract between the parties – to be applied to interest and principal. Then, because there are not sufficient funds left over to cover the monthly payment, late fees are assessed. This scenario is repeated until the loan is put into default status, precipitating the initiation of foreclosure.

The misapplication of payments by servicers illustrates a series of separate, unfair, activities by servicers:

- First, fees are collected from regular monthly payments intended to cover interest, principal and escrow. When the contract specifies an order of applying the funds within the payment to interest, principal and fees, this collection is illegal.
- Secondly, by assessing the fees off the top, other fees are then improperly triggered, creating a cascading effect on the assessment and collection of future improper fees.
- Thirdly, because payments are placed in a suspense account such that even though payments are being paid, the servicing software treats the account as delinquent because the payments are not being applied to the balances due.
- Finally, all of these compounded by the inability or refusal of some servicers to respond to complaints or requests to resolve these confusing and unfair issues.

It is understandable that large servicers might make mistakes. But these problems are not merely mistakes. Mistakes can be corrected, and these issues would not be as problematic if servicers were responsive to homeowners' requests for information and efforts to resolve these problems. But servicers are rarely responsive. As a result, the misapplication of payments creates expensive consequences for homeowners, which could be – but are not – resolved by servicers.

For example, in *Rawlings v. Dovenmuehle Mortgage, Inc.*,[110] the servicing of the homeowners mortgage loan was transferred, and the new servicer claimed that the homeowner failed to make two payments for the months just prior to the transfer. The homeowners responded by sending the new servicer copies of the canceled checks showing that the payments had

[110] 64 F. Supp. 2d 1156 (M.D. Ala. 1999).

been timely made to the old servicer. The new servicer then sent a letter stating that the homeowners owed $38.20 in late fees and that the account was in default. The homeowners again sent copies of the canceled checks and a copy of their account history with the old servicer. Along with the copies, they requested in writing that the error be corrected and sought a copy of their loan history. The servicer then sent an account history, but it was not for their account but for some other borrowers' account. The homeowners then made several telephone calls to the servicer and were told they needed to contact the old servicer. Two more notices of default were sent. Even after the homeowners hired an attorney who also sent a letter to the servicer, they received five more default notices. Eventually, after battling for over seven months to resolve the error, the old servicer admitted it had applied the payments to the wrong account and the new servicer corrected the account.

This long, sad story of the servicers' malfeasance in the *Rawlings* case is typical, and has been repeated hundreds of times in litigation filed across the nation attempting to hold servicers accountable for their misapplication of mortgage payments. The misapplication of payments is one of the most common problems that borrowers are reported to have with servicers. Many servicers are infamous for ignoring grace periods, misapplying and failing to apply funds, and improperly charging late fees.[111] Servicers frequently compound this problem by then reporting the homeowner late to the credit bureaus.

The reasons that servicers misapply payments range from sloppy procedures to more insidious efforts to generate more fee income.

A notorious example of the cascading problems resulting from misapplication of payment problems is the case of *Nosek v. Ameriquest Mortgage Co.*,[112] in which the servicer was persistently unable to provide an accurate accounting of the amounts actually paid by the borrower, and amounts remaining due. In discussing the absurdity of the servicers' position, the court stated:

To credit back late charges but be unable to properly bill the borrower or provide an accurate statement on her account or apply payments from the chapter 13 trustee is unconscionable for a large sophisticated national lender. The Defendant has breached its duty of good faith and fair dealing by inadequately applying, tracking, and crediting payments made by the Plaintiff.

---

[111] *See In re* Ocwen Federal Bank F.S.B. Mortgage Servicing, 2006 WL 794739 (N.D. Ill. Mar. 22, 2006) (denying motion to dismiss state law claims including fraudulent concealment, unjust enrichment, breach of contract, breach of good faith and fair dealing, conversion, negligence, misrepresentation, defamation, and fraud and deceit based on federal preemption grounds; allegations in the multi-district litigation assert that the servicer ignored grace period, misapplied payments, failed to apply payments, improperly charging late fees, improperly force placed insurance, assessed unwarranted fees, declared loans in default prematurely and initiated unfair and illegal foreclosure proceedings); *appeal granted,* 2006 WL 1371458 (N.D. Ill. May 16, 2006).

[112] 363 B.R. 643 (Bankr. D. Mass. 2007) (awarding $250,000 in actual damages to the debtor for her emotional distress and $500,000 in punitive damages based on the servicer's violation of Bankruptcy Code by diverting plan payments to a suspense account). In reversing this judgment, the First Circuit held that sanctions could not be imposed on the servicer for misapplication of plan and mortgage payments because the debtor's plan failed to specify how payments were to be applied. *See In re* Nosek, 544 F.3d 34 (1st Cir. 2008).

The failure to apply payments, even the improper application of a single payment, can have a snowballing effect that can leave the homeowner fighting foreclosure and struggling to repair their credit for months, or even years. In many cases, borrowers attempting to correct errors in their accounts are met with the servicer's callous indifference, compounding the effect of the problem. For example, in *Hukic v. Aurora Loan Servicing*,[113] a clerical error, in which the borrower's payment was recorded as $1135, instead of $1335, left the homeowner battling with subsequent servicers and fending off foreclosure for nearly five years. Despite the fact that every payment was for the correct amount and timely, the failure to correct the clerical error caused each month's payment to be credited to the prior month, along with late fees, and the remaining balance was placed in an escrow account. More than five years later, a state court ordered reinstatement of the monthly payments and waiver of all fees, costs, and penalties against the borrower, and then dismissed the complaint for foreclosure.

The problem of sloppy accounting procedures is not limited to for-profit mortgage servicers. In *In re Sanders,*[114] the Massachusetts Housing Finance Agency was unable to provide a consistent statement of amounts due or an adequate explanation of the legal basis under which it was attempting to collect these various amounts. The court said that "[t]he Agency's evidence in support of these ever-morphing sums and grounds is decidedly unpersuasive—the shifting origins of the claim components, the Agency's inconsistent application of funds paid by the Debtor, the accounting paid by the Debtor, the account requested by the Debtor and largely unfurnished by the Agency, taken together, portray a lender profoundly confused about its rights, obligations and activities with respect to its loan to the Debtor."[115] Because the agency was unable to prove its claim, the court declared the debtor's mortgage current as of the trial date. Unfortunately, this behavior—by a state authorized agency, the purpose of which is to foster homeownership—is far from atypical.

*Improper Late Fees.*

Mortgage servicers compound the problems caused by misapplication of payments by improperly imposing late fees and erroneously reporting the homeowner as being late to credit rating agencies.[116]

Pyramiding of late fees is a term used to describe the practice of taking assessed late fees from the regular payment and leaving part of the scheduled payment overdue resulting in the assessment of another late charge. State statutes and the FTC's Credit Practices Rule (FTC rule) prohibit the pyramiding of late charges.[117] The FTC rule prohibits attributing a borrower's current payment first to outstanding late charges or overdue amounts and then to the installment that is currently due. This FTC rule already declares that this practice (along

---

113 2006 WL 1457787 (N.D. Ill. May 22, 2006) (denying motion to dismiss claim for tortuous interference with credit, allowing tort claim for negligent credit reporting pending a new definite statement, dismissing claims for negligent and intentional infliction of emotional distress and credit defamation as untimely, and dismissing FCRA claim for lack of private right of action against furnisher).
114 2007 WL 188676 (Bankr. D. Mass. Jan. 23, 2007).
115 *Id.* at *1.
116 Islam v. Option One Mortg. Corp., 432 F. Supp. 2d 181 (D. Mass. 2006) (servicer continued to report borrower delinquent even after receiving the full payoff amount for the loan).
117 *See* 16 C.F.R. § 444.4.

with others in installment contracts) is "unfair" under the FTC Act.[118] Under the FTC rule, it is already an "unfair act or practice" for a creditor to impose a late charge "when the only delinquency is attributable to late fee(s) or delinquency charge(s) assessed on earlier installments."[119] Agencies regulating banks, savings banks and credit unions have adopted similar rules applicable to their regulated entities.[120]

In addition, imposing a late charge under these circumstances may violate the payment application provision found in the mortgage documents.[121] Despite the clear prohibitions of the FTC Credit Practices Rule, it appears that Fannie Mae's servicing guides (Fannie Mae guidelines) specifically authorize a servicer to "hold as unapplied" a payment that is only missing a late fee due.[122]

Servicers also improperly assess late fees in connection with incorrect use of suspense accounts. Even when a payment has been placed in suspense (because it was late, not in the full amount, it failed to include fees assessed, or for no reason at all), the uniform notes still do not permit the servicer to call subsequent payments late just because the subsequent payment failed to include enough to make up past amounts wrongfully applied to fees.[123]

*Improper Fees: Inspection Fees, BPO Fees and Other Fees.*

Most standard mortgage contracts authorize mortgage holders to take necessary actions and to pay for whatever is necessary to protect both the value of the property securing the loan

---

118 15 U.S.C. § 45(a).
119 16 C.F.R. § 444.4
120 *See, e.g.,* 12 C.F.R. § 560.33 (OTS).
121 The Fannie Mae/Freddie Mac uniform instruments provide that payments are to be applied to interest first, then principal, and finally escrow charges; any remaining amounts shall then be applied first to late charges.
122 Fannie Mae Single Family Servicing Guide, Part III: General Servicing Functions Chapter 1: Mortgage Payments, Part III, 101.03: Payment Shortages (Jan. 31, 2003): "[I]f a servicer chooses to do so, it may hold as 'unapplied' a payment that does not include late charges (or any allowable prepayment premiums) that are due. The servicer may then use a portion of the subsequent payment to make up the shortage so that the payment can be applied."
123 *See* McAdams v. Citifinancial Mortg. Co., Inc., 2007 WL 141128 (M.D. La. Jan. 16, 2007) (payments allowed to be applied only to interest and principal, not to late fees; in summary judgment motion construed contract against the party who prepared it—the lender). For example, the Fannie Mae/Freddie Mac uniform instruments include language mandating how payments are to be applied. When the servicer fails to apply payments as required by the instrument, the contract has been breached. The following language is in most mortgages and deeds of trust dated March, 1999 and later:

> **Application of Payments or Proceeds.** Except as otherwise described in this Section 2, all payments accepted and applied by Lender shall be applied in the following order of priority: (a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3. Such payments shall be applied to each Periodic Payment in the order in which it became due. Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then
> to reduce the principal balance of the Note.

*See, e.g.*, Fannie Mae/Freddie Mac Uniform Instruments, First Lien Security Instruments, Form 3022: Massachusetts Mortgage (1/01), *available at* www.freddiemac.com/uniform/unifsecurity.html as well as the holder's rights in the property.[124] To the extent the actions of the holder's servicer include payments of money, such funds generally become additional secured debt.[125] Servicers and holders point to this standard language in mortgage documents to justify a variety of property preservation fees, including inspection fees and broker price opinions (BPOs).

Property inspection fees are charged to borrowers for inspections (usually drive-by) to determine the physical condition or occupancy status of the mortgage property. These fees are generally imposed repeatedly and as often as once a week after the account is placed in default status. While the amount charged for property inspection tends to be relatively small, the repetitive nature of the fee can result in charges to the borrower's account of several hundred dollars.

Broker price opinions are determinations of property value typically based on drive-by exterior examination, public data sources, and recent comparable sales. A servicer may obtain a BPO as an alternative to a full appraisal after a loan is placed in default status.

Property preservation fees present a substantial revenue generating opportunity for servicers.[126] In some instances the costs of services provided by third-party vendors are marked-up by the servicer resulting in additional costs to borrowers and additional profits for the servicer. In other cases, default services are performed by the servicer's own subsidiaries or "in-sourced vendors."[127] Profits from these entities or units flow to the servicer, and mark up may likewise occur.[128] As a result, the servicer has an incentive to order services provided by these entities more than may be necessary and reasonable.

Much of the litigation involving property preservation fees has focused on whether these fees are authorized by the mortgage documents as a recoverable charge against the borrower. Courts have generally found that mortgage holders and servicers may charge property preservation fees if those fees are actually incurred[129] and necessary (or appropriate) to

---

124 For example, the Fannie Mae/Freddie Mac uniform security instrument (in Section 9) includes language stating that the "Lender may do and pay for whatever is reasonable and appropriate to protect Lender's interest in the Property and rights under this Security instrument." Prior to 2001, this standard language provided that the "Lender may do and pay for whatever is necessary to protect the value...."

125 The Fannie Mae/Freddie Mac uniform security instrument provides that: "Any amounts disbursed by Lender under this Section 9 shall become additional debt of Borrower secured by this Security Instrument."

126 As the court in *In re Stewart* noted: "While a $15.00 inspection charge might be minor in an individual case, if the 7.7 million home mortgage loans Wells Fargo services are inspected just once per year, the revenue generated will exceed $115,000,000.00." *See In re* Stewart, 391 B.R. 327, 343, n.34 (Bankr.E.D.La. 2008).

127 For example, executives from the largest servicers in the country have reported that increased operating expenses from increased delinquencies and loss mitigation efforts "tend to be fully offset by increases to ancillary income in our servicing operation, greater fee income from items like late charges, and importantly from in-sourced vendor functions…." *See* Countrywide Financial Q3 2007 Earnings Call Transcript (Oct. 26, 2007), *available at* [http://seekingalpha.com/article/51626-countrywide-financial-q3-2007-earnings-call-transcript?page=-1](http://seekingalpha.com/article/51626-countrywide-financial-q3-2007-earnings-call-transcript?page=-1).

128 *See In re* Stewart, 391 B.R. 327 (Bankr.E.D.La. 2008)(finding that although servicer's testimony at trial stated that entity which provided broker's price opinions was an independent affiliate of servicer, servicer later revealed in another court proceeding that entity is actually a corporate division of the servicer and that the true cost incurred by the servicer for broker's price opinions is $50 rather than the $125 charged to the borrower).

129 *See In re* Stewart, 391 B.R. 327 (Bankr.E.D.La. 2008) (disallowing charges for broker's price opinions and finding it unlikely several were in fact performed given that the property was under an evacuation order due to

preserve the value of the property and the holders's rights in the property.[130] Most courts have also held that such fees must be reasonable.[131] If a property has been vacated by the homeowners, legitimate expenses may include amounts reasonable and necessary to winterize a home, to replace or repair locks, restore utilities, and the like.[132]

By contrast, drive-by inspections and BPOs, which serve only to notify the servicer of the occupancy status or value of the property do not directly protect value or affect the holder's rights in the property.[133] Certainly, repeat inspections done weekly or monthly when the servicer is in contact with the homeowner, knows the property is occupied, and has no reason to be concerned about the condition of the property, are not "necessary" or "appropriate."[134] Thus, such fees should not legitimately be charged to the borrower.[135]

Servicers have failed to demonstrate legitimate justification for repeat property inspections. Any possible benefits to servicers and mortgage holders are far outweighed by the injury to consumers in unnecessary costs. For example, in the *Stewart* case, from the period of the borrower's first missed payment in 2000, the servicer had ordered 44 inspections, on average

---

Hurricane Katrina); Scott v. Fairbanks Capital Corp., 284 F.Supp.2d 880 (S.D. Ohio 2003)(costs for protecting mortgaged property may not be charged unless they were actually incurred for of the purposes stated in security instrument). *See, e.g., In re* Parrish, 326 B.R. 708 (Bankr. N.D. Ohio) (stating that lender has obligation to keep a full and accurate accounting of payments made and charges accrued and should be able to document charges such as inspection fees).

130 *See, e.g.,* Scott v. Fairbanks Capital Corp., 284 F. Supp. 2d 880, 890 (S.D. Ohio 2003); Porter v. Fairbanks Capital Corp., 2003 WL 21210115 (N.D. Ill. May 21, 2003) (complaint sufficiently alleged claim under FDCPA that charges for property preservation services and broker price opinions were not permitted under mortgage clause covering costs to protect value of property); Chatman v. Fairbanks Capital Corp., 2002 WL 1338492 (N.D. Ill. June 13, 2002); *In re* Liberty Constr. & Dev. Corp., 106 B.R. 458, 460 (Bankr. E.D. Va. 1989).

131 *See, e.g., In re* Jones, 2007 WL 1112047 (Bankr.E.D.La. Apr 13, 2007)(servicer failed to show that property inspections were necessary and reasonable).

132 These types of services are most commonly required for properties that have been abandoned. Servicers will often argue that inspections are necessary to determine if the property is vacant. To the contrary, a telephone call to the borrower will frequently establish that the property is occupied thereby negating the need for the inspection. For example, HUD regulations governing FHA-insured mortgages state that inspections are permitted only when (1) the mortgage is in default (payment is not received within 45 days of the due date) and efforts to reach the borrower by telephone during that 45 day period have been unsuccessful, or (2) the property is vacant or abandoned. *See* 24 C.F.R. § 203.377.

133 *See* Porter v. Fairbanks Capital Corp., 2003 WL 21210115 (N.D. Ill. May 21, 2003) (plaintiff's sufficiently alleged FDCPA violation claiming that BPO was not "necessary to protect the value of the Property"). *But see* Walker v. Countrywide Home Loans, Inc., 98 Cal. App. 4th 1158, 121 Cal. Rptr. 2d 79 (2002).

134 *In re* Jones, 2007 WL 1112047 (Bankr.E.D.La. Apr 13, 2007)(where servicer presented no evidence concerning its policy guidelines on inspections and could not state any reasons why continuous monthly property inspections were necessary, particularly when inspection reports showed little or no change in the property's condition from month to month and gave lender no cause for concern, property inspections were unreasonable).

135 In addition to the "do and pay whatever is necessary" clause, servicers may attempt to rely upon the standard clause in many mortgages and deeds of trust dealing with inspections, which typically states that the lender or its agent "may make reasonable entries upon and inspections of the Property .... Lender shall give Borrower notice at the time of or prior to an inspection specifying reasonable cause for the inspection." However, servicers normally do not provide any notice to the homeowner of drive-by or curbside property inspections and this clause should not be construed to cover inspections where there is no actual entry on the property. *See* Ladd v. Equicredit Corp. of America, 2001 WL 1033618 (E.D. La. Sept. 7, 2001) (property inspection provision does not apply to drive-by inspections).

every 54 days.[136] At all times, Ms. Stewart had been making regular payments, though late. All of the reports showed that the property was occupied and well maintained. The court in *Stewart* also noted that several reports were apparently done on the wrong property (fourteen of the reports describe Ms. Stewart's home as a brick structure, while sixteen describe it as a frame structure).

*Attorney Fees Charged Before Services Provided*

Most standard mortgage contracts require that the borrower pay the lender's attorney fees in any action to enforce or collect sums due under the note. Generally, however, these fees must be reasonable, and must be actually incurred by the lender.[137] However, in some cases when the servicer sends the loan to be processed for a foreclosure by an attorney, the practice is to assess a flat amount of attorneys fee to cover all of the *anticipated* work for all parts of the foreclosure procedure.[138]

The flat amount is charged even when the initial work generally only includes sending a notice (generally the right to cure notice) to the borrower. Although the initial work done is ministerial and rarely even actually reviewed by an attorney, the balance due on the mortgage loan is increased by the *entire fee the attorney anticipates charging for the foreclosure.* These fees vary in different places around the nation from a low of $1500 to over $4,000.

As a result, the notice of the right to cure – required under state law in most states, and a standard provision in the uniform mortgage documents – includes an inflated amount necessary for the borrower to pay to avoid foreclosure. This practice makes it much more difficult for homeowners to avoid foreclosure – because it requires already strapped borrowers to find thousands of extra dollars to stop the foreclosure.

In general, foreclosure fees and costs are highly inflated. The lender has little incentive to minimize them because they can be passed on to the borrower. Many foreclosure attorneys use a paralegal to generate form documents that may take as little as fifteen minutes of time on a computer. The borrower may contest such a fee as unreasonable.[139] When the attorney has been paid a retainer, but a cure takes place before the foreclosure is completed, the unexpended fees should be returned by the attorney and credited to the account. If not, the fees passed on are not bona fide and can be challenged on that basis.

*Use of Suspense Accounts*

---

[136] *See In re* Stewart, 391 B.R. 327 (Bankr.E.D.La. 2008).

[137] *See* Korea First Bank v. Lee, 14 F. Supp. 2d 530 (S.D.N.Y. 1998) (lender was not entitled to recover more than it paid its attorney or what was reasonable); *In re* Riser, 289 B.R. 201 (Bankr. M.D. Fla. 2003) (attorney fee assessment to debtors' mortgage account when no lender attorney ever appeared in case was "both illegal and fraudulent"). *See also In re* Coates, 292 B.R. 894 (Bankr. C.D. Ill. 2003) (creditor required to disclose agreement between itself and law firm so that court can determine exactly how much creditor is actually being charged for services); *In re* 1095 Commonwealth Ave. Corp., 204 B.R. 284 (Bankr. D. Mass. 1997) (secured creditor fraudulently overstated its claim for legal fees by failing to disclose two-tiered fee arrangement with its attorneys in which attorneys granted bank a discount but bank billed debtors at full standard rate), *aff'd in relevant part, modified in part on other grounds*, 236 B.R. 530 (D. Mass. 1999).

[138] *In re* McMullen, 273 B.R. 558 (Bankr. C.D. Ill. 2001) (flat fee covering attorney fees for entire foreclosure proceeding found excessive where not pro-rated to cover only services actually performed prior to bankruptcy filing).

[139] National Consumer Law Center, Fair Debt Collection § 15.2 (5th ed. 2004 and Supp.).

Servicers use suspense accounts to place payments received from borrowers that, for whatever reason, are not applied to the outstanding loan balance. There is no strong accounting justification for suspense accounts, but they are widely used in the mortgage servicing industry. The ostensible excuse for their use is that the consumer has not provided enough funds to cover a single payment. A major national servicer explained the use of suspense account this way: "If the amount received was not sufficient to pay the contractual obligation according to the loan servicing program, the payment was placed in suspense. When the next payment was received, it was placed in suspense and if the total in suspense then equaled a contractual obligation, then the oldest outstanding contractual obligation was deemed paid, at least in theory."[140]

However, in some cases servicers have been known to hold more than a month's payment in suspense.[141] Servicers may also fail to credit borrowers for funds held in suspense when providing payoff statements or filing proofs of claim in bankruptcy.[142] In bankruptcy cases, servicers may also create a trustee suspense account where payments from the trustee are held prior to being applied to the borrower's account.

As the name "suspense account" implies, borrowers funds held in such accounts are in legal limbo—they are not credited to the loan, the borrower does not receive interest on them, and the account is not a trust account.[143] In most cases, borrowers are unaware that a suspense account even exists and are confused when payments made are not reflected in the accounting that the homeowner receives from the servicer. The shrouded nature of these accounts and uncertain status of the funds they contain, make them ripe for abuse, and abuses do occur:

- Servicers raid suspense accounts to pay unauthorized fees, so that moneys paid by the homeowner intended to be paid for interest and principal on the loan, is instead paid to servicer imposed fees. When this is done it generally violates the Application of Payments section of the contract between the parties, and it also causes future *whole* payments of interest and principal to be applied to back payments.
- The application of payments to fees before interest and principal causes future payments to appear to be only partial, which triggers more late fees.

140 Nosek v. Ameriquest Mortgage Co., 363 B.R. 643 (Bankr. D. Mass. 2007, rev'd, *In re* Nosek, 544 F.3d 34 (1st Cir. 2008). *See also* Fannie Mae Single Family Servicing Guide, Part III: General Servicing Functions, Chapter1: Mortgage Payments (Nov. 1, 2004), 101: Scheduled Mortgage Payments (Jan. 31, 2003), 101.03: Payment Shortages (Jan. 31, 2003) ("Sometimes payments received from the borrower are less than the total amount due. The servicer should not automatically return these payments to the borrower. Instead, the servicer should base its decision to process partial payments on the amount of the shortage and on any special circumstances that might justify the lesser amount. If the servicer decides to accept the payment, any portion of it that equals one or more full installments should be applied. Any remaining portion should be held as 'unapplied funds' until enough money to make a full installment is received.") *available at* www.allregs.com/efnma.

141 *See In re* Fagan, 376 B.R. 81 (Bankr. S.D.N.Y. 2007) (finding at one point servicer held an amount in excess of the monthly mortgage payment in suspense).

142 *See In re* Sanchez, 372 B.R. 289 (Bankr. S.D. Tex. 2007).

143 *See* O. Max Gardner, III, *Mortgage Securitization, Servicing, and Consumer Bankruptcy*, American Bar Association, GP Solo Law Trends and News--Business Law, vol. 2, no. 1 (Sept. 2005), *available at* www.abanet.org/genpractice/newsletter/lawtrends/0509/business/mortgagesecuritization.html

- Leaving money in the suspense account, rather than applying it interest, principal and escrow as it is paid by the borrower creates confusion and precipitates default and foreclosure.

*Escrow Account Abuses*

The existence of an escrow account creates a complex set of issues and potential pitfalls for homeowners. The most common problems relate to the changing amount of the monthly payment and the timely and accurate disbursement of funds to taxing authorities and insurance providers. In addition, the presence of an escrow account complicates the accounting process—leading to questions about whether particular payments should have been applied to the interest and principal of the loan, or to the escrow account. The Real Estate Settlement Procedures Act (RESPA) closely governs the amounts required to be paid by borrowers into an escrow account, the disbursement of payments from the escrow account, and the proper method for addressing surpluses, shortages and deficiencies in escrow accounts. State laws may augment the requirements of RESPA.[144]

There have been numerous instances in which servicers have failed to make timely disbursements from borrowers' escrow accounts for real estate taxes, insurance or other charges. In the most devastating cases, homeowners have lost their homes to tax foreclosure after the servicer failed to make real estate tax payments,[145] while other homeowners have been left to deal with uninsured property damage after the servicer failed to pay insurance premiums.[146] More commonly penalties assessed by the taxing authorities or reinstatement fees imposed by insurance companies as a result of late payments are simply passed on to the borrower.[147]

While such fees or penalties may be relatively small, they can nevertheless lead to escrow account shortages or deficiencies, which in turn may cause the borrowers' mortgage payments to increase. Servicers have also been known to make tax payments on the wrong property altogether, and then force-place insurance rather than pay the homeowner's property insurance with escrow account funds.[148]

Congress passed RESPA to deal with escrow account abuses, and that statute quite clearly requires that servicers properly handle escrow funds in all instances and ensure that taxes

---

144 *See, e.g.,* Cal. Civ. Code § 2954 (West) (limiting the circumstances under which an impound account can be required).
145 *See, e.g.,* Mortgage Electronic Registration System, Inc. v. Alicea, 2006 WL 1149236 (M.D. Pa. Apr. 26, 2006); Choi v. Chase Manhattan Mortg. Co., 63 F. Supp. 2d 874 (N.D. Ill. 1999).
146 *See, e.g.,* Monahan v. GMAC Mortg. Corp., 893 A.2d 298 (Vt. 2005) (affirming $43,380 jury award for consequential and compensatory damages for servicer's conduct in failing to renew flood insurance policy and subsequent uninsured property damage).
147 *See, e.g.*, Settlement Agreement by and between the United States Department of Housing and Urban Development and Mellon Mortgage Company (Sept. 30, 1999), *available at* www.hud.gov/offices/hsg/sfh/res/paul/rsamello.pdf (describing HUD's investigation into Mellon's handling of borrower escrow accounts).
148 *See, e.g.,* Booker v. Washington Mut. Bank, F.A., 2007 WL 475330 (M.D.N.C. Feb. 9, 2007).

and insurance premiums are properly paid. [149] However, HUD – in an unauthorized interpretation of the statute – issued a regulation which allows servicers to avoid their clear obligations to pay taxes and insurance from escrow accounts when the homeowner is 30 days in default.[150] This interpretation is illegal and against both the policy of RESPA and public policy – to discourage default and advance homeownership. Allowing servicers to declare a homeowner in default and then fail to apply the homeowners' funds to insurance premiums and taxes due – will trigger other expensive consequences– precipitates the loss of the home rather than the saving of it.

*Force Placed Insurance*

Mortgage lenders routinely require homeowners to purchase property insurance to protect the lender's interest in the home in case of fire or other casualty. Homeowners whose property is located is certain federally designated flood zones are also required to maintain flood insurance. The loan instruments will authorize the lender to purchase such insurance on behalf of the homeowner if the homeowner fails to present evidence of continuous coverage or if the coverage lapses during the term of the loan.[151] This coverage is called "force-placed" or "collateral protection" insurance.

Typically an insurer will issue a master policy to the servicer or lender under which coverage for individual properties can be added, deleted, or modified. The lender, not the borrower, is named as the insured and coverage is often limited to the lender's interest in the property, that is, the loan balance.[152] When an individual property is added to the master policy, the

---

149 12 U.S.C. § 2605(g).
150 Reg. X, 24 C.F.R. § 3500.17(k)(2).
151 For example, the Fannie Mae/Freddie Mac uniform instruments include the following language:

> **Property Insurance.** Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. . . . If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment. *See, e.g.,* Fannie Mae/Freddie Mac Uniform Instruments, First Lien Security Instruments, Form 3005: California Deed of Trust *available at* www.freddiemac.com/uniform/unifsecurity.html.

While this language permits a servicer or lender to force-place insurance, standing alone, it does not impose a duty on the servicer or lender to procure insurance in the event borrowers allow their policies to lapse. *See, e.g.*, *In re* Riccitelli, 14 Fed. Appx. 2001 (2d Cir. 2001); Caplen v. Security Nat'l Servicing Corp., Inc., 514 F. Supp. 2d 746 (E.D. Pa. 2007).
152 Some insurers may offer dual interest policies issued to the borrower and containing a standard mortgage clause in favor of the lender. In such cases, coverage may extend beyond the loan balance up to the

creditor pays the premium and then seeks reimbursement from the consumer. The cost of such insurance is almost always much higher than a standard homeowner's insurance policy. This type of insurance presents extraordinary potential for abuse. Insurers often provide lenders with refunds, kickbacks or other compensation in relation to force placed insurance policies. Because the lender makes the decision about which insurer to use, and since the lender does not eventually have to pay for the premium, there is a built-in incentive for the lender to select the insurer that pays the lender, or its affiliates, *the most* in the form of kickbacks or other compensation.

The practice of force placing insurance on homeowners is a significant problem with very serious consequences. The placement of this insurance and the lender's efforts to obtain reimbursement from the consumer frequently necessitates a huge increase in the homeowner's monthly payments. As a result, the homeowner may be unable to make the new monthly payments in full (assuming proper notice has been given to the borrower),[153] may incur late payment penalties or other fees, and may eventually face foreclosure. [154]

Servicers have been known to improperly force-place flood insurance or to obtain force placed insurance coverage in an amount greater than the outstanding balance due on the mortgage.[155] Yet, the courts too often protect servicers from these mistakes – the false certification that the property was in a flood zone which triggered the incorrect force-placing

---

replacement value of the home. Unlike regular homeowner's insurance, force-placed insurance also does not generally cover the contents of the home or liability for personal injury occurring on the property.

[153] The Fannie Mae/Freddie Mac uniform instruments provide that force placed insurance costs are payable by the borrower, with interest, but only "upon notice from Lender to Borrower requesting payment." *See* 11 U.S.C. § 2605.

[154] The servicer may be at fault for the coverage lapse where, for example, the servicer maintained an escrow account for the payment or renewal of the homeowner's insurance policy, but failed to make the required payments. *See* Booker v. Washington Mut. Bank, F.A., 2007 WL 475330 (M.D.N.C. Feb. 9, 2007) (servicer disbursed $800 from homeowner's escrow account to pay property taxes on land other than plaintiff's, failed to pay property insurance bill, then purchased and charged homeowners for much more expensive force placed insurance). *See also* Vician v. Wells Fargo Home Mortg., 2006 WL 694740 (N.D. Ind. Mar. 16, 2006) (denying servicer's motion to dismiss claims for breach of contract, breach of fiduciary duty, unjust enrichment, and violations of state UDAP statute and TILA, based on allegations of improper force placed insurance); Dowling v. Select Portfolio Servicing, Inc., 2006 WL 571895 (S.D. Ohio Mar. 7, 2006) (denying servicer's motion to dismiss RICO and fraud claims where servicer improperly force placed insurance on homeowners' property, then attempted to collect cost of premiums, and eventually initiated foreclosure proceedings); Barbera v. WMC Mortgage Corp., 2006 WL 167632 (N.D. Cal. Jan. 19, 2006) (dismissing TILA and RESPA claims as time-barred and remanding state claims to state court where servicer, among other things, initially ignored homeowner's proof of insurance and then failed to credit homeowner's account for premium charges during period of overlapping coverage); Hyderi v. Washington Mut. Bank, FA, 235 F.R.D. 390 (N.D. Ill. 2006) (challenging servicer's policy of not paying insurance bills out of escrow unless it received bill from insurer; class certification denied); Stevens v. Citigroup, Inc., 2000 WL 1848593 (E.D. Pa. Dec. 15, 2000) (finding claims brought regarding force placed insurance not barred by the filed rate doctrine); Johnson v. HomeEq Servicing Corp., 2005 WL 2899632 (Ky. Ct. App. Nov. 4, 2005) (reversing lower court decision and holding that lender, by force placing insurance, waived right to claim homeowner in default for failure to obtain insurance). *See also In re* Ocwen F.S.B. Mortgage Servicing Litigation, 2006 WL 794739 (N.D. Ill. Mar. 22, 2006) (numerous complaints filed alleging, *inter alia,* wrongful placement of force placed insurance).

[155] *See* Hayes v. Wells Fargo Home Mortg., 2006 WL 3193743 (E.D. La. Oct. 31, 2006) (mortgage assignee permitted under contract to unilaterally require increase in amount of flood insurance coverage to value of property rather than amount of outstanding loan balance). *See also* 42 U.S.C. § 4012a(e) (amount of insurance coverage must be "at least equal to the lesser of the outstanding balance or the designated loan or the maximum limit of coverage available for the particular type of property, whichever is less").

of the flood insurance -- are not protected by the preemptive provisions of the National Flood Insurance Act.[156]

*Answers to subparts of Question 15*

a. These servicer practices are clearly unfair. The FTC Act's tri-part test on unfairness requires the following analysis:

*1) Whether the practices in question cause consumers substantial injury.* These activities are never the result of bargained for, contractually agreed upon terms for handling the transaction of accepting mortgage payments, applying them to the amounts due, and protecting the investor. These activities *encourage* default and foreclosure, which makes them against the public interest, as well as not legal under either the note signed by the homeowner and the lender, or the Pooling and Servicing Agreement between the investor and the servicer. These activities are arbitrary and cannot be avoided by the homeowner.

*2) Whether the harm from these practices is not outweighed by benefits to consumers or competition.* This test is most appropriately employed when applied to the exact practice in question. For example, the question should be whether allowing servicers to continue misapply payments, refuse to respond to homeowner concerns, overcharge on fees is a benefit to consumers which outweighs the prohibition of this practice. The secondary, and more global, issue of whether prohibiting these activities would limit access to credit is a global issue – one that will be determined by many more issues than a simple regulation addressing several aspects of the origination requirements for mortgage credit. Moreover, even if one were to take on this question, it is clear that specific rules will only quash abusive servicing, not appropriate servicing.

*3) Consumers cannot reasonably avoid the injury caused by these practices.* This is the critical test to be applied to each of the practices at issue in these proposals. As the FTC has already recognized, homeowners have no ability to choose their servicers or avoid these bad practices. The FTC must recognize that homeowners have no ability whatsoever to avoid these practices.

b. All of the described activities should be prohibited by all servicers of all home loans.

c. By disallowing these activities for servicers covered by the FTC, competition for loans from lenders who were covered by the prohibition would be encouraged. Borrowers

---

156 Further, courts have held that borrowers have no private right of action against mortgage lenders or servicers under the NFIA. *See, e.g.,* Wentwood Woodside I, L.P. v. GMAC Commercial Mortg. Corp., 419 F.3d 310(5th Cir. 2005); Arvai v. First Fed. Sav. & Loan Ass'n of South Holland, 737 F.2d 638, 642 (7th Cir. 1984) ("Congress specifically placed the responsibility of administering and enforcing those aspects of the Flood Program dealing with mortgage lenders with those federal agencies which supervise the lenders"). Courts have routinely denied homeowners claims based upon the failure of mortgage lenders to require flood insurance or to notify borrowers that their property is located in a covered flood zone in accordance with NFIA. *See, e.g.*, Hofbauer v. Northwestern Nat'l Bank of Rochester, Minn., 700 F.2d 1197 (8th Cir. 1983); Callahan v. Countrywide Home Loans, Inc., 2006 WL 2993178 (N.D. Fla. Oct. 20, 2006); *In re* Schweizer, 354 B.R. 272 (Bankr. D. Idaho 2006).

would know that these lenders were more likely to engage in lending practices which assure fairer servicing of loans, and competition for the best servicers would be fostered.

***<u>Question 16 – What prohibitions or restrictions should be adopted by the FTC to deal with the unfair activities of servicers?</u>***

The prohibitions and restrictions agreed to in the FTC's settlements with Fairbanks and EMC should be a starting point for the development of the limitations on the unfair activities of mortgage servicers.[157] Those settlements were agreed to in a different era: one in which the guiding principals were that regulations were bad and anti-consumer. The settlements – while useful in many ways – unfortunately appear to have been unsuccessful in changing the practices of servicers generally. There are still scores of cases against these and other servicers, complaining of many of the practices that are affected by the terms of the settlements. Rather, the FTC should create new, stronger rules, with the settlement terms used as a starting point. The answers to Question 18 and 19 describe our proposals for these rules.

***<u>Question 17 –Specific Information that servicers should be required to provide homeowners to prevent unfairness.</u>***

*Disclosure of Fees*

Servicers should be limited in their collection of fees to only those fees that the originating lender specifically included in the loan documents.

The FTC suggests, within question 17 (in subpart a), that servicers should be required to provide homeowners with "information about fees the servicer is authorized to charge under the mortgage contract over the life of the loan." This would be fine – but should be unnecessary -- as servicers should only be permitted to charge fees which are articulated and allowed under the contract, and state and federal law. The FTC must take care not to establish a rule which might be misread to permit the imposition of fees which are not otherwise allowed. The schedule of fees which can be charged during the term of the loan should – at the least -- be a matter of negotiation between the parties before the transaction is consummated. However, providing the disclosure of what can be substantial and troublesome fees to the homeowner *after* the loan has been consummated and transferred to the homeowner is useless to the homeowner, and presents an opportunity to the servicer to take advantage of the homeowner's trapped position. There is nothing the homeowner can do about those fees at that point. Instead, the rule should be that the servicer is limited in charging only those fees which are specifically authorized (in amount and circumstance) in the contract, and are legal under applicable law.

*Monthly Disclosures*

---

[157] Many of the specific terms of the settlements are articulations that the servicers must comply with existing laws, such as RESPA, the Fair Credit Reporting Act, and the Fair Debt Collection Practices Act. Attempting to repeat those prohibitions in this regulation seems superfluous and unnecessary. It should be obvious that compliance with existing law is required.

Homeowners need lots more information about the status of their loans. Servicers should be required to provide each month, in sufficient time before the next payment is required, the following information:[158]

1. the unpaid principal balance;
2. the monthly payment due as of the next due date and the due date;
3. if there are changes in the monthly payment, and/or other amounts due, the reason for the changes;
4. a complete itemization of each and every fee assessed during the statement period;
5. the amount of the monthly payment which will be applied to interest, principal, escrow, and assessed fees;
6. a toll-free telephone at which the homeowner can reach a live person who can answer the homeowner's questions and has some authority to deal with problems;
7. the total amount due on the loan.

While disclosures alone will most certainly not solve the problems with servicers, requiring this simple, understandable, regular provision of information to homeowners on a monthly basis will significantly reduce misunderstandings and foster home retention.

*Answers to Subparts of Question 17*

i. The failure to provide this information is unfair. Without such information, homeowners can not in a timely manner assess the administration of their accounts. Accordingly, any harm from improper fees can not be avoided if the information is not provided. Lack of transparency does not serve consumers, investors or the market. Servicers should only be permitted to charge fees which are legal under the contract, and existing law, and have been disclosed to homeowners before the contract has been signed. This is a matter of basic contract law. However, given the gross disparity in bargaining power, simply disclosing the amount of fees to homeowners will not adequately protect them from improper charging. The necessary protections are stringent limitations on the amount and circumstances of the assessment of these fees.

Similarly, requiring servicers to provide monthly statements detailing the current status of the loan is a simple matter for servicers' computer systems to generate, and will significantly increase the transparency and understanding of mortgage loans.

ii. All of the described disclosures should be required of all servicers of all home loans.

iii. By requiring these disclosures for servicers covered by the FTC, competition for loans from lenders who were covered by these rules would be encouraged. Borrowers would

[158] The Modified Stipulated Final Judgment and Order signed by both the FTC and Select Portfolio Servicing, Inc. (the new name for Fairbanks) in 2007 required that the notices with this information must be provided at least 12 days before the payment due date. Recommendations numbered 1, 2, 3, 4, and 7 were included in this Modified Stipulated Final Judgment.

know that these lenders were more likely to engage in lending practices which assure fairer servicing of loans, and competition for the best servicers would be fostered.

## ***Question 18 – Proposed Limitations on Fees***

*Assessment of Fees*

The servicer should only be permitted to assess fees if all of the following criteria are met:

- The amount of the fee is authorized by governing state and federal law.
- The fee is specifically authorized by the Note.
- The fee is *not* for doing something required by either the Note or governing law, such as providing the yearly escrow statement,[159] notices of transfer of servicing, or responding to a Qualified Written Request[160] as required by RESPA.
- The circumstances justify the imposition of the fee.

The fees covered by such a rule would include *all* fees charged by servicers, including late fees, property inspection fees, fees for broker price opinions, payoff fees, fax fees.

It is important to note that the *assessment* of fees is very different than the collection of fees. The first issue is whether the assessment of the fee is not unfair. Assuming that the assessment is not unfair, the *collection* of the fee still must not be unfair. In addition to prohibiting unfair collection activities as are already articulated in the Federal Debt Collection Practices Act and similar laws dealing with collection practices, the collection of the fees must also be legal and not unfair. The critical requirement to assure that the collection of fees is fair is to assure that the application of payments made by the homeowner is not unfair.

*Application of Payments.*

The terms of most mortgage notes have specific rules governing the application of payments. This means that each payment received by the servicer must be applied to the various aspects of the mortgage relationship exactly as the contract between the parties

---

159 12 U.S.C. § 2605.

160 12 U.S.C. § 2605(e); Both the remedial nature of the Servicer Act in RESPA and its legislative history suggest that lenders should not be allowed to assess fees for responding to qualified written requests. Not only is the charging of such fees inconsistent with the purpose of the Act, it would have a chilling effect on borrowers' use of this important statutory right. See Ploog v. HomeSide Lending, Inc., 209 F. Supp. 2d 863 (N.D. Ill. 2002) (holding RESPA is remedial in nature); Johnstone v. Bank of America, N.A., 173 F. Supp. 2d 815 (N.D. Ill. 2001) (same); Rawlings v. Dovenmuehle Mortg., Inc., 64 F. Supp. 2d 1156 (M.D. Ala. 1999) (same); Wagner v. EMC Mortg. Corporation, 127 Cal. Rptr. 2d 685 (Cal. Ct. App. 2002) (same).

dictate. This principle – that payments must be applied to interest, principal, amounts due for escrow and for fees only as specifically articulated in the contract between the parties, and is not unfair – is the cornerstone of all of these servicer rules. This would require that suspense accounts be prohibited.

If the goal of the loan servicing is to maintain the loan as a performing loan, as well as to maintain the homeowner's interest in staying in the home, every effort should be made to facilitate the continued payments on the loan, and to avoid default and foreclosure. This is the dynamic that this regulation can most dramatically affect. The FTC's rule must create a new dynamic: to limit the opportunities for collection of additional fees, to incentivize servicers to *avoid* default, rather than encouraging it because of the money-making potential it provides.

Requiring strict adherence to the application of payments rules established in the Uniform Instruments (and imposing these rules on contracts in which the terms are silent) will significantly changes the fee collection landscape for servicers. The effect should be that defaults are discouraged because they will no longer present rich opportunities for profit. The national policy of advancing homeownership will be advanced.

Currently, servicers often will put payments into a suspense account because the payments do not include a) extra fees the servicers have assessed, b) late fees from previous payments that did not include the extra fees charged by the servicers, c) additional amounts charged by the servicer (often for forced placed insurance). Because these payments do not include these extra fees the payments are deemed to be "partial" payments. Yet, under the terms of almost all outstanding mortgage contracts *entered* into since 2001, the Application of Payments section of the Note requires that each payment be applied first to interest, second to principal, third to amounts due for taxes and insurance, and fourth to late fees.[161]

Servicers routinely refuse to apply payments to interest and principal, when the servicers allege some fees are still due. Servicers thus treat payments that should be deemed as full payments as being partial payments because they fail to include extra fees. Payments are then placed in the suspense account, and additional fees continue to accrue. None of this would happen if the servicer were required to apply *all* payments, as they come in, to interest and principal due under the note.

Some servicers may argue that there will be great confusion about how to deal with the application of partial payments. This concern is unfounded. The mathematical application of partial payments to a loan amortization – whether interest accrues based on when the

[161] "2. Application of Payments or Proceeds. Except as otherwise described in this Section 2, all payments accepted and applied by Lender shall be applied in the following order of priority: (a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3. Such payments shall be applied to each Periodic Payment in the order in which it became due. Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then to reduce the principal balance of the Note. If Lender receives a payment from Borrower for a delinquent Periodic Payment which includes a sufficient amount to pay any late charge due, the payment may be applied to the delinquent payment and the late charge." Fannie Mae/Freddie Mac Uniform Note, Paragraph 2 (widely used in the mortgage industry from 2001 and after).

payments are actually made, or based on when the payments are scheduled to be made – is simpler than the confusing fiction of a suspense account.[162]

The key clarification that must be issued with this proposal is that *all payments must be applied to the loan as they are made*, regardless of whether there is some contention that more money may be due at the time the payment is made. This rule is integral to ensuring that servicers treat loans as a means to maintain homeownership, and not simply as a means to milk more fees from the captive homeowners.

The one exception to this rule requiring that the payments be applied to interest, principal and escrow when they are made, would be when the loan has already declared to be in default and on track for foreclosure. So for example, if a consumer is three full payments behind, *and the right to cure letter has already been sent out,* the acceptance of a payment equal to less than the amount due for one month would not cure the default.[163] However, it should still be accepted and applied to the loan – as specified by application of payments rule in the contract. Then, when the homeowner contacts the servicer to find out how much is due to cure the default, the amount needed would be reduced by the amount paid and accepted, making the avoidance of foreclosure more likely.

*Broker Price Opinions and Property Preservation Fees*

In the consent order with Fairbanks Capital Corporation, the FTC has already strongly supported the view that property preservation fees can only if be charged if they are actual, necessary and reasonable. Specifically, the consent order enjoins Fairbanks from assessing or collecting:

Fees for property inspections, provided that Defendants may impose reasonable fees for property inspections actually performed if:

1) the customer's loan payment has not been received within forty-five (45) calendar days of the due date; and

2) the inspections are limited to the initial inspections and to additional inspections during the period of delinquency not more frequent than every thirty (30) calendar days and only if the Defendants (a) have been unable to contact the consumer for the previous thirty (30) calendar days or (b) have been able to contact the consumer but have determined that the mortgaged property is vacant;

Fees for broker's price opinions, provided that Defendants may impose reasonable fee for a broker's price opinion ordered and actually performed if:

(1) the consumer's loan payment has not been received within sixty-three (63) calendar days of the due date; and

---

162 We will be happy to demonstrate this with a spreadsheet to the FTC.

163 At common law the acceptance of a partial payment would generally cure a default, however, most loan contracts of today include a provision allowing the servicer to accept a partial payment without waiving the default.

(2) the broker's price opinions are limited to the initial's broker's price option and additional broker's price opinions during the period of continued delinquency not more frequent than every six (6) months . . ..

Consistent with the Fairbanks consent order, the Commission should adopt a rule declaring that it shall be an unfair and deceptive practice to charge the borrower or assess to the borrower's mortgage account property preservation fees which are not actually incurred, necessary and reasonable. Only the actual amount of third-party vendor costs paid by the servicer should be recoverable. The practice of marking-up third-party vendor charges is deceptive in that it misleads consumers and courts into believing that the actual costs of the services are in fact the "amounts disbursed by Lender" which become additional debt to the borrower under Section 9 of the uniform security instrument. In addition, any Commission rule should include a general statement that it is an unfair and deceptive practice to charge the borrower a property inspection fee when the servicer has information that the home is occupied by the borrower and is being properly maintained.

The repetitive charging of property inspection fees and BPO fees is unfair and causes substantial injury to consumer borrowers. Because the purpose of property inspections is simply to determine whether the property is vacant and still standing, servicers do not need to do these every month or every couple of weeks. The Fairbanks consent order imposes reasonable restrictions but should be further limited. Before ordering an additional inspection, the servicer should be required to make several good faith attempts to contact the borrower using a variety of contact methods (mail, phone and e-mail) to determine whether the property is occupied. To avoid potential abuse, the servicer should be required to document all contact efforts. Additional property inspections during a period of default should be no more frequent than every sixty (60) days and only if the servicer has not been able to establish whether the property is occupied and maintained. Additional broker's price opinions during a period of default should be permitted only if the servicer has a reasonable belief (which it must document) that the value of the property has changed since the prior BPO, and should be no more frequent than every six (6) months as provided in the Fairbanks consent order.

*Attorneys Fees Charged in Foreclosure.*

The remedy for the problem here is simple: Just like other fees, attorneys fees should only be added to the mortgage to the extent they are specifically authorized by the contract, legal under state and federal law, in reasonable amounts, and *actually incurred by attorneys who have already done the work.*

*Limitation on Force-Placed Insurance.*

Most of the problems with force-placed insurance flow from those – generally subprime -- mortgages in which there are no escrow accounts. To the extent that new regulatory or statutory requirements address this issue, most, but not all, of the problem should disappear. However, until escrow accounts are required on most if not all mortgages, there will still be unfair force-placed insurance.

Every mortgage loan requires that before the funds will be advance, proof of property insurance must be provided. Servicers thus have an easy way to determine the information necessary to renew the insurance. The current dynamic in the marketplace – in which servicers are permitted to ignore information in the lenders' files and profit considerably by placing the exorbitantly expensive force-placed insurance must be altered.

When the servicer force-places insurance on a non-escrow mortgage and then charges the homeowner the new premium, the servicer has advanced funds to cover the cost of the new insurance. There is no reason that the servicer should not first be required to advance funds for the better and less expensive product – the previously acquired property insurance.

The only exception to such a rule would be when the homeowner has been denied insurance for a reason unrelated to non-payment of the premium, which would presumably have nothing to do with the servicer's own actions. *Instead servicers should be prohibited from force-placing insurance unless the homeowner's property insurance has been cancelled for some reason other than non-payment. As no home loan is made without existing property insurance, the servicer has the information about the existing insurance.* This is a simple matter to accomplish as the servicer and/or the mortgage holder are listed on the insurance policy as a loss payee and receive notices of cancellation.

However, even in those cases in which escrow accounts are included, there are still some problems with servicers who fail to pay funds from escrow.[164] RESPA requires the servicer holding the escrow account to advance funds in order to make disbursements in a timely manner.[165] However, problems are caused as the result of an unauthorized aspect of HUD's regulation under RESPA that allows servicers to *not* pay insurance or taxes when the homeowner is 30 days in default. The HUD regulation must be either repealed or superseded by this FTC regulation.

*Answers to subparts of Question 18*

These proposed prohibitions track the unfair activities described in response to Question 15, such that the answers here would be the same as those provided to the subparts to Question 15

## ***Question 19 – Servicers' Responses to Requests for Information***

*Responding to Requests for Information and Dispute Resolution*

[164] Allowing servicers to profit from the homeowner's failure to comply with an important contractual requirement – to maintain property insurance on the home – assures that servicers will look for opportunities to force place insurance. Yet, servicers are also responsible for failing to pay for the premiums for the lower priced property insurance obtained by the homeowner. This creates an absurd invitation to servicers to look for ways to avoid paying escrow funds to cover existing property insurance so that they can achieve the substantial profit provided from force-placed insurance (from the commissions).

[165] Reg. X, 24 C.F.R. § 3500.17(k)(1). Regulation X also requires the servicer to advance funds in order to make disbursements in a timely manner as long as the "borrower's payment is not more than 30 days overdue." See Reg. X, 24 C.F.R. § 3500.17(k)(2).

RESPA's requirements imposed on servicers to respond fully and in a timely fashion to a Qualified Written Request need not be restated here. However, RESPA's requirements, enforcement regime, and incentives clearly are not sufficient to have encouraged servicers to establish mechanisms to communicate with homeowners. Instead, the FTC should make it an unfair practice for servicers to *fail to have* adequate dispute resolution mechanisms. At a minimum –

- Servicers should be required to set up systems that tracks all information received from a homeowner and records it in a central place – including letters, notices, emails, and faxes – so that all representatives answering the calls will have access to this information.
- Homeowners should be able to call servicers and reach either the same representative, or some one who works in the same, small unit. Servicer representatives should be assigned to homeowners by zip code, or smaller geographical designations, such that homeowners do not have to spend hours repeating their information and attempting to resolve problems.
- Servicer representatives should be authorized to resolve disputes, or if not able to resolve the particular issue, required to pursue the issue until it is resolved.
- Servicers should establish telephone numbers that allow homeowners to reach the same representative or small unit relatively quickly.
- Emails, along with accompanying PDF files (showing proof of payments or receipt of tax or insurance information) should be accepted by servicers.

*Answers to subparts of Question 19*

These proposed prohibitions track the unfair activities described in response to Question 15, such that the answers here would be the same as those provided to the subparts to Question 15.

## ***Question 20 – Loan Performance and Loss Mitigation in Servicing***

*Voluntary Loan Modifications Fail to Address Consumers' Needs*

Loan modifications have not made a dent in the burgeoning foreclosures. A recent paper in the Boston Federal Reserve Bank's Public Policy series found that less than eight percent of all the loans 60 days or more delinquent were modified during 2007-2008.[166] Professor Alan White, in examining pools of securitized mortgages, found that the number of modifications varied dramatically by servicer, ranging from servicers who modified as many as 35 percent of the loans in foreclosure to as few as 0.28 percent of the loans in foreclosure in November 2008.[167] Even at the high end of 35 percent of all mortgages in foreclosure, the modification

---

166 Manuel Adelino, Kristopher Gerardi & Paul S. Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 35 (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf.
167 Alan M. White, Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Modification Contracts, Conn. L. Rev. 12-13 (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325534.

rate is not enough to reduce the foreclosure rate to pre-crisis levels.[168] HAMP has not yet improved the situation: although modifications increased during the first quarter of 2009, all data indicate that the number and rate of total modifications fell back during the second quarter.[169]

Worse, the modifications offered pre-HAMP (and presumably still by servicers not offering HAMP modifications) were overwhelmingly ones that increased the borrower's payment and principal balance. Only about three percent of the delinquent loans studied in Boston Federal Reserve Bank paper received modifications that reduced the payment.[170] Professor White's data shows that, in the aggregate, modifications increase the principal balance.[171] While the first quarter 2009 data from the OCC and OTS shows that a majority of the modifications (excluding short term payment plans or forbearance agreements) decreased the payment, most of those modifications also increased the principal balance by capitalizing arrears.[172] Unsurprisingly, redefault rates on loan modifications remain high.[173]

The official numbers available to date on the HAMP program reflect a modest start at best.[174] The good news is that, on paper at least, 75 percent of all the loans in the country should be covered by HAMP.[175] The bad news is that only 55,000 trial modifications have been offered and only 300,000 letters with information about trial modifications have been sent to homeowners. As the President acknowledges, foreclosures still outnumber modifications under the program.[176] The 300,000 letters containing information about trial

---

[168] See Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12 (noting that the number of foreclosures has more than doubled from pre-crisis levels).

[169] See, e.g., Gretchen Morgenson, Fair Game – So Many Foreclosures, So Little Logic, N.Y. Times, July 4, 2009 (reporting that modifications peaked in February 2009 and have since declined while the number of foreclosures and delinquencies has continued to rise); California Reinvestment Coalition, The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California (2009) (reporting observations by housing counselors that loan modifications declined in the second quarter); Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White).

[170] Manuel Adelino, Kristopher Gerardi & Paul S. Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf.

[171] Alan White, Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports, Fordham Urb. L. J. 20 (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538# .

[172] Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 5 (June 2009), *available at* http://files.ots.treas.gov/482047.pdf.

[173] Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 6 (June 2009), *available at* http://files.ots.treas.gov/482047.pdf.

[174] United States Department of the Treasury, Making Home Affordable Progress Report, May 14, 2009, *available at* http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf

[175] United States Department of the Treasury, Making Home Affordable Progress Report, May 14, 2009, *available at* http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf.

[176] Tami Luhby, Obama mortgage plan needs work: Many borrowers are not getting help under president's modification or refinancing plan, CNN Money.com, July 8, 2009; Press Conference by the President, The White House, Office of the Press Secretary (June 23, 2009), *available at*

modifications are obscured by the more than 2 million homeowners in foreclosure and the over 770,000 new foreclosure starts in the first quarter alone.[177]

Servicers are still staffing up to deal with homeowners in distress.[178] Administration officials have admitted that the industry is not yet up to the task.[179] The progress servicers have made in hiring loan modification staff, although real, is not keeping up with the numbers of foreclosures filed by those same servicers.

We do not yet have any data on the characteristics or performance of the HAMP loan modifications. However, extensive reports from advocates around the country show that the quality of loan modifications offered too often does not comport with HAMP guidelines. Advocates for homeowners continue to report problems with implementation of the program.[180] Servicers are all too often refusing to do HAMP modifications, soliciting a waiver of homeowners' rights to a HAMP review, and structuring offered modifications in ways that violate HAMP. These violations may be harder to detect than the gross failure of servicers to date to process a meaningful number of modifications, but they will vitiate HAMP just as surely. On July 29, 2009, borrowers in Minnesota filed a class action[181] against the U.S. government alleging that the HAMP program violates Constitutional procedural due process requirements by failing to provide homeowners with proper notice and a right to appeal decisions by loan servicers administering the program. The plaintiffs are seeking an injunction on foreclosures until the government promulgates necessary procedures to ensure its fair administration.

*The Structure of the Servicing Industry is a Major Impediment to Loss Mitigation*

Investors are losing mind-boggling large sums of money on foreclosures.[182] The available data suggests that investors lose ten times more on foreclosures than they do on

---

http://www.whitehouse.gov/the_press_office/Press-Conference-by-the-President-6-23-09 ("Our mortgage program has actually helped to modify mortgages for a lot of our people, but it hasn't been keeping pace with all the foreclosures that are taking place,").

177 Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009) (reporting that 3.85% of 44,979,733 mortgages surveyed were in foreclosure in the first quarter and that 1.37% of mortgages surveyed had foreclosure starts in the first quarter; the MBA survey data covers 80% of the mortgage market, so the numbers are extrapolated by dividing the MBA numbers by 80%).

178 See, e.g., Peter S. Goodman, Promised Help Is Elusive for Some Homeowners, N.Y. Times, June 3, 2009.

179 Peter S. Goodman, Paper Avalanche Buries Plan to Stem Foreclosures, N.Y. Times, June 29, 2009) (quoting Michael Barr, Assistant Secretary for Financial Institutions at the Treasury Department: "They need to do a much better job on the basic management and operational side of their firms . . . .What we've been pushing the servicers to do is improve their infrastructure to make sure their call centers are doing a better job. The level of training is not there yet.").

180 See, e.g., California Reinvestment Coalition, The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California (2009); Peter S. Goodman, Paper Avalanche Buries Plan to Stem Foreclosures, N.Y. Times, June 29, 2009.

181 Williams v. Geithner, D. Minn. (July 28, 2009), *available at* http://www.hppinc.org/projects/index.php?strWebAction=resource_detail&intResourceID=112.

182 Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White) (65% loss severity rates on foreclosures in June 2009).

modifications.[183] In attempting to make sense of this puzzle, we should remember that servicers are not investors. Investors hold the note, or a beneficial interest in it, and are, in general, entitled to repayment of the interest and principal. Servicers collect the payments from the homeowners on behalf of the investors. The bulk of their income comes from a percentage payment on the outstanding principal balance in the pool; the bulk of their net worth is tied to the value of the mortgage servicing rights they purchased. A servicer may or may not lose money –or lose it in the same amounts or on the same scale –when an investor loses money. And it is servicers, not investors, who are making the day-to-day, on the ground, decisions as to whether or not to modify any given loan.

Servicers continue to receive most of their income from acting as largely automated pass-through accounting entities, whose mechanical actions are performed offshore or by personified computer systems.[184] Their entire business model is predicated on making money by skimming profits from what they are collecting: through a fixed percentage of the total loan pool, fees charged homeowners for default, interest income on the payments during the time the servicer holds them before they are turned over to the owners, and affiliated business arrangements. Servicers make their money largely through lucky or strategic investment decisions: purchases of the right pool of mortgage servicing rights and the correct interest hedging decisions. Performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs.[185] Servicers have cut costs by relying more on voicemail systems and less on people to assist homeowners, by refusing to respond to homeowners' inquires and by failing to resolve borrower disputes. Servicers sometimes actively discourage homeowners from attempting to resolve matters. Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate.[186] As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead homeowners are being pushed into short-term modifications and unaffordable repayment plans.

---

183 Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White).

184 See, e.g., In re Taylor, 2009 WL 1885888 (Bankr.E.D.Pa. Apr 15, 2009).

185 See Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 17 (Mar. 16, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331(noting that "servicers' contribution to corporate profits is often . . . tied to their ability to keep operating costs low").

186 Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, The Incentives of Mortgage Servicers: Myths and Realities 9-10 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008-46); State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3 at 8 (2008), http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf; Preston DuFauchard, California Department of Corporations, Loss Mitigation Survey Results 4 (Dec. 11, 2007); cf. Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 3 (2008) (expressing concern as to servicers' abilities to meet staffing needs).

Creating affordable and sustainable loan modifications for distressed homeowners on a loan-by-loan basis is labor intensive.[187] Under many current pooling and servicing agreements, additional labor costs incurred by servicers engaged this process are not compensated by the loan owner. By contrast, servicers' costs in pursuing a foreclosure are compensated. In a foreclosure, a servicer gets paid before an investor; in a loan modification, the investor will usually continue to get paid first. Under this cost and incentive structure, it is no surprise that servicers continue to push homeowners into less labor-intensive repayment plans, non-HAMP loan modifications, or foreclosure.

Most servicers derive the majority of their income based on a percentage of the outstanding loan principal balance.[188] For most pools, the servicer is entitled to take that compensation from the monthly collected payments, even before the highest-rated certificate holders are paid. The percentage is set in the PSA and can vary somewhat from pool to pool, but is generally 25 basis points for prime loans and 50 basis points for subprime loans.[189] This compensation may encourage servicers to refuse principal reductions and to seek capitalizations of arrears and other modifications that increase the principal balance. As explained above, in answer to Question 15 relating to late fees, late fees alone constitute a significant fraction of their total income and profit.[190] Servicers thus have an incentive to push homeowners into a default situation and keep them there: if the loan pays late, the servicer is more likely to profit than if the loan is brought and maintained current. Float income encourages servicers to delay turning over payments to investors for as long as possible.

For servicers, their most important asset is the value of their mortgage servicing rights. Whether or not the servicer made the correct speculative investment decision when it bought the mortgage servicing rights to a pool of mortgages does more to shape its profitability than any other single factor. A servicer's performance has only a marginal impact on the performance of the loan pool; the way a servicer increases its net worth is not by doing a top-notch job of servicing distressed mortgages but by gambling on market trends. Servicers with thin margins may need to squeeze all they can out of increasing performance from delinquent loans; servicers with stronger pools are likely to be less invested in the performance of the loans they manage.[191] This dynamic leaves many servicers indifferent to the performance of the loans they service and unmotivated to hire and train the staff needed to improve performance.

---

187 Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 7(Oct. 3, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

188 See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008) (typically receive 50 basis points annually on the total outstanding principal balance of the pool).

189 Anthony Pennington-Cross & Giang Ho, Loan Servicer Heterogeneity & The Termination of Subprime Mortgages 2 (Fed. Res. Bank of St. Louis Working Paper No. 2006-024A); 26 NCLC Reports, Follow the Money: How Servicers get Paid May/June 2008..

190 See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008); Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Pol'y Debate 753, 758 (2004).

191 Vikas Bajaj & John Leland, Modifying Mortgages Can Be Tricky, N.Y. Times, Feb. 18, 2009 (reporting views of Credit Suisse analyst that "[s]maller companies . . . that are under more financial pressure and have more experience in dealing with higher-cost loans have been most aggressive in lowering payments" than larger companies, who offer weaker modifications).

A recent paper confirms that extremely few loan modifications are being done and, in an attempt to solve the puzzle, propounds an economic model to explain the dearth of loan modifications.[192] Under the terms of that economic model, investors recover more if a borrower brings the loan current or refinances than if the lender modifies the loan. This is a commonsense and unobjectionable observation. Both the FDIC Loan Mod-in-a-Box NPV test and the HAMP NPV test build in the likelihood of cure in determining whether a loan modification or foreclosure is the more profitable path for investors.

In more normal times, it is surely rational for a servicer to spare itself the time and expense of modifying a loan in favor of the possibility of cure. In normal times, when cure rates exceeded foreclosure rates, an investor would have little objection to the wait-and-see-approach.[193] However, this model cannot explain the failure to perform loan modifications when we observe real world conditions: dropping cure rates, due in part to the restricted ability to refinance, even for homeowners with high credit scores;[194] homes so deeply underwater that investors lose 65 percent of the mortgage debt on average in foreclosure;[195] and a lack of other, more attractive places, to invest funds.

Servicers may make a little money by making a loan modification under the government HAMP plan, but it will definitely cost them something. On the other hand, failing to make a loan modification will not cost the servicer any significant amount out-of-pocket, whether the loan ends in foreclosure or cures on its own. Until servicers face large and significant costs for failing to make loan modifications, until servicers are actually at risk of losing money if they fail to make modifications, no incentive to make modifications will work. What is lacking in the system is not a carrot; what is lacking is a stick.[196] Servicers must be

---

192 Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 35 (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf. In addition to the overall limitations of a theoretical economic model to explain the complex web of interacting motivations impacting the numbers of loan modifications, there appear to be some errors in the model, even as a theoretical exercise. For example, the model assumes that the value of the unmodified loan is the greater of the unpaid principal balance or the value of the home, after adjusting for the costs of the foreclosure. But, in fact, it should be the lesser of the two. A foreclosing lender cannot legally recover more than the unpaid principal balance and is practically unlikely to recover more than the net foreclosure value of the home. This error results in an overstatement of the value of foreclosure, particularly in a market where home prices are declining, and thus undervalues modifications.

193 Alan White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports,* Fordham Urb. L. J. 17-18 (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538#; *see also* Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 5 (2008) (reporting that half of all active loans facing reset in the first three-quarters of 2007 refinanced; more than one-quarter of all remaining loans refinanced after reset); State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3 at 8 (2008), http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf (reporting that 23% of closed loss mitigation efforts in May 2008 were either refinancings or reinstatements in full by the borrower).

194 David Streitfeld, *Tight Mortgage Rules Exclude Even Good Risks,* N.Y. Times, July 10, 2009.

195 *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary,* 111th Cong. (2009) (testimony of Alan M. White).

196 *See Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary,* 110th Cong., 2nd Sess. (Nov. 19, 2008), *available* http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&wit_id=4083 (statement of

required to make modifications, where appropriate, and the penalties for failing to do so must be certain and substantial.

***a Taking foreclosure action without first verifying loan information and reasonably investigating any disputes is an unfair or deceptive act or practice and should be prohibited.***

While the Real Estate Settlement Procedures Act currently requires servicers to respond to borrowers' request for information and disputes within 60 days, in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure.

Advocates around the country report that servicers routinely provide inadequate information regarding outstanding loans, including statements of capitalized arrears that appear to be inaccurate without any supporting documentation. While the homeowner works with servicing staff to correct the record of the amount owed, based on payments made and fees levied during servicing, a separate operation pursues foreclosure. The Commission should prohibit taking foreclosure action without first verifying loan information and without reasonably investigating any dispute regarding the servicing of the loan or the amount owed. A reasonable process for verification and investigation must include communicating with the borrower and giving the borrower an opportunity to respond on a reasonable timeline, as well as an opportunity for the borrower to escalate the issue internally at the servicer.

Proceeding to foreclosure without first verifying that the amounts sought to be collected, and without first addressing any pending dispute in such regard is both deceptive and unfair. Such acts are deceptive because the servicer's movement to foreclosure essentially is a statement that certain amounts are owed to the servicer and have not been paid. Even sophisticated consumers (and their representatives) find it difficult to dissect servicing payment histories and the technical explanations riddled with codes provided by servicers of how amounts owed have been calculated. Surely, vulnerable consumers are in no position to question amounts owed especially on a foreclosure timeline. Thus, consumers are likely to believe that the amounts sought by the servicer are accurate – a deception on homeowners and perhaps on the court processing the foreclosure.

To the extent that the amounts sought by servicers are inaccurate, and in many instances based on inaccurate records regarding late payments, escrow problems and the like, proceeding to foreclosure also is unfair. Wrongly proceeding to foreclosure without verifying records and resolving disputes may result in the loss of a home to a family, as well as decreased property value in the neighborhood. Moreover, the cost of proceeding to foreclosure increases a homeowner's liability substantially, particularly in judicial foreclosure states where a foreclosure can significantly raise costs for a consumer due to summary judgment motions that are resource-intensive and other litigation costs. These amounts generally are capitalized into the principal, thus making a later loan modification more difficult to afford.

---

Russ Feingold, Member, Sen. Comm. on the Judiciary) ( "One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure.").

Homeowners can not reasonably avoid such injury. While a homeowner may be able to challenge a foreclosure, this generally takes substantial resources. In a non-judicial foreclosure state, a homeowner must find counsel and find the basis for filing an affirmative action to stop the foreclosure. Once a servicer has initiated the foreclosure process, a homeowner sustains substantial financial burdens as well as a timeline marching toward loss of the home. Homeowners can not, on their own, change that process. While a homeowner can challenge the amounts in the foreclosure proceeding, or file a separate action to make such a challenge, this burden is high and the servicer still is in the position of having all the information regarding the loan's servicing history and amounts owed.

It is hard to identify market benefits where a servicer proceeds to foreclosure without first verifying information and resolving disputes. There is broad agreement that performing loans generally produce greater revenue than foreclosures. Moreover, there is no public benefit in a system where amounts collected are not owed or where homeowners are steamrolled into foreclosure, thus losing the ability to accrue personal wealth and triggering neighborhood losses. While the servicers may benefit from the decreased costs associated with summary foreclosure actions, any benefit is illegitimate and is substantially outweighed by the harm to investors, homeowners and communities.

***b. & d. Proceeding to foreclosure without offering an affordable loan modification consistent with net present value to qualified homeowners is unfair or deceptive and should be banned.***

In addition to the need to verify amounts owed and resolve disputes, it is incumbent upon servicers to provide alternative to foreclosure where possible. As noted above, investors lose substantial amounts from foreclosures. Unnecessary foreclosures in place of loan modifications and other home-saving loss mitigation options produce unnecessary losses for investors. Moreover, homeowners are unnecessarily displaced and communities take an unnecessary hit. Servicers have always had a panoply of workout options, but often the incentives result in homeowners being pushed out of their homes, instead of finding help to retain their homes. Accordingly, the Commission should prohibit servicers from proceeding to foreclosure without first offering an affordable loan modification to qualified homeowners.

This rule would not mandate a loan modification for every homeowner – just the analysis. The servicer would be required to assess whether a homeowner in default qualifies for a loan modification and then would develop an affordable proposal. The only loan modification offers that would be required would be those consistent with the servicer's obligation to maximize net present value for the investor. In other words, the investor would profit more from the modification than from foreclosure (taking into account the chance of cure, changes in property values, etc.). This standard would create a floor that maximizes benefits to homeowners, communities and investors. Moreover, a servicer should be required to explore other loss mitigation options, such as deeds in lieu and short sales, prior to any foreclosure, if the homeowner does not qualify for the loan modification. Counseling and mediation are excellent means for arriving at these ends, but ultimately the question is whether the servicer has provided a loan modification offer.

Proceeding to foreclosure without offering affordable loan modifications consistent with net present value to qualified homeowners is unfair and deceptive. It is deceptive because placing a homeowner in foreclosure represents that this outcome is the only option left for the homeowner (and the servicer and investor), and that all other options have been explored. Seeking to take someone's home implies that the homeowner is unable to take any actions to keep it. If a homeowner qualifies for a loan modification that is consistent with the investor's interests, then foreclosure is not the inevitable outcome that the foreclosure process presents it to be. Moreover, causing a homeowner to lose a home in foreclosure when a less onerous, but still devastating, outcome such as a short sale or deed in lieu is possible, similarly is deceptive.

Proceeding to foreclosure without a reasonable loan modification offer is unfair because it wreaks substantial injury on the homeowners and their communities – and thus contributes to the destabilization of the economy.[197] Neighbors lose equity;[198] crime increases;[199] tax revenue shrinks.[200] Communities of color remain at the epicenter of the crisis; targeted for

---

[197] *See, e.g.,* Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12; Ira J. Goldstein, The Reinvestment Fund, Lost Values: A Study of Predatory Lending in Philadelphia, at 62/-/63 (2007), *available at* www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf (discussing disastrous community impact left behind by failed subprime lenders).

[198] *See* John P. Harding, Eric Rosenblatt, & Yao Vincent, The Contagion Effect of Foreclosed Properties (July 15, 2008), *available at* http://ssrn.com/abstract=1160354; Letter, Senator Dodd to Senator Reid (Jan. 22, 2008) (describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), *available at* http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf; Staff of the J. Economic. Comm., 110th Cong., 1st Sess., The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here (2007), *available at* http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=c6627bb2-7e9c-9af9-7ac7-32b94d398d27&Region_id=&Issue_id= (projecting foreclosed home owners will lose $71 billion due to foreclosure crisis, neighbors will lose $32 billion, and state and local governments will lose $917 million in property tax revenue); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Pol'y Debate 57, 69, 75 (2006) ("for each additional conventional foreclosure within an eighth of a mile of a house, property value is expected to decrease by 1.136 percent"; estimating total impact in Chicago to be between $598 million and $1.39 billion); William C. Apgar, Mark Duda, & Rochelle Nawrocki Gorey, The Municipal Cost of Foreclosures: A Chicago Case Study (Hous. Fin. Policy Research Paper 2005), at 1, *available at* www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf; John P. Harding, Eric Rosenblatt, & Yao Vincent, The Contagion Effect of Foreclosed Properties (July 15, 2008), *available at* http://ssrn.com/abstract=1160354; Letter, Senator Dodd to Senator Reid (Jan. 22, 2008) (describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), *available at* http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf.

[199] *See, e.g.,* J.W. Elphinstone, *After Foreclosure, Crime Moves In*, Boston Globe, Nov. 18, 2007 (describing Atlanta neighborhood now plagued by house fires, prostitution, vandalism and burglaries); Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime,* 21 Housing Stud. 851 (2006)**,** *available at* www.prism.gatech.edu/~di17/housingstudies.doc (calculating that for every 1% increase in the foreclosure rate in a census tract there is a corresponding 2% increase in the violent crime rate).

[200] *See, e.g., .,* Staff of the J. Economic Comm., 110th Cong., 1st Sess., The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here (2007), *available at* http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=c6627bb2-7e9c-9af9-7ac7-32b94d398d27&Region_id=&Issue_id= (projecting foreclosed home owners will lose $71 billion due to foreclosure crisis, neighbors will lose $32 billion, and state and local governments will lose $917 million in property tax revenue); William C. Apgar, Mark Duda, & Rochelle Nawrocki Gorey, The Municipal Cost of

subprime, abusive lending, they now suffer doubly from extraordinarily high rates of foreclosure and the assorted ills that come with foreclosure.[201]

Being placed into foreclosure instead of being given an opportunity to save your home is not reasonably avoidable by the consumer. The servicer drives the process, as noted above, and the homeowner is generally in a defensive position once the foreclosure process starts. In addition, when a loan modification is at issue, it is the servicer, not the homeowner, who holds the key information regarding how the analysis is done, including whether the loan is consistent with net present value and thus advantageous for the investor. The costs to pursuing foreclosure over a loan modification are high. Home loss, the lost equity associated with capitalized foreclosure costs, and the personal and neighborhood social and economic costs associated with such displacement are high; investors also lose substantial monies from such foreclosures. And these losses totally outsize the size and importance of any benefit that servicers reap from denying loan modifications to qualified homeowners.

***c. Consumer waivers in loan modifications are unfair or deceptive and should be banned.***

Servicers have long sought waivers of consumer rights when offering loan modifications and other loss mitigation to homeowners. Despite opposition from policymakers and homeowners, they have continued. Moreover, while the HAMP program prohibits waivers of legal rights, many servicers still are seeking waivers from homeowners or an admission of default.[202] Servicers also have asked homeowners to waive their right to a HAMP loan modification review in favor of a non-HAMP loan modification.[203] Not only does this violate HAMP rules but it demonstrates bad faith. Some servicers also are requiring homeowners to sign a waiver that states that any HAMP loan modification will be suspended if the homeowner subsequently files for bankruptcy[204] (which will be likely for some set of homeowners in part because re-defaults do not entitle homeowners to a second modification).

---

Foreclosures: A Chicago Case Study (Hous. Fin. Policy Research Paper), 2005, at 1, *available at* www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf.

201 *See, e.g.,* Michael Powell & Janet Roberts, *Minorities Affected Most as New York Foreclosures Rise,* N.Y. Times, May 15, 2009; Mortgage Foreclosure Filings in Pennsylvania: A Study by the Reinvestment Fund for the Pennsylvania Department of Banking 36 (Mar. 2005), *available at* www.trfund.com/policy/pa_foreclosures.htm; Paul Calem, Kevin Gillen & Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. Real Estate Fin. & Econ. 393 (2004); Ira Goldstein, The Reinvestment Fund, Predatory Lending: An Approach to Identify and Understand Predatory Lending (2002) (showing that areas within the City of Philadelphia that are predominately African American or Latino also tended to have higher concentrations of foreclosure sales and were more vulnerable to predatory lending); *cf.* AARP Pub. Pol'y Inst., A First Look at Older Americans and the Mortgage Crisis 5 (2008), http://assets.aarp.org/rgcenter/econ/i9_mortgage.pdf (African Americans and Hispanics are foreclosed on at roughly three times the rate of white Americans).

202 *See* Appendix F, Ocwen Loan Servicing Loan Modification Agreement dated June 1, 2009 (seeking waiver of all legal rights by homeowner) Attachment G, Aurora Loan Services "workout agreement" dated May 20, 2009 (seeking homeowner admission of default and stating that the trial payments will not remove the homeowner from delinquency).

203 *See, e.g.,* Appendix H (Chase Agreement seeking to obtain waiver of homeowner's right to a HAMP loan modification in favor of a non-HAMP loan modification offered prior to March 4, 2009).

204 *See*, *e.g.,* Attachment I (WaMu HAMP trial plan agreement requiring waiver of HAMP loan modification if homeowner later enters bankruptcy).

The Commission should ban waivers of consumer rights in all loan modification and workout agreements because they are deceptive or unfair. First, waivers of consumer rights are deceptive because the form waivers in the agreements are presented as a necessary and reasonable exchange for a loss mitigation agreement provided in the ordinary course of business. They are not. Moreover, the waiver itself implies that the consumer's needs will be adequately addressed by the contract and that any pre-existing concerns will no longer be relevant, however this often is not the case when a consumer re-defaults and needs to address underlying problems in the loan. Waivers in HAMP loan modifications are deceptive because the servicer is presenting the contract as complying with the government program and the consumer is relying on the government imprimatur as a form of protection, however the contract does not comport with government guidelines. Finally, the waiver in a form contract presents the consumer with a false choice between signing a loan modification agreement with a waiver or facing default and foreclosure.

The waivers also are unfair. Waiving one's rights to later pursue legal claims can result in substantial injury where the loan modification fails and the consumer seeks to save the home by challenging the underlying loan terms but finds that the right to do so has been waived. This could leave a consumer defenseless in the face of a foreclosure. Because the waivers are part of form contracts, individual borrowers do not have the bargaining power to avoid these contracts. In fact, the average or vulnerable consumer may not even appreciate the depth of the problem with these provisions. The only countervailing benefit for such a waiver, is that the lender and servicer can use their greater economic leverage and sophistication to evade their legal responsibilities. Providing loss mitigation is part of the servicer's duties; not a means to erase future liability.

## ***<u>Question 21 – Mortgage Loans in Connection with Bankruptcy Proceedings</u>***

### Failing to disclose fees incurred during a Chapter 13 bankruptcy case and then seeking to collect them from the consumer after discharge/dismissal

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to Chapter 13 as a last resort for saving their homes. One of the most significant provisions in Chapter 13 is the right to cure defaults on loans, even if the mortgage holder or servicer has called the loan due ("accelerated") before the bankruptcy is filed and even if such right to cure does not exist under state law or the consumer's loan contract. For long-term loans a consumer has fallen behind on and is not able to pay-off in full within the three to five years of a Chapter 13 plan, such as a home mortgage, section 1322(b)(5) of the Bankruptcy Code permits the homeowner to cure the default within a reasonable time by making payments on the arrears together with the ongoing payments during the plan.

Code section 1322(b)(5) recognizes not only that a consumer debtor may make payments under the plan to cure a prepetition default but also may provide for the "maintenance of payments while the case is pending." If the consumer debtor makes all payments required by the confirmed plan to payoff the arrearage amount listed in the mortgage creditor's proof of claim, and maintains the ongoing postpetition payments as required under the mortgage documents, the debtor will emerge from bankruptcy fully current on the mortgage as if no prepetition default existed.

For this home preservation model to be successful, there must be full disclosure of all postpetition "maintenance" payments.[205] Unfortunately, it has become increasingly common for mortgage creditors to add fees and charges to mortgage accounts without notice to the borrower, trustee or bankruptcy court while the bankruptcy case is pending, and without disclosing the fees in a proof of claim or seeking court approval. Some creditors secretly maintain these charges on the debtor's account while the bankruptcy is pending and wait to collect the fees once the bankruptcy case is closed or when the loan is paid off or refinanced.[206] Others include the postpetition fees in the proof of claim but fail to separately list or itemize them. Many debtors emerge from a Chapter 13 case after three to five years of struggling to cure an arrearage only to have the servicer begin foreclosure anew based on claims of unpaid fees for such items as attorney's fees, property inspections, broker price opinions, and other charges allegedly incurred during the Chapter 13 case.

One of the first cases to challenge this practice was *Tate v. NationsBanc Mortgage Corp.*[207] The *Tate* court found that attorney's fees listed on proofs of claim under the label "bankruptcy fee" were *per se* unreasonable under Code section 506(b) because the creditor failed to obtain approval of the fees under Bankruptcy Rule 2016. At the same time *Tate* was being litigated, a series of class action lawsuits had been filed against numerous mortgage servicers and auto lenders Bankruptcy Court for the Southern District of Alabama, which issued a number of written opinions.[208]

The first two cases to go to trial were *Slick v. Norwest Mortgage, Inc.* and *Harris v. First Union Mortgage Corp.* In *Slick*, the court found that the servicer Norwest initially prepared and filed proofs of claim in its borrower's Chapter 13 cases using in-house staff, and that it did not charge borrowers a separate fee for this work. Over the course of several years, this work was transferred to various outside law firms and bankruptcy service companies. With the outsourcing of this work came the practice of charging debtors a fee in the range of $75 to $125 for the preparation of proofs of claim. Evidence at trial also established that while

---

[205] *In re* Sanchez, 372 B.R. 289, 297 (Bankr.S.D.Tex. 2007)("in order for the bankruptcy system to function-every entity involved in a bankruptcy proceeding must fully disclose all relevant facts"); *In re* Jones, 366 B.R. 584, 602-03 (Bankr.E.D.La.2007)("Bankruptcy courts can not function if secured lenders are allowed to assess postpetition fees without disclosure and then divert estate funds to their satisfaction without court approval").

[206] Some servicers refuse to provide normal escrow account statements and payment change notices to borrowers in bankruptcy, depriving these borrowers of the opportunity to pay the amounts due during the chapter 13 case and subjecting them to later collection efforts. *E.g.*, *In re* Dominique, 368 B.R. 913 (Bankr.S.D.Fla. 2007)(servicer failed to provide escrow statements during chapter 13 plan and just before plan completion provided debtors with an escrow account review indicating a $6,397 escrow deficiency); *In re* Rizzo-Cheverier, 364 B.R. 532 (Bankr.S.D.N.Y. 2007)(servicer allowed deficiency in escrow account to accrue and then, without notice to debtor, applied trustee plan payments intended for prepetition arrears to postpetition escrow deficiency).

[207] 253 B.R. 653 (Bankr. W.D.N.C. 2000).

[208] *See In re* Powe, 282 B.R. 31 (Bankr.S.D.Ala. 2001); *In re* Noletto, 281 B.R. 373 (Bankr.S.D.Ala. 2001); *In re* Powe, 281 B.R. 336 (Bankr.S.D.Ala. 2001); *In re* Noletto, 281 B.R. 36 (Bankr.S.D.Ala. 2000); *In re* Sheffield, 281 B.R. 24 (Bankr.S.D.Ala. 2000); *In re* Harris, 280 B.R. 899 (Bankr.S.D.Ala. 2001); *In re* Harris, 280 B.R. 876 (Bankr.S.D.Ala. 2001); *In re* Noletto, 280 B.R. 868 (Bankr.S.D.Ala. 2001); *In re* Powe, 280 B.R. 867 (Bankr.S.D.Ala. 2001); *In re* Powe, 280 B.R. 734 (Bankr.S.D.Ala. 2002); *In re* Harris, 280 B.R. 724 (Bankr.S.D.Ala. 2001); In re Powe, 280 B.R. 728 (Bankr.S.D.Ala. 2001); *In re* Powe, 278 B.R. 539 (Bankr.S.D.Ala. 2002); *In re* Slick, 280 B.R. 722 (Bankr.S.D.Ala. 2001). *See also* Chrysler Financial Corp. v. Powe, 312 F.3d 1241 (11th Cir. 2002).

Norwest initially disclosed these fees on proofs of claim, it later changed its policy in response to "pending litigation, industry litigation and opinions of in-house counsel" and no longer disclosed the fee on claims or in any other manner.[209]

The Alabama bankruptcy court found that the practice of hiding these postpetition fees from debtors and bankruptcy courts violates Code section 506(b) and denies Chapter 13 debtors the right to fully cure mortgage defaults under section 1332(b)(5). A creditor should not be permitted to pick and choose which fees are to be paid under a Chapter 13 plan as part of its claim for arrearage and costs, and then attempt to collect fees not included in the claim after the case is closed. Moreover, if the fees are not disclosed, the judge found that neither the debtor nor the court can assess their reasonableness as required by section 506(b), and they are therefore rendered *per se* unreasonable.[210]

In order to send a clear message to creditors that this practice will not be tolerated, the Alabama bankruptcy court invoked its power under Code section 105 and imposed a monetary sanction of $2 million against the creditor.[211] The court found that its award was justified based on the calculated business choice made by the creditor:

> The decision was a business and bottom line driven decision. Norwest created this issue by its major policy shift - to outsource certain actions and lay that cost on borrowers. It benefitted financially from that action. Once a decision was made to charge debtors for a previously "free" service, Norwest knew it had two choices - to disclose that a fee was being charged or to not disclose it. At first it made a disclosure. Then, when it encountered a court challenge to the fees it charged, it changed its policy. It chose not to disclose the fees it charged anymore. Nondisclosure or "hiding" a fee always carries some risk, particularly when the "target" of the nondisclosure is unsophisticated.[212]

Bankruptcy courts have adopted different views as to the procedure that should be followed to disclose fees during a chapter 13 case. Some courts find that a formal application under Bankruptcy Rule 2016 in the case of attorney's fees should be filed by the creditor.[213] Other

---

[209] The change is policy apparently came in response to the lawsuit filed in Majchrowski v. Norwest Mortgage, 6 F.Supp.2d 946 (N.D.Ill. 1998).

[210] *See also* Noletto v. NationsBanc Mortgage Corp., 281 B.R. 36, 47 (Bankr.S.D.Ala. 2000)("Fees which are not disclosed at all, fees which are not properly claimed with specificity, or are not included in the arrearage claim to be paid through the plan if the plan so provides, are per se unreasonable because they are improperly charged."); Harris v. First Union Mortgage Corp., 280 B.R. 876, 885 (Bankr.S.D.Ala. 2001).

[211] A similar $2 million punitive damage award was issued in Harris v. First Union Mortgage Corp.

[212] Though many of Judge Mahoney's written opinions in these cases were published, the opinions awarding sanctions in *Slick* and *Harris* are not recorded. They are available, however, on the court's website, at the following address for the Slick opinion: http://www.alsb.uscourts.gov:8081/ISYSquery/IRLC587.tmp/1/doc; and for the Harris opinion: http://www.alsb.uscourts.gov:8081/ISYSquery/IRLC59B.tmp/9/doc.

[213] *See In re Padilla*, 379 B.R. 643 (Bankr.S.D.Tex. 2007) (finding that disclosure of postconfirmation attorney fees through a Rule 2016 fee application is required to ensure debtors can exercise their right to cure postconfirmation defaults and to receive their "fresh start;" court can order under § 105(a) disgorgement of fees charged to debtors without a proper Rule 2016 application or in violation of the confirmed plan.; *In re Sanchez*, 372 B.R. 289 (Bankr.S.D.Tex. 2007)(holding that creditor's failure to disclose post-confirmation fees charged to debtor and to file fee application under Rule 2016 violated automatic stay); *In re* Jones, 366 B.R. 584 (Bankr.E.D.La. 2007) (legal fees

courts believe that disclosure may be made in the creditor's initial or amended proof of claim if the fees are separately itemized.[214] However, they are all in agreement that full disclosure is essential.

The hiding of fees in Chapter 13 cases is unfair and causes substantial injury to consumer debtors. The practice ensures that fees will avoid any possibility of court scrutiny. Even if the fees are reasonable and authorized, the failure to disclose them deprives consumer borrowers of the right to provide for their payment during the bankruptcy case, jeopardizing borrowers' opportunity for a fresh start. Consumers can not reasonably avoid the injury caused by this practice since only mortgage holders and their servicers possess the needed information about the fees being charged. The practice is also deceptive in that it misleads consumers into believing that their Chapter 13 plan payments, if made successfully, will bring their account current and prevent them from being foreclosed upon. Thus, the Commission should adopt a rule declaring the failure to disclose fees during a Chapter 13 case an unfair and deceptive practice. The actual method of disclosing such fees can be left to local courts and the Advisory Committee on Bankruptcy Rules.[215]

**Failing to apply properly payments in bankruptcy to pre-petition/post-petition categories of the consumer's debts**

The effect of a cure in a Chapter 13 case is to nullify all consequences of the prebankruptcy default.[216] Once the Chapter 13 plan is confirmed in a case involving a long-term mortgage, the debtor's ongoing mortgage payments should be applied from the petition date in accordance with the mortgage contract terms and original loan amortization as if no default exists, with all prepetition arrears being paid separately under the plan as a component of the mortgage servicer's proof of claim.[217] The Supreme Court in *Rake v. Wade* succinctly described this treatment of payments towards the separate ongoing mortgage obligation and arrearage claim as follows:

---

incurred postpetition and preconfirmation must be approved by court as reasonable under § 506(a) and upon application filed under Rule 2016).

214 *In re* Madison, 337 B.R. 99 (Bankr.N.D. Miss. 2006)(prepetition attorney fees and costs may be requested in proof of claim if disclosure is specific and fees are itemized); *In re* Powe, 281 B.R. 336 (Bankr.S.D.Ala. 2001)(creditor may include an attorney fee demand in a proof of claim without filing an application under Rule 2016 if the claim is sufficiently detailed and provides adequate notice to the debtor); *In re* Biazo, 314 B R 451 (Bankr.D.Kan. 2004)(without ruling on whether Rule 2016 fee application is required for fee requests related to stay relief motions, court found that creditor's inclusion of attorney fees and costs as item of "amount now due and owing" in stay relief motion failed to provide adequate notice).

215 The Bankruptcy Rules Committee is presently considering a national Bankruptcy Rule that will compel disclosure of fees during Chapter 13 cases. *See* Bankruptcy Rules Committee Agenda Materials, October 2008, available at: http://www.uscourts.gov/rules/Agenda%20Books/Bankruptcy/BK2008-10.pdf.

216 The House Report to the Bankruptcy Reform Act of 1994 reaffirms that this is the intent of Congress. *See* H.R. Rep. No. 835, 103d Cong., 2d Sess. 55 (1994) reprinted in 1994 U.S.C.C.A.N. 3340 ("It is the Committee's intention that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred.")

217 *See In re* Jones, 366 B.R. 584 (Bankr.E.D.La. 2007) (plan confirmation "recalibrates" the amounts due as of the petition date); *In re* Wines, 239 B.R. 703 (Bankr. D.N.J. 1999) (post-petition mortgage debt treated like a current mortgage and consists of those payments which come due after the bankruptcy petition is filed); *In re* Rathe, 114 B.R. 253 (Bankr. D. Idaho 1990).

> As authorized by § 1322(b)(5), the plans essentially split each of respondent's secured claims into two separate claims - the underlying debt and the arrearages. While payments of principal and interest on the underlying debts were simply 'maintained' according to the terms of the mortgage documents during the pendency of petitioners' cases, each plan treated the arrearages as a distinct claim to be paid off within the life of the plan pursuant to repayment schedules established by the plans.[218]

Although cure plans have been part of Chapter 13 practice since the Bankruptcy Code's enactment in 1978, mortgage creditors continue to struggle with the application of payments in a manner which the law requires. The problem is that mortgage creditors persist in treating timely payments received after a bankruptcy is filed as if they were late. This occurs because of the industry practice outside of bankruptcy of crediting payments received to the oldest outstanding installment due. Incredibly, despite the extreme complexity and sophistication of software systems that have been developed to deal with servicers' normal operations, no automated system is apparently available commercially to deal with the bifurcated payment application requirements of Chapter 13 cases. While servicers attempt to manually override their automated systems, it is unrealistic to expect that this can be done regularly without error every month for the three to five years of the plan.

What this means for consumer debtors is additional costs in the form of unauthorized fees. As payments are deemed late or insufficient, the automated systems treat payments as unapplied and divert them to suspense accounts, impose late fees and additional interest charges, and order property inspections and other default related services.[219] Legal fees are imposed on debtors for groundless stay relief motions, typically without disclosure to the debtor or court approval. In *In re Jones*,[220] for example, it was discovered after the court had approved a refinancing of the debtor's mortgage that the mortgage creditor had collected an additional $24,450 in unlawful postpetition fees and interest charges at the closing because of payment application errors and other servicing errors during the chapter 13 case. Cases such as *In re Jones* demonstrate clearly that the industry-wide failure of servicers to properly apply payments in Chapter 13 is unfair and causes substantial injury to consumer debtors.

This breakdown of the servicing system also results in debtors often not being notified of interest rate adjustments on adjustable rate mortgages or payment changes on escrow accounts. It is not uncommon for debtors who successfully complete their chapter 13 plans to receive a bill for thousands of dollars of previously undisclosed improper fees once they emerge from bankruptcy. For example, in *In re Dominique*,[221] the servicer failed to send escrow account statements during the

---

[218] Rake v. Wade, 508 U.S. 464, 473 (1993). Although the holding in *Rake v. Wade* with respect to the payment of interest on arrears was superceded by the enactment of § 1322(c), the Supreme Court's description of the typical chapter 13 cure plan remains accurate.

[219] In *In re* Nosek, 363 B.R. 643 (Bankr.D.Mass. 2007), the bankruptcy court awarded under § 105(a) $250,000 in actual damages to the debtor for her emotional distress and $500,000 in punitive damages based on the servicer's violation of § 1322 by diverting plan payments to a suspense account. In reversing this judgment, the First Circuit held that sanctions could not be imposed on the servicer for misapplication of plan and mortgage payments because the debtor's plan failed to specify how payments were to be applied. *See In re* Nosek, 544 F.3d 34 (1st Cir. 2008).

[220] 366 B.R. 584 (Bankr.E.D.La. 2007).

[221] 368 B.R. 913 (Bankr.S.D.Fla. 2007).

chapter 13 plan and just before plan completion, provided debtors with an escrow account review showing that a $6,397 escrow deficiency was owed.

Cases such as *In re Jones* and *In re Dominique* demonstrate clearly that the industry-wide failure of servicers to properly apply payments in Chapter 13 is unfair and causes substantial injury to consumer debtors. The failure of servicers to have automated systems to address this problem all but guarantees that the practice will harm a large number of consumers in the 300,000 to 500,000 Chapter 13 cases filed annually.[222] An FTC rule declaring the practice unfair and deceptive may prompt the industry to finally address the problem by making modifications to servicing systems such as the widely used mortgage service platform (MSP) within the LPS case management system.[223]

In addition to unauthorized charges directly resulting from the payment misapplication, the practice can cause debtors to incur additional legal costs in responding to groundless motions to dismiss or convert Chapter 13 cases, or to obtain relief from the automatic stay. In many cases, the payment misapplication problems simply go undetected, but nevertheless cause the debtor's Chapter 13 case to fail and potentially result in loss of the home.

Consumers can not reasonably avoid the injury caused by this practice since they do not have the ability to control or influence the payment application process. Once a consumer files a Chapter 13 case that seeks to cure a default, bankruptcy law determines the parties' rights and actions with respect to the mortgage cure and there are no different choices the consumer can make to avoid the injury. Mortgage holders and their servicers are charged with processing payments in accordance with the law.

**Charging of specific unnecessary or excessive fees in bankruptcy cases (e.g., duplicative attorneys' fees)**

*Proof of Claim and Bankruptcy Fees*

Consumer debtors in chapter 13 cases are routinely charged a "proof of claim fee" or "bankruptcy fee" in the range of $150 to $400.[224] This fee is incurred postpetition but prior to plan confirmation, and is generally treated as a legal fee included as part of the arrearage amount needed to cure a mortgage default.[225] It purportedly covers the initial set-up work of

[222] For the 12-month period ending June 30, 2003, there were 472,811 chapter 13 cases filed. The most recent statistics show that for the 12-month period ending June 30, 2008, there were 344,421 chapter 13 cases filed. See statistics on bankruptcy filings compiled by the Administrative Office of the U.S. Courts, available at http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm.

[223] Lender Processing Services, Inc., f/k/a Fidelity National Information Services, Inc.

[224] This is the general range of fees in current cases. In earlier cases generally before 2005, the more common proof of claim fee was approximately $150. *See, e.g.*, *In re* Marks, 2005 WL 4799326, (Bankr.W.D.La. Nov 30, 2005)(involving $150 proof of claim fee); *In re* Sheffield, 281 B.R. 24 (Bankr.S.D.Ala. 2000)(noting that $150 proof of claim fee routinely charged in all cases involving servicers that had entered into agreements with LOGS Financial Services)

[225] The question of whether bona fide legal fees may be charged to the borrower in a chapter 13 case turns on applicable nonbankruptcy law. If a mortgage holder's claim is secured by the debtor's principal residence, the consumer debtor's chapter 13 plan may not modify the rights of the holder of the secured claim.[225] Generally, then, a mortgage holder may include in its proof of claim for both prepetition and postpetition attorneys fees if they are reasonable and permitted under underlying mortgage documents and state law.

the law firm hired by the servicer when a borrower files chapter 13 and tasks related to the filing of a proof of claim in the bankruptcy case.[226] It may also include "monitoring" the case until plan confirmation. For example, America's Servicing Company (ASC) and Wells Fargo have agreements for Chapter 13 cases filed in Texas to pay a $250 fixed fee (plus an additional $150 fee for filing a fee application) to the Barrett Daffin law firm for the following "Claim Services:"

> Case set-up and review of petition, schedules, and statement of financial affairs; search for prior bankruptcy filings by this debtor; preparation and filing of a Notice of Appearance; preparation and filing of the Proof of Claim; review of the plan with regard to treatment of the Applicant's interest; and supervision of the case through confirmation.[227]

As the bankruptcy court noted in the Alabama class action cases discussed in the previous section, these fees have not always been charged to consumer debtors in bankruptcy cases. In fact, because much if not all of the work that the fee is charged for had previously been done in-house by servicers as part of their normal servicing operations, all expenses incurred for preparing proofs of claim were borne by servicers as general operating expenses in the same way that expenses are incurred for preparing escrow notices and collections notices sent by servicers.

At some point, however, some servicers began to charge these fees directly to consumer bankruptcy debtors. In apparent response to legal challenges that these fees were not authorized by the underlying mortgage documents if treated as an ordinary servicer cost of doing business,[228] servicers began to move the in-house claim filing functions to law firms. This outsourcing of proof of claim preparation has now become commonplace in the mortgage industry.

An initial question brought about by this change in practice is whether it is reasonable for mortgage servicers to retain counsel as a matter of course to perform this function in all chapter 13 cases. Some courts have held that the preparation of bankruptcy claims is a ministerial act for which no attorney fees should be charged to the debtor.[229] In disallowing a proof of claim fee, one court described the work as follows: "The information contained in a proof of claim generally comes from a creditor's file and is not legal in nature to the extent attorney involvement is required. The process generally requires filling in blanks on the form and attaching documentation."[230] Other courts have recognized that attorney involvement may be appropriate in particular cases or that a small fee may be permissible for

---

[226] *In re* Collins, 2009 WL 1607737 (Bankr.S.D.Tex. Jun 08, 2009)($250 fee charged for "initial set-up work included both internal administrative tasks and the filing of the initial proof of claim in each case").
[227] *In re* Rangel, 2009 WL 1531961 (Bankr.S.D.Tex. May 29, 2009).
[228] *E.g.*, Majchrowski v. Norwest Mortg., Inc., 6 F.Supp.2d 946 (N.D.Ill. 1998).
[229] *In re* Madison, 337 B.R. 99, 105 (Bankr.N.D. Miss. 2006)(no attorney fee should be allowed for preparation of proof of claim or for "additional legal services such as file setup, attorney review of loan documents, or attorney review of bankruptcy plan as those services are unnecessary for preparation and filing of a proof of claim, which is basically a mathematical computation"); *In re* Allen, 215 B.R. 503 (Bankr.N.D.Tex. 1997); *In re* Thomas, 186 B.R. 470 (Bankr.W.D.Mo. 1995); *In re* Banks, 31 B.R. 173 (Bankr.N.D.Ala. 1982); *In re* Cipriano, 8 B.R. 697 (Bankr.D.R.I. 1981).
[230] *In re* Marks, 2005 WL 4799326, *2-3 (Bankr.W.D.La. Nov 30, 2005).

services other than preparation of the claim performed by a law firm to facilitate the filing of accurate proofs of claim by mortgage servicers.[231]

The more significant question for the purposes of the Commission's rulemaking is whether servicers are engaging in unfair and deceptive practices by representing that these fees are legal fees when they are not. The recent case of *In re Taylor*[232] provides clear evidence that although proof of claim preparation has been outsourced to large national firms that purport to be law firms, the actual work is not performed by paralegals or other legal professionals, and it is not done under the supervision of an attorney.

As described in *Taylor*, the consumer debtor's mortgage servicer was HSBC Mortgage Corp, which uses the LPS case management system.[233] This system is commonly used in the servicing industry and includes the mortgage service platform (MSP). When a borrower files a chapter 13 bankruptcy, a program within MSP called NewTrak automatically refers the case to a national law firm, Moss Codilis LLP, based on the Default Services Agreement that HSBC has with LPS. Moss Codilis is the exclusive claims agent assigned to file proofs of claim for HSBC.[234]

Proofs of claim are prepared at Moss Codilis by two sets of "clerks." One set of clerks is assigned to verify the debtors' social security numbers and loan numbers. The other set of clerks prepares the claim based on information on NewTrak. The clerks are not legally trained and are not paralegals. According to the testimony in *Taylor*, these clerks "were not legally trained, i.e., paralegals, but were experienced in this task from having worked for mortgage companies."[235]

The proof of claim process at Moss Codilis is overseen by a "Compliance Director," who is an attorney.[236] The Compliance Director's signature is electronically affixed to each proof of claim. However, this attorney reviews only a random sample of 10% of the filed claims. Despite the application of Bankruptcy Rule 9011 to proofs of claim, the evidence in *Taylor* suggests that 90% of the claims filed by HSBC are not prepared or reviewed by a Moss Codilis attorney.[237] None of the claims are reviewed by the HSBC representative before they are filed. The actual proof of claim filed in the *Taylor* case listed an incorrect mortgage payment amount and attached an incorrect mortgage note.

The evidence in *Taylor* makes clear that the proof of claim preparation process at Moss Codilis does not involve the practice of law. The work is done by clerks whose experience was obtained from having previously worked at mortgage servicing companies. Unlike the traditional law firm model, the work is not done by trained non-attorney legal professionals under the supervision of an attorney. By adding an attorney signature to the proof of claim, even though the attorney has not personally reviewed or supervised the preparation of the

---

[231] *In re* Madison, 337 B.R. 99, 105 (Bankr.N.D. Miss. 2006).
[232] *In re* Taylor, 2009 WL 1885888 (Bankr.E.D.Pa. Apr 15, 2009).
[233] Lender Processing Services, Inc., f/k/a Fidelity National Information Services, Inc.
[234] *Taylor* at *3.
[235] *See Taylor*, at *3, n. 13.
[236] The "Compliance Director" reports to the CEO of Moss Codilis, who is not an attorney. *See Taylor*, at *3, n. 12.
[237] *See Taylor*, at *3-4.

vast majority of filed claims, mortgage servicers and the law firms that participate in these outsourcing systems falsely create the impression in the bankruptcy system that the fees charged to consumer debtors represent the provision of legal services and are therefore recoverable against the borrower under the fee shifting provisions of the mortgage documents. As the case law reflects, and perhaps as a result of this deceptive practice, proof of claim and bankruptcy fees are routinely treated by bankruptcy courts as attorney fees.[238]

This practice is unfair and deceptive because consumer debtors, trustees and bankruptcy courts are wrongly induced into believing that proof of claim fees are reasonable and appropriate as recoverable attorneys fees, and are therefore not subject to challenge. If the true nature of the fees is clearly disclosed, debtors and trustees would be more likely to file objections to such fees. Bankruptcy courts would be loathe to approve proof of claim fees assumed to be attorney fees upon learning that the fees actually represent little or no provision of legal services. With the proper information, it might well be expected that a bankruptcy court would reduce a $250 proof of claim fee to $50 (or some proportional reduction to reflect the actual legal services provided).

The apparent purpose for charging proof of claim and bankruptcy fees is to shift expenses previously borne by servicers themselves to borrowers.[239] The subterfuge created by falsely labeling these fees as attorney fees furthers this goal by permitting these fees to avoid court scrutiny. As such, this unfair and deceptive practice causes substantial monetary injury to consumer debtors. Proof of claim fees are routinely charged to debtors in Chapter 13 cases and most if not all of the major national servicers now outsource to national "law firms" the preparation and filing of bankruptcy claims. Even if falsely labeled proof of claim fees are charged in only one-half of the cases filed annually (approximately 175,000 cases), and assuming these fees would be allowed in a reduced amount of $50 rather than $250 as in the example above, consumer debtors under this projection are being overcharged by approximately $35 million per year.

The harm from this practice is not outweighed by benefits to consumers or competition. The charging of unauthorized, unnecessary, or excessive fees provides no benefit to consumers. In Chapter 13 cases, it places additional financial burdens on consumers who are struggling to satisfy required plan obligations. Moreover, by favoring one creditor with unauthorized payments, the practice violates the fair distribution scheme among creditors in bankruptcy and is therefore harmful to competition.

Consumers are not reasonably able to avoid the injury caused by this practice because servicers control the claim filing process and make independent choices about what services

---

[238] *See, e.g.*, *In re* Rangel, 2009 WL 1531961 (Bankr.S.D.Tex. May 29, 2009); *In re* Madison, 337 B.R. 99, 105 (Bankr.N.D. Miss. 2006); *In re* Allen, 215 B.R. 503 (Bankr.N.D.Tex. 1997); *In re* Thomas, 186 B.R. 470 (Bankr.W.D.Mo. 1995).

[239] For mortgages loans held by a securitized trust, servicers also benefit by being able to recover out-of-pocket expenses from investors under the terms of applicable pooling and servicing agreements, whereas they are not permitted to do so if the expense is part of the servicer's general overhead and labor costs. *See* Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities* 17 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008-46).

are outsourced or referred to counsel. Once a consumer files a Chapter 13 case that seeks to cure a default, there are no different choices the consumer can make to avoid the injury.

The Commission should prohibit as an unfair and deceptive practice the charging or assessing of any fee to consumer debtors that is falsely represented as a fee for legal services provided. All fees for which a servicer seeks recovery against the debtor or the debtor's property in a bankruptcy case should be clearly labeled to indicate whether the fee represents a charge for legal services provided to the servicer, and the claim, pleading, or application should describe the legal services that have been provided.[240]

*Property Preservation Fees*

Upon the filing of a Chapter 13 petition, a consumer's property and financial affairs are subject to the control and supervision of the bankruptcy court. The debtor must file his or her plan with the court within 15 days after the case filing.[241] The debtor must immediately begin making payments under his or her proposed plan, within 30 days after the case is filed.[242] All Chapter 13 cases are assigned a trustee to oversee the case, review the plan, and make disbursements to creditors. In many districts, even the ongoing postpetition mortgage payments are disbursed by the trustee. Courts are also required to conduct hearings on confirmation promptly after the case is filed, within 20 to 45 days after the meeting of creditors.[243] If the debtor falls behind on plan payments, the trustee will file a motion seeking to have the case dismissed or converted to Chapter 7.

Bankruptcy Code section 1322(b)(2) ensures that a mortgage holder's rights are fully protected in a bankruptcy proceeding. Any challenge to the holder's status or lien rights would require the filing of an adversary proceeding or other proceeding in which it would be notified with appropriate service of process.[244]

For the reasons discussed in the servicing section above, the Commission should adopt a rule declaring that it shall be an unfair or deceptive practice to charge the borrower or assess to the borrower's mortgage account property preservation fees which are not actually incurred, necessary and reasonable. Because of the highly supervised nature of Chapter 13 bankruptcy proceedings, the Commission should also consider additional restrictions before such fees may be imposed on a consumer debtor in a Chapter 13 case. If the debtor is making payments under a confirmed chapter 13 plan, the mortgage holder's property interest and rights under the security agreement are protected and there should be no need for a servicer to conduct property inspections and BPOs. Thus, servicers should not be permitted to charge consumer debtors for property inspections and BPOs in chapter 13 cases. If a servicer has reason to believe that the holder's property interest and rights are affected, the servicer should be required to obtain bankruptcy court approval before incurring property preservation fees if they are to be charged to the debtor.

[240] While the problems of outsourcing have been exposed in bankruptcy cases, they exist outside bankruptcy as well. The Commission may wish to consider adopting a rule on this issue with broad application to all servicer fees charged for legal services.
[241] Fed. R. Bankr. P. 1007(c).
[242] 11 U.S.C. § 1326(a).
[243] 11 U.S.C. § 1324.
[244] Fed. R. Bankr. P. 7004.

For all property preservation fees charged to borrowers, whether or not the borrower is in a bankruptcy proceeding, the Commission should also prohibit as an unfair or deceptive practice the charging of such fees to borrowers if they have not been first reviewed by a live person employed by the servicer. The evidence in *In re Stewart*[245] established that the widely used mortgage service platform (MSP) within the LPS case management system automatically orders a property inspection if certain conditions are triggered within the software based on investor guidelines and the mortgage loan terms. The MSP program automatically generates a work order for the property inspection, permits the vendor who conducts the inspection to upload the report to the system, generates a check to the vendor, and charges the borrower's account. All of this is done without any human intervention or review.

In *Stewart*, several property inspections were apparently done on the wrong property (14 describe Ms. Stewart's home as a brick structure, while 16 describe it as frame structure). If some human intervention were required before property preservation fees are charged to borrowers, perhaps Ms. Stewart would not have been charged for more than half of these fees.

**Filing of proofs of claim or other bankruptcy filings without a reasonable basis (i.e., impose a substantiation requirement beyond Rule 11 of the Federal Rules of Civil Procedure)**

Problems with the filing of incomplete and inaccurate proofs of claim have been well documented in the bankruptcy system.[246] As described in the *Taylor* case discussed above, the filing of proofs of claim signed by an attorney in which only 10% of the claims are actually reviewed raises serious ethical concerns. The *Taylor* court correctly concluded that the attorney had failed to make reasonable inquiry before signing the proof of claim filed in the case, as required by Bankruptcy Rule 9011.[247]

In many respects, problems with the filing of groundless stay relief motions are more acute. It is increasingly common for mortgage servicers to make errors in crediting bankruptcy debtors' payments in chapter 13 cases, and to file motions for relief when a debtor is actually current with postpetition payments. One bankruptcy judge in *In re Gorshtein*[248] could no longer tolerate the "computer did it" defense so often raised in these cases and decided to send a message to servicers and their attorneys appearing in his court that they better get the facts straight before filing stay relief motions.

The *Gorshtein* court described the problem as follows. Countless motions for relief are filed in bankruptcy courts throughout the nation and most often they are not contested. Since institutional servicers with computerized accounting systems can be expected to complete the relatively simple task of applying a debtor's payments without mistake, it is generally more expeditious and cost effective to simply require motions based on attorney

[245] 391 B.R. 327, 336 (Bankr.E.D.La. 2008).
[246] Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Texas L. Rev. 121 (2008).
[247] *In re* Taylor, 2009 WL 1885888, *20 (Bankr.E.D.Pa. Apr 15, 2009).
[248] *In re* Gorshtein, 285 B.R. 118 (Bankr.S.D.N.Y. 2002).

submissions of the facts rather than a creditor affidavit based on personal knowledge. And since such motions in many courts are resolved without hearing if not objected to, and many debtors are *pro se* or no longer have attorneys representing them on stay relief motions, the court must rely upon the integrity of the servicer's written submissions in granting relief. As a result, the *Gorshtein* court expressed its grave concern that "the system and debtors served by it are seriously at risk in cases where a lift stay motion is based on an allegation of material post-petition default where none exists."[249] Debtors may lose their homes and other creditors may lose equity in foreclosure.

Two of the three cases reviewed by Judge Hardin in *Gorshtein* involved explanations by the servicers for their mistakes that the court described as of the "dog ate my homework" variety. In one case, the servicer obtained insurance on the property, apparently force placed, for a policy coverage amount of $1 million rather than $100,000, resulting in a premium of $10,368. This caused the servicer to increase the debtor's postpetition mortgage payment by approximately $1,000 per month and mistakenly treat the account in default.

In the second case, the servicer's Bankruptcy Specialist ultimately confirmed that the debtor was current with postpetition payments only after explaining that the problem was caused by an accounting system which was set up to apply only "full" payments. The debtor had submitted her postpetition payments using several money orders for each monthly payment, most likely because of amount limitations imposed by the money order vendor. Since the servicer's accounting system looked only for full payments and could not deal with two split payments totaling the full amount, it treated the payments as partial payments and diverted them to the debtor's suspense account.

The *Gorshtein* court noted that good faith mistakes generally do not result in sanctions being imposed under section 105 of the Code or Bankruptcy Rule 9011.[250] However, the court was obviously frustrated by the servicers' conduct in these cases and concluded that it did not fall within the safe harbor for good faith mistakes. What seemed to tip the balance was that the documentary evidence proving that the debtors were current with their payments was right in the servicers' own files, and could have been discovered upon reasonable investigation. In imposing sanctions on the servicers, the court stated:

> Whether the cause of the false certification should be labeled intent to deceive, gross negligence, incompetence or mere inadvertence is indeterminable and, in any event, really does not matter. It does not matter because the result is the same for the debtor and the judicial process, which will be victimized by the misstatement if for any reason the debtor fails to respond timely to a baseless motion. The integrity of the judicial process is undermined when the court is asked to grant substantive relief based on a certification of purported fact which is contradicted by the movant's own records. In such cases, sanctions are warranted.[251]

---

[249] Gorshtein, 285 B.R. at 121.

[250] Bankruptcy Rule 9011 has been held to apply to a servicer even if it has not signed a pleading or document filed with the court. In *In re Kilgore*, 253 B.R. 179 (Bankr.D.S.C. 2000), the mortgage servicer's actions in providing its counsel with incorrect information that led to the filing of the motion for relief and foreclosure action were found to warrant an award of sanctions.

[251] Gorshtein, 285 B.R. at 126.

More recent cases reveal problems that go well beyond servicer and attorney incompetence. These cases all involve the problems stemming from the separation of functions between national default service firms and the local firms that are part of a national network of law firms. In *In Re Rivera*,[252] the local firm retained to file stay relief motions admitted that it had engaged in the regular and long term use of "pre-signed" certifications in support of stay relief motions. At least 251 certifications had been filed after the signatory on the certifications no longer worked for the "default servicer" the firm was representing. The *Rivera* court noted that the practice was embedded in the local firm's procedures, and young staff members were trained in the use of pre-signed documents.

In *In re Parsley*,[253] the court described in detail the relationship between mortgage servicers and the national and local firms used to file motions for relief. The national firm in *Parley* retained the local firm to file a motion for relief which contained inaccuracies regarding the arrears on the account. Significantly, the national firm's engagement letter with the local firm specifically prohibited any communication between the local firm and the servicer, who is the movant on the motion and purportedly the local firm's client. In other words, the arrangement between the national and local firms prohibited the local firm from communicating directly with its own client. Another court has described the role of local counsel as "dutiful scribes."[254]

It was also revealed that the National Firm, through a separate entity employing 300-350 legal assistants, prepares "simplified" loan histories that are provided to the local firm for use in prosecuting stay relief motions.[255] However, no attorney for the national firm ever reviews these histories for accuracy before they are provided to the local firm. The court described the problem as follows:

> Tracing the steps leading up to the filing of the Motion shows that this is an assembly line process. There are attorneys involved throughout this process that should be catching these errors. However, the attorneys do not dedicate sufficient time and care to ensure adequate quality control.

The court in *Parsley* also commented on why mortgage servicers seem to prefer this model in which they are potentially able to disavow responsibility for errors. The court noted that servicers'"attitude is that once it has referred the file to national counsel, it does not want to be bothered with any details about the pleadings and proceedings which follow."

The unfair and abusive practices discussed in these cases that flow from the way in which legal work is handled on behalf of mortgage servicers calls out for Commission action. While bankruptcy courts can regulate these practices when brought to their attention based on their authority under Code section 105 and Bankruptcy Rule 9011, the problems are systemic and require that more broad-based steps be taken. The Commission should

---

[252] 342 B.R. 435 (Bankr. D.N.J. 2006).
[253] 384 B.R. 138 (Bankr. S.D. Tex. 2008).
[254] *See In re* Stewart, 391 B.R. 327 (Bankr.E.D.La. 2008).
[255] The legal assistants do a "cut and paste" job using the servicer's loan history.

prohibit as unfair or deceptive any contracts of engagement between mortgage servicers, default service providers, and law firms that prevent law firms and their attorneys from fulfilling their ethical obligations to their clients and the courts, or which impede the attorney-client relationship.

***<u>Question 22 – Recent Reports and Research Supporting Mortgage Servicing Rulemaking</u>***

Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 and 2008 Remittance Reports*, Fordham Urban L. J. (forthcoming 2009).

Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston Public Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf.

Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Modification Contracts,* Conn. L. Rev. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325534.

Michael Laidlaw, Stephanie Whited, Mary Kelsch, Fitch Ratings, U.S. Residential Mortgage Servicer Bankruptcies, Defaults, Terminations, and Transfers 2 (2007).

Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities* (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008-46).

John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification: Preliminary Results and Implications* (Berkeley Ctr. for Law, Business, and the Economy, Mar. 35, 2009), *available at* http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.25.09.pdf.

Diane Pendley, Kathleen Tillwitz, Karen Eissner, Thomas Crowe, Stephanie Whited, Fitch Ratings, Rating U.S. Residential Mortgage Servicers (2006).

Anthony Pennington-Cross & Giang Ho, *Loan Servicer Heterogeneity & The Termination of Subprime Mortgages* (Fed. Res. Bank of St. Louis Working Paper No. 2006-024A).

Michael A. Stegman, Roberto G. Quercia, Janneke Ratcliffe, Lei Ding, & Walter R. Davis, *Preventive Servicing Is Good for Business and Affordable Homeownership Policy,* 18 Housing Policy Debate 243, 270-273 (2007).

Michael Guttierez, Michael S. Merriam, Richard Koch, Mark I. Goldberg, Standard & Poors, Structured Finance: Servicer Evaluations (2004).

Tomasz Piskorski, Amit Seru & Vikrant Vig, Securitization and Distressed Loan Renegotiation: Evidence From the Subprime Mortgage Crisis (Dec. 2008), at 18, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646.

Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008).

Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims,* 87 Tex. L. Rev. 121 (2008).

## V. Conclusion

We commend the Commission on setting out an ambitious scope of work in connection with this rulemaking. We urge the Commission to act, and to issue rules affecting originators, assignees and servicers that address the core problems that have brought on this foreclosure crisis, and that have made it difficult to overcome. Well-crafted rules targeting abuses will not restrain credit; they simply will allow affordable, fair credit to flourish, rather than being crowded out by the race to the bottom.

Today's foreclosure crisis is cause for bold action. To date, measures to prevent future predatory lending have been tabled, and mortgage servicing reform has been sidetracked by voluntary programs that so far have produced few results. The Commission can play a significant role in steering the market toward a future where lender, servicer and investor interests are aligned with those of consumers. We urge you to take up that challenge.

# Appendix A

## APPENDIX A

### Ms. Nessia Jones

Nessia Jones is a 56-year old African American who has lived in her home in Decatur, Georgia for 28 years. Ms. Jones has received Social Security widow's and/or disability benefits since 1988. Her mental and physical health is poor and requires an extensive medication regime. Ms. Jones's adult daughter who lives with her has been disabled since an infant, is profoundly mentally retarded, and suffers from seizures. In 2006, GreenPoint Mortgage Funding made her two mortgage loans that should never have been made.

**Loan Summary**

| | |
|---|---|
| Lender | GreenPoint Mortgage Funding, GreenPoint Mortgage Funding |
| Loan date | October 31, 2006<br>October 31, 2006 |
| Principal | $120,700.00<br>$30,100.00 HELOC |
| Interest rate | 8.625% fixed<br>13.25% ARM |
| APR | 9.168%<br>NA |
| Term | 30 years<br>15 years |
| Monthly payment | $938.79 P&I only<br>$327.80 interest only |
| Escrow | None<br>None |
| LTV | 80%<br>100% |

**Ability to pay:** Ms. Jones's monthly income at closing was $633 in Social Security. The combined monthly mortgage payments ($1,266.59) were 200% of her monthly income.

**Income verification:** The loan application stated Ms. Jones was not employed, received Social Security disability benefits, and that her income was $3,950 in employment income. The information on the loan application was obviously inconsistent and falsified. No one receives Social Security benefits in that amount. (The average monthly Social Security benefit for disabled workers in 2006 was $947. The maximum retirement benefit was only $2,053.) The lender's loan files did not include any documentation of her income. GreenPoint apparently made these mortgages based on the value of the home ($150,900 per GreenPoint's appraisal), not her ability to pay.

**Coverage and effect of FRB rules:** The second mortgage would not have been prohibited as it was a HELOC. The first mortgage would be considered a "higher priced loan."

**Status:** A demand letter was sent June 18, 2007. GreenPoint denies liability. Litigation is pending in the U.S. Bankruptcy Court, Northern District of Georgia.

Appendix B

# APPENDIX B

## Ms. Avonia Carson

Avonia Carson is a 68-year-old African American. She has lived in her home in southeast Atlanta since 1971. Her adult son, who had lived with her since 2001 after an accident that rendered him blind and in need of 24-hour care, recently moved into a personal care home. Ms. Carson has custody of her four-year-old great-granddaughter, for whom she has been caring since birth. Ms. Carson is on a fixed monthly income of $1,233.00 from Social Security. In 2006, Wachovia Bank made her a mortgage loan she could not possibly afford. Five months later, JPMorgan Chase Bank made her a second mortgage she had no way of paying.

JPMorgan Chase Bank made her a second mortgage she had no way of paying.

**Loan Summary:**

| | |
|---|---|
| Lender | Wachovia Bank, NA<br>JPMorgan Chase |
| Loan date | June 12, 2006<br>November 17, 2006 |
| Principal | $135,293.00<br>$30,000.00 |
| Interest rate | 6.87% fixed<br>8.55% ARM |
| APR | 6.97%<br>8.547% |
| Term | 30 years<br>10 years |
| Monthly payment | $892.69 P&I only<br>$372.80 P&I only |
| Escrow | None<br>None |
| LTV | 81%<br>99% |

**Ability to pay:** Both Wachovia and Chase made mortgage loans without regard to Ms. Carson's ability to pay. At the time of each closing, Ms. Carson's monthly income was about $1,135. The debt-to-income ratio (not including an escrow) in the first mortgage was 79%. When the first and second mortgage payments were combined ($1,265.49), the debt-to-income ratio was 112%.

**Income verification:** Neither Wachovia nor Chase had a loan application or any documentation of Ms. Carson's income in the respective loan files. Wachovia apparently extended the first mortgage based on the value of the home ($167,000 per Wachovia's appraisal), not her ability to pay.

**<u>Coverage</u>:** Neither loan would be covered by the HOEPA rules because the APRs for both the first and second mortgages fall below the trigger for "higher priced loans."

**<u>Status</u>:** A demand letter was sent to Wachovia December 13, 2007. Wachovia stopped its foreclosure scheduled for January 2, 2008, but states its actions regarding the loan were proper and lawful. The parties have been in settlement negotiations, but the matter remains pending. The claims against Chase have been settled.

Appendix C

## APPENDIX C

### Ms. Mary Overton

Mary Overton is an elderly African-American widow who has owned her Brooklyn home since 1983. Although she suffers from serious health ailments that limit her mobility and practically confine her to the ground floor of her home, she manages to care for her teenage grandson, who lives with her. Ms. Overton did not finish high school and has difficulty understanding numbers.

In mid-2005, Ms. Overton met with representatives of Ameriquest Mortgage Company and explained that she needed a reverse mortgage so that she could make repairs to her home. At the time, Ms. Overton lived on a fixed income of $825 per month and did not have any debt on her home. Ameriquest led her to believe that she was signing a reverse mortgage, but instead gave her a 2/28 loan with initial monthly payments that were nearly three times her income.

In order to make it appear that she could afford the loan, Ameriquest employees created a fake set of financial documents to include in her loan file, including fake tax returns, a fake 401(k), a fake employment statement showing that she sold makeup for Avon, and a fake lease agreement.

**Loan Summary:**

| | |
|---|---|
| Lender: | Ameriquest Mortgage Company |
| Loan Date: | May 9, 2005 |
| Principal: | $285,000 |
| Term: | 30 years |
| Loan Type: | 2/28 |
| Interest Rate: | Initial rate of 8.99%; LIBOR + 6.75% |
| Initial monthly payments: | $2,291 (principal & interest only) |
| APR: | 10.453% |
| LTV: | 50% |

**Status:** Ms. Overton reached a confidential settlement with Ameriquest in August 2007.

Appendix D

# APPENDIX D

## Ms. Josephine Reese

Josephine Reese is a 57-year-old African-American who has resided in her home in southwest Atlanta for 27 years. Ms. Reese is both mentally and physically disabled. She and her now 17-year-old son struggle financially. Her fixed monthly income is comprised of $1,434 from Social Security disability and a disability pension. On October 13, 2006, Wachovia Bank extended two mortgage loans to her that she could never afford.

**Loan Summary**

| | |
|---|---|
| Lender | Wachovia Bank<br>Wachovia Bank |
| Loan date | October 13, 2006<br>October 13, 2006 |
| Principal | $88,256.00 |
| HELOC | $12,900.00 |
| Term | 40 years<br>15 years, respectively |
| Interest rate | 6.62% fixed<br>9.5% initially, 18% cap |
| APR | 6.78%<br>NA |
| Monthly payment | $778.18 P&I only<br>* |
| LTV | 70%<br>80% |
| Escrow | None<br>None |

* No funds were advanced at closing.

**Lending Without Regard to Ability to Pay:** Wachovia made both mortgage loans without regard to Ms. Reese's ability to pay. Ms. Reese's monthly income then was $1,384. The first mortgage payment alone of $778.18 (not including an escrow) comprised 56% of her monthly income.

**Direct Knowledge of Inability to Pay Based on Income Documentation:** Although Wachovia's loan file contains no loan application, Wachovia documented her income for its loan file with a printout of Ms. Reese's Wachovia checking account history for the previous six weeks (showing direct deposits of her Social Security and pension checks). Wachovia apparently made these loans based on the value of her home ($126,000 according to the Wachovia loan officer), not her ability to pay.

**Coverage:** Neither loan is within the scope of the HOEPA rules. The APR of the first mortgage falls below the trigger for "higher priced loans." The second mortgage would be excluded because it is a home equity line of credit.

**Status:** Ms. Reese fell behind on the mortgage payments. Ms. Reese's legal aid attorney sent a demand letter to Wachovia on November 16, 2007. Wachovia has denied her claims. Litigation is pending in the U.S. District Court, Northern District of Georgia.

Appendix E

## APPENDIX E

## MS. OAKERETA WILLIAMS

Oakereta Williams is a 73-year-old woman who lives in Brooklyn with her 17-year-old grandson. She has owned her home since 1959. She never finished high school and is financially unsophisticated. Before retiring, she held a variety of jobs, including salesperson, laundry hand presser, and babysitter.

On February 28, 2005, Ms. Williams refinanced her home for $335,000 with Delta Funding Corp. in order to make home repairs. At the time of the mortgage, Ms. Williams's income consisted of $709 in social security, $1,600 in rental income for two rental units in her home, and $277 in welfare payments for her grandson, which terminated several months later when her grandson turned eighteen.

**Loan Summary:**

| | |
|---|---|
| Lender: | Delta Funding Corp. |
| Loan Date: | February 28, 2005 |
| Principal: | $335,000 |
| Term: | 30 years |
| Interest rate: | 6.24% fixed |
| APR: | 6.42% |
| Monthly payments: | $2,060.47 |
| LTV: | 64% |

**Ability to Pay:** The mortgage was unaffordable on its face. With taxes and insurance included, the mortgage created a debt-to-income ratio for Ms. Williams of 88% and left her with $300 in residual income. When the welfare payments for Ms. Williams's grandson ceased, the debt-to-income ratio rose to 99%, leaving Ms. Williams with about $25 in residual income for all household and living expenses. Ms. Williams had substantial equity in her home. At the time of the loan, her house was appraised at $525,000.

**Coverage:** Ms. Williams's loan would not have violated the HOEPA rules because the APR falls below the trigger for "higher priced loans."

**Status:** In 2006, HSBC Bank, as trustee, initiated foreclosure proceedings against Ms. Williams. Ms. Williams filed a third-party complaint against Delta and others. Delta recently filed for bankruptcy.

Appendix F
Ocwen Loan Servicing Loan Modification Agreement dated June 1, 2009 (seeking waiver of all legal rights by homeowner).

Ocwen Loan Servicing, LLC
P.O.Box 785052
Orlando, Florida 32878



June 1, 2009

Loan Number: [redacted]
Property Address: [redacted]

## PROPOSED MODIFICATION AGREEMENT

Dear Borrower(s):

Enclosed please find a proposed modification agreement (the "Agreement") on your loan referenced above for your review and consideration.

In order to accept this modification on your loan, you must complete ALL of the following steps **on or before** June 12, 2009, ("Due Date"):

1. **SIGN** the bottom of the Agreement on the line(s) for the Borrower(s);
2. **FAX** the fully executed Agreement to: Attention: Home Retention Department (407) 737-5693
3. **PAY** the full down payment in the amount of: $1,281.00 [*See Payment Instructions Attached*]
4. **NEW MONTHLY PAYMENT:** $737.82 **(which may or may not include escrow)** starting on July 1, 2009.
5. **SEND** proof of insurance coverage* (Send proof of insurance ONLY to Escrow Dept. DO NOT include the Agreement.) Attention: Escrow Department Fax: 1-888-882-1816 E-mail:dateinsuranceinfo@ocwen.com

* Proof of insurance and the Agreement must be sent separately to the correct departments using the fax numbers provided above. Failure to send proof of insurance coverage before the Due Date will constitute acceptance of a force placed policy and agreement to pay the costs of such force placed policy, so long as all other items are complete.

Time is of the essence on this offer. If ALL of the items above are not completed by the Due Date, the Agreement shall have no force or effect and any down payment received will be returned to you. Please be advised that Ocwen Loan Servicing, LLC will not delay, postpone or otherwise stop any collection efforts until ALL of the steps above have been completed.

If you have any questions or require additional information, please contact the Home Retention Department directly at (877) 596-8580.

Sincerely,

Ocwen Loan Servicing, LLC

6348635

Ocwen Loan Servicing, LLC
P.O.Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

## PAYMENT REMITTANCE INFORMATION

**PLEASE DON'T FORGET TO:**

1. Make checks payable to Ocwen Loan Servicing, LLC.
2. Always include your loan number with your payment.
3. The down payment must be in the form of certified funds.

**OVERNIGHT DELIVERY**
**(Money Order & Certified Checks Only)**
OCWEN LOAN SERVICING, LLC
ATTN: CASHIERING DEPARTMENT
12650 INGENUITY DRIVE
ORLANDO, FL 32826

**MONEY GRAM**
**RECEIVER CODE:**
**PAYABLE TO:** OCWEN LOAN SERVICING, LLC
**CITY:** ORLANDO
**STATE:** FLORIDA
**REFERENCE:** [redacted]
**AGENT LOCATER:** (800) 926-9400

**BY WUQC**
**Code City:** Ocwen
**State:** FL
**Reference:** Loan #
**Attn:** Home Retention Department,
Home Retention Consultant

**BANK WIRE**
**BANK:** JPMorgan Chase Bank, NA
**ABA:**
**ACCOUNT NAME:** Ocwen Financial Corporation
**ACCOUNT NUMBER:**
**REFERENCE:** Loan Number, Property Address, and Borrower Name

Email: Transferfunds@ocwen.com with the details of the wire.

## LOAN MODIFICATION AGREEMENT

Ocwen Loan Servicing, LLC ("Ocwen") is offering you this Loan Modification Agreement ("Agreement"), dated June 1, 2009, which modifies the terms of your home loan obligations as described in detail below:

A. the Mortgage, Deed of Trust, or Security Deed (the "Mortgage"), dated and recorded in the public records of CLAY County, and

B. the Note, of the same date and secured by the Mortgage, which covers the real and personal property described in the Mortgage and defined therein as the "Property", located at [redacted]

Pursuant to our mutual agreement to modify your Note and Mortgage and in consideration of the promises, conditions, and terms set forth below, the parties agree as follows:

1. You agree that the new principal balance due under your modified Note and the Mortgage will be $125,056.60. Upon modification, your Note will become contractually current; however, fees and charges that were not included in this principal balance will be your responsibility.

2. You promise to make an initial down payment in the amount of $1,281.00 on or before June 12, 2009, after which you will commence payments of principal and interest in the amount of $555.87 beginning on July 1, 2009 and continuing on the same day of each succeeding month for a five (5) year period. At the end of this period, your payment is subject to change based on paragraph 4 below.

3. Any payments due for taxes and insurance will be your responsibility in addition to the payments of principal and interest required under the terms of this modification. If this loan is currently escrowed, Ocwen will continue to collect the escrow amounts with your monthly principal and interest payment.

4. Upon Modification, the annual rate of interest charged on the unpaid principal balance of your loan will be 4.42100%. This rate will remain in effect until the end of a five (5) year period beginning with your first payment after the down payment. At the end of this period, your interest rate will be calculated according to the terms of your original loan documentation.

6348635

5. You promise to make payments of principal and interest on the same day of each succeeding month until May 1, 2036, at which time a final balloon payment in an amount equal to all remaining amounts under the Note and Modification will be due.

6. You will comply with all other covenants, agreements, and requirements of your Mortgage, including without limitation, the covenants and agreements to make all payments of taxes, insurance premiums, assessments, escrow items, impounds, and all other payments that you are obligated to make under the Mortgage, except as otherwise provided herein.

7. If you sell your property, refinance, or otherwise payoff your loan during the 12 months following the date of Modification, the Modification will be voidable at the sole option of Ocwen and all amounts owed under the obligations existing prior to the Modification will be due and owing.

8. You understand and agree that:

   (a) All the rights and remedies, stipulations, and conditions contained in your Mortgage relating to default in the making of payments under the Mortgage will also apply to default in the making of the modified payments hereunder.

   (b) All covenants, agreements, stipulations, and conditions in your Note and Mortgage will remain in full force and effect, except as herein modified, and none of the your obligations or liabilities under your Note and Mortgage will be diminished or released by any provisions hereof, nor will this Agreement in any way impair, diminish, or affect any of Ocwen's rights under or remedies on your Note and Mortgage, whether such rights or remedies arise there under or by operation of law. Also, all rights of recourse to which Ocwen is presently entitled against any property or any other persons in any way obligated for, or liable on, your Note and Mortgage are expressly reserved by Ocwen.

   (c) Any expenses incurred in connection with the servicing of your loan, but not yet charged to your account as of the date of this Agreement, may be charged to your account after the date of this Agreement.

   (d) You have no right of set-off or counterclaim, or any defense to the obligations of your Note or Mortgage.

   (e) Nothing in this Agreement will be understood or construed to be a satisfaction or release in whole or in part of your Note and Mortgage.

   (f) You agree to make and execute such other documents or papers as may be necessary or required to effectuate the terms and conditions of this Agreement which, if approved and accepted by Ocwen, will bind and inure to your heirs, executors, administrators, and assigns.

   (g) You understand that this agreement is legally binding and that it affects your rights. You confirm that you have had the opportunity to obtain, independent legal counsel concerning this Agreement and are signing this Agreement voluntarily and with full understanding of its contents and meaning.

   (h) Corrections and Omissions. You agree to execute such other and further documents as may be reasonably necessary to consummate the transactions contemplated herein or to perfect the liens and security interests intended to secure the payment of the loan evidenced by the Note.

9. BY EXECUTING THIS MODIFICATION, YOU FOREVER IRREVOCABLY WAIVE AND RELINQUISH ANY CLAIMS, ACTIONS OR CAUSES OF ACTION, STATUTE OF LIMITATIONS OR OTHER DEFENSES, COUNTERCLAIMS OR SETOFFS OF ANY KIND WHICH EXIST AS OF THE DATE OF THIS MODIFICATION, WHETHER KNOWN OR UNKNOWN, WHICH YOU MAY NOW OR HEREAFTER ASSERT IN CONNECTION WITH THE MAKING, CLOSING, ADMINISTRATION, COLLECTION OR THE ENFORCEMENT BY OCWEN OF THE LOAN DOCUMENTS, THIS MODIFICATION OR ANY OTHER RELATED AGREEMENTS.

10. BY EXECUTING THIS MODIFICATION, YOU IRREVOCABLY WAIVE ALL RIGHTS TO A TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM ARISING OUT OF OR RELATING TO THIS MODIFICATION AND ANY RELATED AGREEMENTS OR DOCUMENTS OR TRANSACTIONS CONTEMPLATED IN THIS MODIFICATION.

____________________________ ____________________________

6348635

Ocwen Loan Servicing, LLC

By: ______________________________

Borrower: l

6348635

Appendix G
Aurora Loan Services "workout agreement" dated May 20, 2009 (seeking homeowner admission of default and stating that the trial payments will not remove the homeowner from delinquency).

Aurora • Loan Services

LMIT 0038261699

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

May 20, 2009

12C

3640038261699534LM22405-20-09

RE: Loan No.
Property Address:

Dear Customer(s):

Enclosed please find two copies of a Special Forbearance Agreement which has been prepared on your behalf. Please sign, date and return one copy to Aurora Loan Services and retain the second copy for your records.

You have been conditionally approved for this Special Forbearance Agreement as a result of the information that you provided to Aurora Loan Services. Your approval for the Special Forbearance Agreement is conditional upon Aurora Loan Services verifying the information that you provided.

Please execute the attached Special Forbearance Agreement and return it along with (1) the information requested in the enclosed package; (2) the completed financial statement; and (3) your initial payment in the amount of $870.41. This payment as well as the requested information must be received in our office on or before 06/01/2009.

To expedite processing of your Special Forbearance Agreement, please fax the signed Agreement to Aurora Loan Services at 866-517-7975, and remit the initial payment via Western Union Quick Collect. When sending funds via Western Union, please use the Code City: BLUFF, NE and always include your Aurora Loan Services loan number for prompt posting to your account. Any funds received after 5:00 p.m. ET will be posted the next business day.

Certified Funds should be made payable to Aurora Loan Services. Please include your Aurora Loan Services loan number on the certified funds and mail the funds separately to our Payment Processing Center at:

<u>Overnight Delivery Services</u>
Aurora Loan Services
Attn: Cashiering Dept.
10350 Park Meadows Drive
Littleton, CO 80124

or

<u>U.S. Postal Delivery Services</u>
Aurora Loan Services
Attn: Cashiering Dept.
P.O. Box 5180
Denver, CO 80217-5180

IMPORTANT INFORMATION ON PAGE 2

Aurora • Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No.



Please mail all correspondence, requested information and the executed agreement to our Servicing Center at:

| Overnight Delivery Services | or | U.S. Postal Delivery Services |
|---|---|---|
| Aurora Loan Services | | Aurora Loan Services |
| Attn: Home Retention | | Attn: Home Retention |
| 2617 College Park | | P.O. Box 1706 |
| Scottsbluff, NE 69361 | | Scottsbluff, NE 69363-1706 |

Not withstanding anything to the contrary contained in the Special Forbearance Agreement, the parties hereto acknowledge the effect of a discharge in bankruptcy that may have been granted to the Borrower(s) prior to the execution hereof and that the Lender may not pursue the Borrower(s) for personal liability. However, the parties acknowledge that the Lender retains certain rights, including but not limited to the right to foreclose its lien under appropriate circumstances. The parties agree that the consideration for this Agreement is Aurora Loan Services' forbearance from presently exercising its rights and pursuing its remedies under the Security Instrument as a result of the Borrower's default of its obligations there under. Nothing herein shall be construed to be an attempt to collect against the Borrower(s) personally or an attempt to revive personal liability.

Signing the attached documents in no way affects or eliminates any rights you have been given in this letter or any correspondence attached hereto.

If you have any questions, please contact one of our Home Retention Counselors at the address above or by calling 800-550-0509.

Sincerely,

Home Retention Group
Aurora Loan Services

Enclosure

Aurora Loan Services is a debt collector. Aurora Loan Services is attempting to collect a debt and any information obtained will be used for that purpose. However, if you are in bankruptcy or received a bankruptcy discharge of this debt, this communication is not an attempt to collect the debt against you personally, but is notice of a possible enforcement of the lien against the collateral property.

Aurora • Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

WORKOUT AGREEMENT

BY AND BETWEEN AURORA LOAN SERVICES

AND

Property Address:

Loan No.

This Workout Agreement is made May 20, 2009, by and between AURORA LOAN SERVICES ("Lender") located at 2617 College Park, Scottsbluff, NE 69361, and (individually and collectively, "Customer").

WHEREAS, Lender is the servicing agent and/or the owner and holder of a certain Note dated 06-14-06, executed and delivered by Customer, in the original principal amount of $ 256,000 (the "Note"). The Note is secured by a mortgage, deed of trust or comparable security instrument dated 06-14-06, (the "Security Instrument"), on the property located at the address specified above (the "Property"). The Note and Security Instrument are collectively referred to as the "Loan Documents".

WHEREAS, Customer is in default under the Loan Documents, has failed to make payment of monthly installments of principal, interest, and escrow, if any, and has incurred additional expenses authorized under the Loan Documents, resulting in a total arrearage now due of $ 30,515.07, as more particularly set forth below:

| | | |
|---|---|---|
| Unpaid monthly payment(s) of PITI* from 07-01-08 through and including 05-20-09 | $ | 25,906.65 |
| Accrued Late Charges | | 689.92 |
| NSF Charges | | .00 |
| Legal Fees | | 1,808.00 |
| Corporate Advances** | | 2,110.50 |
| Other Fees*** | | .00 |
| Minus Credit (suspense balance/partial payment) | | .00 |
| Total Amount Due (the "Arrearage") | $ | 30,515.07 |

* "PITI" means the monthly payment of principal, interest, and escrows, required, for taxes and insurance premium installments.

** "Corporate Advances" include, but are not limited to, property inspection fees, property preservation fees, legal fees, foreclosure fees and costs, appraisal fees, BPO (i.e. broker price opinion) fees, title report fees, recording fees, and subordination fees.

*** "Other Fees" include, but are not limited to, short payment advances and Speed ACH fees.

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. '



WHEREAS, as a result of Customer's default, Lender (i) has the right to accelerate, and to require Customer to make immediate payment in full, all of the sums owed under the Note and secured by the Security Instrument, (ii) has so accelerated and declared due in full all such sums, and (iii) may have already commenced foreclosure proceedings to sell the Property.

WHEREAS, as of the date of execution of the Agreement, Lender commenced Foreclosure proceedings to sell the property on 10/29/08 by legal filing in the county and state where the Property is located A Foreclosure sale has not yet been scheduled.

WHEREAS, customer has requested Lender's forbearance in exercising its rights and remedies under the default provisions of the Loan Documents and with regard to any foreclosure action that may now be pending.

WHEREAS, Customer has requested and Lender has agreed to allow Customer to repay the Arrearage pursuant to a loan work-out arrangement on the terms set forth herein.

NOW, THEREFORE, in consideration of the promises and mutual covenants herein contained, the parties hereto agree as follows:

1. Term. This Agreement shall expire on the "Expiration Date," as defined in Attachment A.

2. Lenders Forbearance. Lender shall forbear from exercising any or all of its rights and remedies now existing or arising during the term of this Agreement under the Loan Documents, provided there is no "Default", as such term is defined in paragraph 5.

3. Customer's Admissions. Customer admits that the Arrearage is correct and is currently owing under the Loan Documents, and represents, agrees and acknowledges that there are no defenses, offsets, or counterclaims of any nature whatsoever to any of the Loan Documents or any of the debt evidenced or secured thereby.

Customer admits and agrees that any and all postponements of a foreclosure sale, made during the term of this Agreement or in anticipation of this Agreement, are done by mutual consent of the Customer and Lender and that, to the extent allowed by applicable law, any such foreclosure sale may be postponed from time to time until the loan evidenced by the Note is fully reinstated or the foreclosure sale is consummated. Lender shall be under no obligation to dismiss a pending foreclosure proceeding until such time as all terms and conditions of this Agreement and Attachment A have been fully performed.

4. Terms of Workout. See Attachment A, which is made a part hereof.

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. (



5. Default. If Customer fails to make any of the payments specified in Attachment A on the due dates and in the amount stated, or otherwise fails to comply with any of the terms and conditions herein or therein (any such even hereby defined as a "Default"), Lender, at its sole option, may terminate this Agreement without further notice to Customer. In such case, all amounts that are then owing under the Note, the Security Instrument, and this Agreement shall become immediately due and payable, and Lender shall be permitted to exercise any and all rights and remedies provided for in the Loan Documents, including, but not limited to, immediate commencement of a foreclosure action or resumption of a pending foreclosure action without further notice to Customer.

6. No Waiver. Nothing contained herein shall constitute a waiver of any of all of the Lender's rights or remedies, including the right to commence or resume foreclosure proceedings. Failure by Lender to exercise any right or remedy under this Agreement or as otherwise provided by applicable law shall not be deemed to be a waiver thereof.1

7. Status of Default and Foreclosure. Customer acknowledges that if the Lender previously notified the Customer that the account was in default, that the Note and Security Instrument are accelerated and the debt evidenced by the Note is due in full, the account remains in default, such Loan Documents remain accelerated, and such debt due in full, although Customer may be entitled by law to cure such default by bringing the loan evidenced by Note current rather than paying it in full. Lender's acceptance of any payments from Customer which, individually, are less than the total amount due to cure the default described herein shall in no way prevent Lender from continuing with collection action, or require Lender to re-notify Customer of such default, re-accelerate the loan, re-issue any notice, or resume any process prior to Lender proceeding with collection action if Customer Defaults. Customer agrees that a foreclosure action if commenced by the Lender against Customer will not be withdrawn unless Lender determines to do so by applicable law. In the event Customer Defaults, the foreclosure will commence, or resume from the point at which it was placed on hold, without further notice.

8. Limited Modification. Except as otherwise provided in this Agreement, the Note and Security Instrument, and any amendments thereto, are ratified and confirmed and shall remain in full force and effect.

---

1 A typical example of this would be if Lender decides to accept a partial or untimely payment from Customer instead of returning such payment or terminating this Agreement as provided herein, Lender shall not be precluded from rejecting a subsequent partial or untimely payment, terminating this Agreement, or taking any other action permitted by applicable law.

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [redacted]



9. Application of Payments. The payments received by Lender from Customer pursuant to this Agreement shall be applied, at Lender's sole option, first to the earliest monthly payment under the Note that is due. Any amounts received by Lender that are less than the full payment under then due and owing under this Agreement shall be, at Lender's sole option, (1) returned to Customer, or (2) held by Lender in partial or suspense payment balance until sufficient sum is received by Lender to apply a full payment. If this Agreement is canceled and/or terminated for any reason, any remaining funds in this partial or suspense payment balance shall be credited towards Customer's remaining obligation owing in connection with the loan and shall not be refunded.

10. Methods of Making Payments. All payments made to Lender under this Agreement shall (i) contain the Lender's loan number shown above, (ii) unless otherwise agreed to by the Lender, be payable in certified funds by means of cashier's check, Western Union (code city: Bluff,NE) money order, or certified check, and (iii) be sent to AURORA LOAN SERVICES as specified in Attachment A. Any payment made other than strictly pursuant to the requirements of this paragraph 10 and Attachment A shall not be considered to have been received by Lender, although Lender may, in its sole discretion, decide to accept any non-conforming payment.

11. Credit Reporting. The payment status of Customer's loan in existence immediately prior to execution of this Agreement will be reported monthly to all credit reporting agencies for the duration of this Agreement and thereafter. Accordingly, Lender will report the loan subject to this Agreement as delinquent if the loan is not paid current under the Loan Documents, even if Customer makes timely payments to Lender under this Agreement. However, Lender may disclose that Customer is in a repayment or work-out plan. This Agreement does not constitute an agreement by Lender to waive any reporting of the delinquency status of loan payments.

12. Property Taxes, Insurance, and Other Amounts. If Customer's loan is not escrowed for taxes and insurance premium payments, it is Customer's responsibility to pay all property taxes, premiums for insurance, and all other amounts Customer agreed to pay as required under the terms of the Loan Documents. Customer's failure to pay property taxes, amounts owed on any senior lien security instrument, other amounts that may attain priority over the Security Instrument, or insurance premiums, in each case before their due date, shall constitute a Default hereunder.

13. The Entire Agreement. This Agreement sets forth all of the promises, covenants, agreements, conditions and understandings between the parties hereto with respect to the subject matter hereof. This Agreement supersedes all prior understandings, inducements or conditions, express or implied, oral or written, with respect thereto except as contained or referred to herein. This Agreement may not be amended, waived, discharged or terminated orally but only by an instrument in writing.

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [redacted]



14. Time is of the Essence. The Customer agrees and understands that TIME IS OF THE ESSENCE as to all of the Customer's obligations under this Agreement. The grace period for monthly payments under the Loan Documents will not apply to payment under this Agreement. Therefore, the Lender must receive the payments under this Agreement on or before the Due Dates specified in Attachment A.

15. Assignment by Customer Prohibited. This Agreement shall be non-transferable by Customer. However, if the legal or beneficial interest or the servicing of this loan is transferred by Lender, this Agreement inures to the benefit of any subsequent servicer or beneficial interest holder of the Note.

16. Severability. To the extent that any word, phrase, clause, or sentence of this Agreement shall be found to be illegal or unenforceable for any reason, such word, phrase, clause, or sentence shall be modified or deleted in such a manner so as to make the Agreement, as modified, legal and enforceable under applicable law, and the balance of the Agreement or parts thereof shall not be affected thereby, the balance being construed as severable and independent; provided that no such severability shall be effective if it materially changes the economic benefit of this Agreement to either party.

17. Execution in Counterparts. This Agreement may be executed and delivered in two or more counterparts, each of which, when so executed and delivered, shall be an original, but such counterparts shall together constitute but one and the same instrument and Agreement. Facsimile signatures shall be deemed as valid as originals.

18. Customer Contact. If Customer has any questions regarding this matter, Customer should contact one of Lender's Loan Counselors at the address above or by calling 800-550-0509.

IN WITNESS HEREOF, the parties hereto have caused this Agreement to be duly executed as of the date signed.

Dated: ____________________ ____________________
Borrower

Dated: ____________________ ____________________
Borrower

Aurora Loan Services
Dated: ____________________ ____________________

Aurora Loan Services is a debt collector. Aurora is attempting to collect a debt and any information obtained will be used for that purpose. However, if you are in bankruptcy or received a bankruptcy discharge of this debt, this communication is not an attempt to collect the debt against you personally, but is notice of a possible enforcement of the lien against the collateral property.

Aurora • Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

ATTACHMENT A-STIPULATED PAYMENTS

a.1 For purposes of repayment of the Arrearage, Customer shall pay $870.41, on or before 06/01/2009. Thereafter, Customer shall pay three (3) stipulated monthly payments each in the amount of $870.41 (each, a "Plan payment"). On or before 06/01/2009 (the "Agreement Return Date"), Customer shall execute and return the Agreement, including this Attachment A, in accordance with the following instructions:

| If by overnight mail service to | or | if by US Postal Services to |
|---|---|---|
| Aurora Loan Services<br>Attention: Home Retention<br>2617 College Park<br>Scottsbluff, NE 69361 | | Aurora Loan Services<br>Attention: Home Retention<br>P.O. Box 1706<br>Scottsbluff, NE 69363-1706 |

The Agreement will be of no force and effect unless Lender receives the executed Agreement, including Attachment A, as well as the first Plan payment by the Agreement Return Date. Customer shall remit to Lender the first Plan payment, in the amount specified above, made payable to Aurora Loan Services in certified funds by means of cashier's check, money order, Western Union (code city: Bluff, NE), or certified check. All Plan payments, including the first Plan payment, shall contain the Lender's loan number shown in the Agreement and, unless otherwise agreed to by the Lender, shall be payable in certified funds as described above are to be sent to Lender's Payment Processing Center in accordance with the following instructions:

| If by overnight mail service to | or | if by US Postal Services to |
|---|---|---|
| Aurora Loan Services<br>Attention: Cashiering Department<br>10350 Park Meadows Drive<br>Littleton, CO 80124 | | Aurora Loan Services<br>Attention: Cashiering Department<br>P.O. Box 5180<br>Denver, CO 80217-5180 |

a.2 Plan payments are to be paid on or before the 1st day of every month (each, a "Due Date"). Lender must receive each Plan payment by the Due Date of each month. The Agreement shall expire on the Due Date of the last Plan payment contemplated by section a.1 above (the "Expiration Date"). At the time Customer makes the third (3rd) Plan payment under this Agreement, it shall be the Customer's responsibility to provide Aurora with accurate and complete financial information in support of the Customer's request for a loan modification or other workout option. Customer must also provide Lender with a completed Borrower's Financial Statement and proof of income (copies of Customer's two (2) most recent pay stubs) to enable Lender to properly evaluate Customer's current financial situation and the Customer's request for a loan modification or other loan workout option. Tender of the last Plan payment shall not be deemed acceptance by Aurora of a workout plan or loan modification.

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [redacted]

b. The aggregate Plan payment will be insufficient to pay the Arrearage. At the Expiration Date, a portion of the Arrearage will still be outstanding. Because payment of the Plan payments will not cure the Arrearage, Customer's account will remain delinquent. Upon the Expiration Date, Customer must cure the Arrearage through a full reinstatement, payment in full, loan modification agreement or other loan workout option that Lender may offer (individually and collectively, a "Cure Method.") Customer's failure to enter into a Cure Method will result in the loan being disqualified from any future Lender Home Retention Group program with respect to the loan evidenced by the Note, and regular collection activity will continue, including, but not limited to, commencement or resumption of the foreclosure process, as specified in paragraphs 5 and 7 of the Agreement.

IN WITNESS HEREOF, the parties hereto have caused this Attachment A to be duly executed as of the date signed below.

Dated: ______________________ ______________________
Borrower

Dated: ______________________ ______________________
Borrower

Aurora Loan Services

Dated: ______________________ By: ______________________

Title: ______________________

Aurora • Loan Services

May 20, 2009

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

3640038261699534LM02905-20-09

RE: Loan No.
Borrower(s):

Property Address

ITEMIZATION OF FEES, COSTS AND OTHER CHARGES

Dear Customer(s):

This Addendum supplements the Attached Letter.

Below is a detailed itemization of the unpaid fees, costs and other charges due on the above-referenced loan.

| Description | Unpaid Balance |
| --- | --- |
| Foreclosure Fees | $1,609.50 |
| Post Liquidation Transaction | $96.00 |
| Property Value Fee | $405.00 |

Appendix H

Chase Agreement (seeking to obtain waiver of homeowner's right to a HAMP loan modification in favor of a non-HAMP loan modification offered prior to March 4, 2009).

**JPMorgan Chase Bank, National Association,**
**successor interest to Washington Mutual Bank** ("Lender") has offered to try to qualify you for a modification (an "MHA Modification") under the Making Home Affordable Plan announced by the Obama Administration on March 4, 2009. You have declined to be considered for an MHA Modification, opting instead to go forward with the modification offer made by Lender to you prior to the March 4, 2009 announcement (the "Prior Modification").

Had you qualified for an MHA Modification, you may have been entitled to the following:

- A reduction in monthly payment to no more than 31% of documented and verified gross monthly income (DTI).
- A modification sequence requiring the Lender to first reduce the interest rate (subject to a rate floor of 2%), then if necessary extend the term or amortization of the loan up to a maximum of 40 years, and then if necessary forbearing principal to get to the 31% DTI.
- Up to $1,000 of principal reduction payments on your mortgage each year for up to five years for making your payments on time each year.

By signing below, you acknowledge that (i) you have been advised of and understand the above features of an MHA Modification, (ii) you understand and agree that Lender is not obligated to match such features in the Prior Modification, (iii) you have voluntarily declined consideration for an MHA Modification, and (iv) you have agreed to hold Lender, its successors and assigns, harmless as a result of your decision to decline consideration for an MHA Modification and enter into the Prior Modification.

| | |
|---|---|
| ____________________ | ____________ |
| Borrower Name | Date |
| ____________________ | ____________ |
| Borrower Name | Date |
| ____________________ | ____________ |
| Borrower Name | Date |
| ____________________ | ____________ |
| Borrower Name | Date |
| ____________________ | ____________ |
| Borrower Name | Date |
| ____________________ | ____________ |
| Borrower Name | Date |

Appendix I
WaMu HAMP trial plan agreement (requiring waiver of HAMP loan modification if homeowner later enters bankruptcy).

WaMu

Washington Mutual
7255 Baymeadows Way
Jacksonville, FL 32256

TRIAL PLAN AGREEMENT

* Your loan is now due for the months of 06/09 to 06/09.
* You must send $0.00 to reduce your total delinquency.
* We must receive the initial payment of $922.37 along with your signed Trial Plan Agreement ("Agreement") by 07/01/09. After that, the payment schedule outlined below must be followed. If you do not make your payments on time, or if any of your payments are returned for non-sufficient funds, this Agreement will be in breach and collection and/or foreclosure activity will resume.

Your payments must be received in our office on or before the following dates:

| | |
|---|---|
| $922.37 | 08/01/09 |
| $922.37 | 09/01/09 |

Payments are subject to change due to escrow analysis and or interest rate changes, if applicable. If you are notified of a payment adjustment, please contact our office immediately so we can adjust the terms of your Agreement accordingly. If all payments are made as scheduled, we will reevaluate your application for assistance and determine if we are able to offer you a permanent workout solution to bring your loan current.

All of the original terms of your loan remain in full force and effect, unless specifically mentioned within this Agreement. If any part of this Agreement is breached, Washington Mutual has the option to terminate the Agreement and begin or resume foreclosure proceedings pursuant to your loan documents and applicable law.

You acknowledge that in the event you file a petition in bankruptcy, Washington Mutual may elect to take any and all actions necessary, including, but not limited to voiding this Agreement, filing a Motion for relief from the automatic stay or a Motion to dismiss or any permitted state law remedies, which in Washington Mutual's judgment are reasonably necessary to secure or protect our security, the value of the security and/or to enforce our rights under the original terms of your loan.

I/We agree to the above Agreement and will make payments as outlined above. I/We understand that foreclosure action can be taken if the terms of this Agreement are not met.

______________________________ Date ______________________________

Equal Housing Lender