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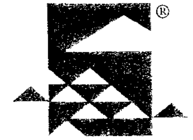

America's Community Bankers®

Diane M. Casey
President & Chief Executive Officer

July 5, 2000

Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Re: Responsible Alternative Mortgage Lending
65 FR 17811 (April 5, 2000) Docket No. 2000-34

Dear Sir or Madam:

America's Community Bankers (ACB) is pleased to comment on the advanced notice of proposed rulemaking (ANPR) issued by Office of Thrift Supervision (OTS) on responsible alternative mortgage lending.[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

ACB members participate in many important programs and partnerships that help average Americans become and remain homeowners. This commitment of ACB's members to homeownership is not only good for communities, it is good for business. In contrast, predatory lending practices undermine homeownership and damage communities. ACB pledges to work with the OTS and other policy makers to eliminate predatory lending practices in the most effective way and to provide all credit-worthy borrowers with access to sound loans.

General

This ANPR explores a wide range of solutions to the predatory lending problem. They include additional state initiatives; altering the OTS regulations that implement the Alternative Mortgage Transactions Parity Act (Parity Act)[2]; possible new OTS regulations on high-cost mortgage loans; imposing differential regulation of subprime mortgage lending, depending on safety and soundness or examination ratings; possible new OTS regulations dealing with thrift subsidiaries or affiliates; and suggested OTS-imposed due diligence requirements with respect to secondary market activities.

[1] 65 Fed. Reg. 17811 (April 5, 2000).
[2] 12 U.S.C. 3801-3806.

In general, ACB is concerned that new regulations could discourage certain types of lending by unfairly labeling legitimate loans as "predatory" or stigmatizing legitimate loan terms. Specifically, ACB recommends against a separate OTS regulation defining and restricting high-cost loans, because it would apply only to OTS-regulated institutions. Instead, ACB notes that Congress is considering legislative changes to the Home Ownership and Equity Protection Act (HOEPA)[3] and that the Board of Governors of the Federal Reserve System (Federal Reserve) has authority to increase consumer protections under the HOEPA. Provisions of Regulation Z that implement HOEPA are in effect today.[4] The Federal Reserve's authority ranges from lowering the HOEPA annual percentage rate (APR) thresholds; including more items in the points-and-fees trigger; defining certain practices as unfair, deceptive or abusive; and examining non-bank mortgage lending subsidiaries of bank holding companies.

While ACB recommends against a separate OTS HOEPA-like regulation, the OTS has a strong role to play through its implementation of the Parity Act. OTS should work to ensure that both new and current rules that attempt to curb predatory lending are applied equally to federally insured savings associations and state-licensed and chartered housing lenders that can choose to follow federal, rather than state, law under the Parity Act.

OTS and other policy makers that attempt to deal with predatory lending face serious challenges. Defining predatory lending is difficult. In writing a definition, it is essential to recognize the important difference between loan product terms, which are inherently neutral, and predatory lending practices. If a definition does not recognize this difference, it will result in restrictions that limit the availability of credit while allowing predators to continue their deceptive lending practices. The focus of regulation should be on enhancing systems to detect and deter deception and fraud, without restricting the availability of credit.

Any loan term is subject to abuse if it is not properly disclosed, or if the loan representative is willing to falsify documents. Firms most commonly associated with predatory practices are not federally insured and are not subject to rigorous examination and supervision. If existing and new regulations are effectively applied only to federally supervised depository institutions, they will fail to deal with the problem. Therefore, ACB recommends increased supervision of non-federally insured lenders. The ANPR itself acknowledges this issue, stating that with respect to high-cost lending and subprime loans "thrifts are not engaged in significant levels of these activities."[5]

ACB also believes that increased homeownership education and counseling would be an effective way to protect potential victims of predatory lending. The importance of homeownership counseling cannot be overemphasized in helping borrowers avoid becoming victims of predatory lenders. It is particularly important for borrowers with little or no experience in homeownership and finance. ACB members currently provide

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[3] Pub. L. 103-325, Title I, Subtitle B (Sept. 23, 1994.
[4] 12 CFR 226.32.
[5] 65 Fed. Reg. 17811 (April 5, 2000).

counseling on their own or in combination with other institutions or community groups. Lenders, community groups, and public agencies should work to expand these programs.

ACB Survey Results

ACB recently surveyed approximately 300 of our members to help us respond to this ANPR. Of these, 79 responded. We believe that these figures provide a representative sample of our member institutions, their activities and their views on a number of issues that the OTS has raised. The results of the survey are attached.

State & Local Initiatives

The ANPR requests comment on the effectiveness of state laws and regulation that address predatory lending. We note that only one state, North Carolina, currently has such a statute. Also, licensing, regulation, and supervision of non-depository institution lenders at the state level is limited and uneven.

The North Carolina statute dealing with predatory lending became effective July 1, 2000. Therefore, it is too soon to evaluate its effects. The statute bans a number of terms for any home loan (other than open-end or reverse mortgages) defined as high cost. A loan is considered high cost if:

- The APR is more than 10 percentage points over the comparable Treasury rate:
- The points and fees total more than five percent of the total loan amount for loans $20,000 and larger or the smaller of $1,000 or eight percent of the total loan amount for loans smaller than $20,000; or
- Prepayment penalties are permitted more than 30 months after loan closing or prepayment penalties could exceed two percent of the loan amount.

If a loan exceeds any of these thresholds, the loan may not include:

- A call provision;
- Balloon payments;
- Negative amortization;
- Post-default rate increase;
- Two periodic payments at closing;
- Modification or deferral fees; and
- Financed points and fees.

In addition, homeownership counseling is required, the loan may not be made without regard to ability to repay, and home improvement contracts must pay loan proceeds to the borrower, jointly to borrower and contractor, or through a third-party escrow agent.

Loans over the Fannie Mae/Freddie Mac limit or $300,000 (whichever is lower) are not covered.

Legal counsel in the state has concluded that this new statute is designed to effectively preclude high-cost lending. Therefore, it is important for legitimate lenders to be careful to avoid exceeding any of the thresholds.

Other state and local initiatives are still in the proposal stage, so it is impossible to evaluate them based on experience. However, they and the North Carolina law are based on many of the concepts discussed in the section involving new restrictions on high-cost loans. As expressed in more detail in our comments in that area, ACB is concerned that, because predatory lending is characterized by abusive practices, some of the new requirements that focus on specific loan terms could lead to harmful results. This problem would be compounded if too many loans become subject to the new limitations on loan terms. The North Carolina law uses HOEPA's APR trigger, but HOEPA's threshold for points and fees – five percent of the total loan amount for loans $20,000 – is stricter. The North Carolina/HOEPA APR threshold is currently – 10 percentage points above the comparable Treasury rate – but there are legislative proposals to lower it. The North Carolina statute is drafted to incorporate any changes in the federal APR threshold. Those changes, and any market-related changes in Treasury rates could affect the number of loans covered by the new state restrictions.

Even as currently written, ACB believes that the definition of a high cost loan in North Carolina's law is overly broad in one key respect. It includes any home loan under $300,000 that is subject to prepayment penalty if the borrower pays off the mortgage later than 30 months after closing. As discussed in more detail below, agreeing to prepayment penalties can enable borrowers to obtain loans with lower interest rates or fees than they would otherwise obtain.

As indicated below regarding the Parity Act, ACB generally believes there are significant advantages to both consumers and lenders from uniform rules that apply across state lines. We are concerned that institutions attempting to operate regionally or nationwide could face a patchwork of inconsistent requirements. This would make it more difficult to develop workable lending programs for the widest range of consumers. Fortunately, federal savings associations and their customers enjoy the benefits of uniform federal standards.

Should OTS Modify its Regulations Implementing the Alternative Mortgage Transactions Parity Act?

In 1982, Congress passed the Parity Act as part of broader financial services legislation. According to the findings and purpose of the Parity Act, Congress recognized that "increasingly volatile and dynamic changes in interest rates have seriously impaired"

lenders' ability to provide fixed-term, fixed rate credit.[6] The purpose of the Parity Act was to permit state-chartered lenders to offer alternative mortgage instruments under a system of uniform federal rules. (Alternative mortgage instruments include variable-rate loans and loans that provide for balloon payments.)

Though interest rates are not as volatile as they were in the 1970s and 1980s, alternative mortgage instruments remain a vital part of housing finance. They allow borrowers and lenders to craft mortgage terms that are adapted to individual situations. As our nation's population becomes ever more mobile and diverse, the need to allow lenders to offer a wide range of mortgage products under uniform rules is as compelling today as it was in 1982.

The Parity Act permits state-chartered or licensed housing lenders (state housing creditors) to follow OTS rules, rather than state law, with respect to alternative mortgage instruments. (The Parity Act permits state-chartered banks to follow the rules of the Comptroller of the Currency applicable to national banks.) The ANPR asks which OTS rules should apply: 1) only those rules that apply exclusively to alternative mortgages, or 2) every regulation that imposes conditions that affect a federal savings association's ability to make alternative mortgages.

ACB believes that the second option most closely tracks Congressional intent under the Parity Act. The Parity Act's purpose was to put state housing creditors on the same footing as federally chartered institutions, not to provide a less restrictive regulatory environment. In that regard, ACB strongly urges that any regulations that emerge from this rulemaking process be applied fully to state housing creditors under the Parity Act. Similarly, if the Federal Reserve – which has rulemaking authority over HOEPA – or some other federal agency adopts additional rules in this area that apply to federal savings associations, the OTS should extend them to state housing creditors.

It is not, however, sufficient to impose the same regulations on all lenders. Indeed, many lenders assert they must adhere to the same regulations that insured depository institutions must follow. However, not all housing lenders are subject to the same level of supervision as that experienced by insured depository institutions. Most other lenders are examined on a complaint-only basis and are not subject to regularly scheduled examinations for safety, soundness, and regulatory compliance. The Parity Act does not directly address this issue; it does not require federal supervision of state housing creditors. State regulators are still responsible. ACB recommends that OTS work closely with state officials and the Federal Trade Commission to ensure that OTS and other federal regulations apply in fact, as well as in theory, to state-licensed lenders. This will help avoid a situation where state law is preempted but federal regulations are not enforced.

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[6] 12 U.S.C. 3801(a)(1).

Should OTS Adopt Regulations on High-Cost Mortgage Loans?

The ANPR asks whether OTS should propose new restrictions and disclosures on "high-cost" loans and impose those requirements on loans not currently covered by HOEPA. This section of ACB's comment will discuss the question of whether OTS regulations should cover more loans than are now covered by HOEPA. The next section of our comment responds to the specific new restrictions that are suggested in the ANPR.

OTS Regulations on High Cost Loans

ACB does not believe that OTS should adopt a definition of high cost loan that is different than that provided for all lenders under HOEPA. Congress is considering legislative changes to HOEPA and HOEPA already gives the Federal Reserve considerable authority to strengthen the protections under the statute. During Congressional testimony on May 24, 2000, Governor Edward Gramlich indicated that the Federal Reserve would consider taking further action along these lines. We note that the HUD/Treasury joint report on predatory lending strongly recommended that the Federal Reserve use its existing authority to lower the HOEPA thresholds and increase consumer protections.[7] Given the fact that Congress has given the Federal Reserve authority to implement HOEPA, ACB questions whether the OTS has the authority to issue its own regulations that are inconsistent with the Federal Reserve regulations.

Even if OTS believes it has such authority, ACB believes that they would increase the regulatory burden on many institutions and confuse consumers. While ACB has concerns about the specific recommendations both in the HUD/Treasury report and in proposed legislation, we believe that it would be better for consumers and industry alike if any changes to HOEPA applied to all institutions, not just those regulated and supervised by the OTS. OTS regulations would pose the same sort of difficulty in the national mortgage market that a patchwork of inconsistent state laws could have. For example, a national bank would continue to operate under HOEPA, while OTS-regulated institutions – including federal savings associations and state-licensed lenders (operating under the Parity Act) – would adhere to the OTS HOEPA-style regulatory scheme in addition to having to comply with the provisions in Regulation Z that implement HOEPA. Consumers should enjoy the same protections, regardless of the institutions they patronize, and institutions that offer similar products should operate under the same rules.

ACB recognizes that OTS could apply its new HOEPA-style rules to state-licensed lenders under the Parity Act, which would provide parity at least among federal and state savings associations and other state-licensed lenders. However, the better solution would be to work to ensure that HOEPA standards – current and revised – apply to those same institutions, just as they would apply to lenders such as national and state banks.

[7] "Curbing Predatory Home Mortgage Lending: A Joint Report" (June 20, 2000).

Subprime vs. Predatory Lending

While we do not believe that OTS should propose its own HOEPA-style regulation, ACB offers the following comments that would apply to an OTS proposal. They would apply equally to proposals in Congress or ones considered by the Federal Reserve under its existing HOEPA authority.

It is important that policy makers distinguish between subprime lending and predatory lending practices. These terms are often mistakenly used interchangeably. Subprime lending provides financing to individuals with credit blemishes or other risk factors, though at somewhat higher rates or under stricter terms than are available to more credit worthy borrowers. The rise of subprime lending has given many previously underserved borrowers access to credit; before the expansion of subprime lending, a consumer either qualified for a prime loan or was denied credit. Subprime loans now offer a middle ground and have helped consumers achieve and maintain home ownership at record levels.

A properly underwritten subprime mortgage benefits both the borrower and the lender. To be considered properly underwritten, a subprime loan – indeed any loan – must be priced appropriately. The best credit risk enjoys the lowest rate; those with poorer records must pay more, but are at least granted credit. By expanding the pool of eligible borrowers, lenders are able to add earning assets to their books. By taking borrowers' circumstances into account in pricing, lenders are properly compensated for the risks they take. Done right, subprime lending is good for an institution's customers, stakeholders, and the deposit insurance funds.

It is also fair to the borrowers. They can benefit from subprime lending by obtaining needed funds while having the opportunity to repair their credit history. ACB strongly supports the reporting of good performance on such loans to credit bureaus so that borrowers get a chance to move back into the prime category.

In contrast, true predatory lending benefits only the lender, especially through unreasonably high fees. All lending should balance the interests of lenders and borrowers. The mortgage broker, home improvement contractor, or lender gain excessive fees, while borrowers who cannot meet the terms of their loans may diminish their equity, damage their credit ratings and even risk the loss of their home. To avoid foreclosure borrowers must often carry ultra-high debt service until they can secure new financing. These predatory lenders charge far more than what is required to fairly compensate for risk. They do so to extract as much profit from the transaction as possible and then walk away with the proceeds.

Expanded HOEPA Coverage

Unfortunately, the general descriptions of predatory lending cannot easily be translated into clear statutory or regulatory language. Rather than attempting to define the term

"predatory lending," HOEPA drew a line between high-cost loans – which triggered special disclosures and restrictions – and all other loans. This bright line has the advantage of clarity, but HOEPA does not encompass all loans that might be predatory. In fact, ACB members believe that the current APR threshold of 10 percent over comparable Treasuries could be lowered to eight percent without unduly restricting the subprime market. According to the recent report by HUD and the Treasury, only 0.7 percent of subprime loans originated from July through September of 1999 met the current HOEPA APR threshold.[8] By lowering the threshold from 10 to eight percent, HUD and Treasury estimate that five percent of subprime loans would be covered.[9] ACB will recommend that the Federal Reserve seriously consider taking this step under its current HOEPA authority. However, we will caution the Federal Reserve and other policy makers against lowering the thresholds too far. Such an action might unfairly label legitimate subprime loans as predatory.

Lowering the threshold to eight percent would cover loans at the far end of the spectrum and provide some additional protection to consumers. Doing so will not, however, solve the problem. Some lenders may try to avoid the HOEPA trigger by shifting the coupon rate and the up-front fees by small amounts. In any event, predatory lenders may not bring the HOEPA disclosures to the borrowers' attention or tell the borrower the disclosures are irrelevant. As pointed out earlier, rules without enforcement are no solution.

Some loans that are not truly "predatory" might fall into the HOEPA ambit if it is tightened too much.[10] This could impose additional burdens on legitimate subprime lenders – additional disclosures; restrictions on terms; and reduced access to the secondary market – without effectively dealing with the predatory lending problem.

We also are concerned that certain rates and terms might be defined as "predatory," even though in some circumstances they would be appropriate. It could depend on the facts and circumstances of the particular transaction.[11]

In addition to increasing the number of loans considered high-cost, some have suggested increasing the disclosures that must be made for these loans. ACB believes that requiring

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[8] Id at p. 85.
[9] Id at p. 87.
[10] Federal Reserve Governor Edward Gramlich described the problem this way in his May 1, 2000 letter to Senate Banking Committee Chairman Phil Gramm. The Governor wrote: "HOEPA's triggers may bring subprime loans not associated with unfair or abusive lending within the acts's coverage. Similarly, abusive practices may occur in transactions that fall below the HOEPA triggers." In a similar letter sent on May 5 to Chairman Gramm, Comptroller of the Currency John D. Hawke, Jr. summed up the problem this way: "I am concerned that attempting to define this term [predatory lending] risks either over- or under-inclusiveness."
[11] Governor Gramlich described the problem with new rules this way before the House Banking Committee on May 24, 2000: "Frankly, the value of rules prohibiting such practices is uncertain, given the nature of predatory practices. Some occur even though they are already illegal, and others are harmful only in certain circumstances. The best solution in many cases may simply be stricter enforcement of current laws."

additional disclosures would provide little benefit. The HUD/Treasury forums presented substantial evidence that the existing disclosures are sometimes ineffective, and more elaborate disclosures might even give predators more opportunities to confuse. Rather, efforts should be focused on simpler, "plain English" disclosures that focus consumer attention to relevant information. Regulators should also work to ensure that they are provided in a timely way, particularly by institutions that are not regularly supervised.

One difficulty in covering more loans and increasing restrictions is that many predatory lenders are not subject to the same strict supervision as savings associations and other depository institutions. By overly tightening restrictions on subprime lending, there is a risk of discouraging insured depository institutions from making responsible subprime loans, which would effectively open the door even wider to unregulated predators.

Regulators have suggested that they will not consider HOEPA loans for purposes of Community Reinvestment Act compliance, a step ACB supports. The secondary mortgage market, at least as far as the government-sponsored enterprises are concerned, will not now accept HOEPA loans. These are helpful steps under the current HOEPA limits, but could be perversely damaging if the current trigger values are decreased too far. Such a chain of events could cut off funding to some legitimate lending.

While ACB is prepared to recommend to the Federal Reserve that it decrease the HOEPA APR threshold to eight percent, policy makers should recognize that changes in the marketplace have already tightened the threshold and that this trend could well continue. Under current law, a HOEPA loan is defined, in part, as one that carries an interest rate more than 10 percentage points above "the yield on Treasury securities having comparable periods of maturity…."[12] This benchmark is flawed in the current and reasonably foreseeable interest-rate climate.

As a result of the steadily falling federal deficit, fewer long-term Treasury securities are available. Because the market sees a relative shortage of these securities, it is willing to accept a lower rate for them. So, even without changing the statutory standards of HOEPA, market forces are already tightening the law. The rate for long-term Treasury securities is far lower than for comparable instruments issued by GSEs. As the supply of Treasury securities falls, or even dries up, HOEPA's Treasury benchmark will become lower as compared to other securities of comparable maturity.

Should OTS Add New Restrictions on High-Cost Loans?

The ANPR suggests a number of new restrictions that could be imposed on newly defined high-cost loans and asks the following questions:

- *Should OTS impose limits on financing certain fees or charges?*
- *Are limits on refinancing appropriate?*

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[12] 12 U.S.C. 1602(aa)(1)(A).

- *Are prepayment penalties appropriate for high-cost loans?*
- *What limits on balloon payments, negative amortization, post-default interest rates and mandatory arbitration clauses would be appropriate for high cost loans?*
- *Should OTS require lenders to determine the suitability of a mortgage product for a particular borrower?*
- *Should OTS require institutions to notify applicants for high-cost loans of the availability of home loan counseling programs before closing?*

As indicated above, ACB believes that abusive practices – e.g., falsifying documents; hiding or obscuring disclosures; orally contradicting disclosures – are the essence of predatory lending. The proper remedy for these abuses is to ensure that loan originators do not violate laws against fraud and properly disclose loan terms. Restricting loan terms that have a legitimate role in the marketplace is not the right solution. ACB also is concerned that many legitimate loan terms might be improperly stigmatized as "predatory" and driven from the marketplace by other regulation or legislation if they are flatly prohibited for "high-cost" loans. Therefore, ACB strongly opposes proposals to prohibit terms that can be beneficial to consumers and lenders as part of legitimate transactions. These are ACB's comments on the particular terms mentioned in the ANPR:

Limits on Financing Fees or Charges

Predators often load loans with unreasonable fees, adding thousands of dollars to the principal that the borrower must repay. While these techniques may be used in predatory loans, financing fees may also have legitimate purposes for subprime, and even prime loans.

Credit insurance – which provides a benefit in the case of death, disability or unemployment – is one frequently cited loan feature that predators can abuse. But, when properly structured and fully disclosed, financing credit insurance can benefit consumers. By barring <u>any</u> type of financed credit insurance, e.g., for death or disability, regulation could effectively deny consumers an economical way to finance protection that could well help <u>prevent</u> foreclosures. Again, the real issue is whether the risk is one for which a particular borrower should seek insurance and whether the insurance premium is actuarially appropriate.

Some critics have pointed out that single-premium credit life insurance may be a particularly poor bargain for consumers when the entire premium is rolled into the loan principal. That is because the premium may cover 10, 15, or 30 years of coverage, while the loan may be paid-off well before that time. ACB understands that the insurance industry is willing to provide appropriate refunds of any unused premium in those cases. That would seem to be a sensible compromise.

Other fees, such as brokerage commissions, may also be financed. This can help consumers better afford charges that might otherwise have to be paid in a lump sum at closing, perhaps reducing funds needed for the downpayment. Of course, like many other practices, adding charges to principal can be used to mask the charges or increase the originators compensation. According to testimony presented to the HUD/Treasury Predatory Lending Task Force, predatory lenders often deceive borrowers about the charges being included in the loan principal. Just because predators fail to disclose all the charges that might be included in a loan's principal, that is no reason to ban including such charges from a broad class of subprime loans. It is another reason to examine and police patented predators.

Limits on Refinancing

Another frequent predatory technique involves frequent refinancings, sometimes within a brief period. The most egregious example we have heard was refinancing low-cost Habitat for Humanity loans and replacing them with a relatively high-rate loans. We do not know how often this has occurred, but it is completely inappropriate.

The ANPR also asks whether the OTS should limit or prohibit refinancing an institution's own (or an affiliate's) mortgage unless the annual percentage rate for the new loan is less than the rate reflected on the existing note and no fees are financed. Again, this responds to techniques often used by predators. However, such a rule would be overly broad and unrealistic. Under certain circumstances a savings association may refinance its own loan or an affiliate's loan at higher rates. For example, a borrower may wish to convert a substantial amount of equity into cash, resulting in a higher loan-to-value ratio and risk profile for the new transaction. Alternatively, a borrower may want to convert equity to cash, and market rates may have simply risen since the original loan was made. While repeated refinancings at higher rates are reportedly a common predatory practice, a borrower and a lender may find it mutually agreeable to restructure their business relationship. The suggested rule would deny the borrower the ability to refinance through the lender they know best. A well-informed consumer who chooses and can afford the obligation should not have that option foreclosed.

Prepayment Penalties

Unreasonable prepayment penalties can make it extremely difficult for a borrower to replace a loan made on an abusive or predatory basis. In other instances, prepayment penalties – which are typically in effect only a few years – are appropriate. They decrease the likelihood that a borrower will pay off a loan quickly (decreasing anticipated income to investors) or compensate the investor for lost income if the borrower does decide to prepay the loan.[13]

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[13] Moreover, the regulations of the Comptroller of the Currency governing adjustable rate mortgages offered by national banks allow such banks to impose prepayment penalties notwithstanding contrary state law. See 12 CFR Section 34.23. Since 1982, this regulation has also applied to state banks under the OCC's Parity Act regulations. See 12 CFR Section 34.24. Thus, when the OTS amended its Parity Act regulation in 1996 to

What is the benefit to the borrower? In the current marketplace investors are willing to accept a loan with a lower interest rate, provided it provides the protection of a prepayment penalty. This is an especially good option for borrowers who expect to remain in their homes for a longer period. It is also important to emphasize that these clauses may discourage the refinance option for only a limited time and may not be binding at all if the borrower seeks to sell the home. In some cases, borrowers prefer loans without prepayment penalties and lenders do not include them. This is an appropriate market response, not an indication that the government should step in with an arbitrary rule.

Balloon Payments

Balloon payment provisions can be used by predatory lenders to force refinance or even foreclosure. However, they can serve an appropriate purpose where the borrower wishes to pay the loan on a long-term schedule, but fully expects to refinance or repay the loan before the date the balloon payment is due. For example, a borrower may have a fixed-rate, fully amortizing loan (no balloon) coupled with a line of credit with interest-only payments until a date certain when the loan must be paid in full. A borrower who is fully informed by the lender and who understands his or her obligations can avoid foreclosure by a planned sale of the property, refinancing the line of credit, seeking an extension before the final due date, or taking some other action.

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include the OTS prepayment penalty regulation applicable to federal savings institutions, it was only "leveling the playing field" by giving OTS' housing creditors the same ability to impose prepayment penalties that the OCC's housing creditors had enjoyed since 1982. If the OTS were to remove the prepayment penalty regulation from its housing creditors, it would put those creditors at a competitive disadvantage vis a vis national and state banks. If the OTS were to take the prepayment penalty away from federal savings associations as well, those institutions would similarly be put at a competitive disadvantage vis a vis national and state banks.

Existing federal law already imposes restrictions on prepayment penalties in various circumstances. Existing restrictions on prepayment penalties are found in OTS regulations at 12 CFR Section 590.4(d) [prohibiting prepayment penalties for certain residential mobile home loans] and 12 CFR Section 591.5(b)(2), (3) [prohibiting prepayment penalties in connection with certain due-on-sale clause situations and certain property sales]. These OTS regulations apply to all lenders, not just savings associations. In addition, there are prohibitions on prepayment penalties in HOEPA and the Federal Reserve regulation at 12 CFR Section 226.32(d)(6),(7). In short, federal law already imposes restrictions on prepayment penalties where appropriate, and additional restrictions are not necessary.

Over the years, prepayment penalties have been at the forefront of the federal preemption litigation battle. See, e.g., Meyers v. Beverly Hills Fed. Savings & Loan Ass'n, 499 F. 2d 1145 (9th Cir. 1974) [upholding the federal preemptive effect of the former FHLBB's prepayment penalty regulation] and National Home Equity Mortgage Association v. Face, 64 2d 584, 591 (E.D. Va. 1999), appeal docketed, No. 99-2331 (4th Cir., Oct. 21, 1999) [upholding the federal preemptive effect of the OTS' Parity Act regulation which extends the benefits of the OTS' prepayment penalty regulation to OTS housing creditors]. To impose restrictions on prepayment penalties at this point in time would be seen as a broad retreat by the OTS from its historical commitment to the federal preemption doctrine. The imposition of such prepayment penalty restrictions would be tantamount to a relinquishment of a legal position that was vindicated only after great effort, and would encourage further costly challenges to OTS preemption positions in other areas.

Negative Amortization

Some loans have payment schedules that are so low that interest is added to the principal, rather than being paid as it accrues. This can be harmful if too much interest is added to the loan's principal and the loan terms do not provide a way to reverse the process. However, like a prepayment penalty, the possibility of negative amortization can help borrowers. For example, some lenders offer fixed-payment, adjustable rate loans that – depending on prevailing interest rates – could result in some negative amortization. These loans are sometimes made to ease the debt service requirement for a defined and often limited period. The interest rate on these loans is capped, the possibility of negative amortization is fully disclosed, and the negative amortization potential is itself capped. Sometimes the negative amortization is provided to assist the borrower in a time of financial stress or in times of unusually high short-term interest rates.

Post-Default Interest Rates

ACB members we have contacted have indicated that the mortgages they issue do not include clauses that increase the note rate as a result of late payment or default.

Arbitration Agreements

Arbitration agreements have been criticized when included in some HOEPA loans or loans deemed "predatory." However, arbitration can be a simple, fast, more affordable alternative to foreclosure litigation. Attorneys who represent homeowners victimized by predatory lenders often complain that they lack the time and resources to pursue claims in court. Fair and properly structured arbitration arrangements could help them. Of course, they must be fully and properly disclosed. In legitimate agreements, consumers retain all of their substantive legal rights. And, the record shows that there is no inherent bias against consumers in arbitration

Suitability

One technique used by predatory lenders is to saddle an individual with a loan that he or she is clearly in no position to repay. Hence, the ANPR suggests requiring an analysis of the borrower's ability to repay without relying on collateral. This seems like a common sense requirement, and certainly it is one of the first things for which any bank examiner would look. But again, there may be some situations where, for example, both the lender and borrower understand that the loan will be outstanding for only a short time. One common example is a "bridge loan" where repayment will come from the sale of the borrowers current residence. In that case, a regulation could interfere with the borrower's needs and desires.

The broader question is whether institutions should document the suitability of a particular loan for a particular borrower. This is a beguiling, but unnecessary, new requirement for savings associations. Lenders who undergo strict federal supervision,

must already demonstrate that their loans are made according to sensible underwriting guidelines. And, the secondary market imposes its own standards. ACB members and other depository institutions that meet both governmental and market standards have a good record of making loans that borrowers can repay. Imposing a suitability standard -- a concept from securities law -- would add a major new level of complexity. A securities broker must ensure that a particular security is suitable for the investor -- taking into account the investor's complete financial situation. That is a much different standard that should not be casually imported into the mortgage lending context, subject to a different and rigorous regulatory regime.

Education & Counseling

ACB strongly supports homeownership education and counseling and our members have no objection to telling borrowers that counseling is available. In fact, many of our members offer counseling or participate in joint programs. However, we are reluctant to endorse mandatory counseling for all high-cost loans, as some have suggested – particularly if a substantially higher number of loans are covered by a new definition. It would be hard to get prospective borrowers to sit through counseling sessions if they do not feel it is necessary and do not want to. Mandatory counseling could also create perverse incentives and give rise to meaningless counseling programs. Consumer representatives told the HUD/Treasury joint task force that they were concerned that counseling certifications could become yet another document that predatory lenders would routinely falsify. And, they indicated that if the mandatory counseling actually took place, it could be used as a shield against later claims that the loan was predatory or otherwise improper.

Nevertheless, ACB believes that counseling can be a real benefit to borrowers, especially those with little or no experience in homeownership and finance. Counseling gives potential victims of predatory lenders tools to avoid signing up for an inappropriate loan.

ACB is a founding member of the American Homeowner Education and Counseling Institute (AHECI) that supports national standards for organizations and individuals that provide education and counseling services. This organization is the creation of a diverse group of mortgage industry stakeholders and who realized that existing educational programs or counseling services had neither uniform content or value. The effort also recognized the need to determine and measure the qualifications and standards of conduct of those who deliver these services. AHECI has established minimum standards for educational program content and duration; these standards have been widely circulated and well received by the industry. Formal testing of educators/counselors will begin later this year. AHECI certification of instructors and program approval will provide borrowers and lenders of a degree of assurance as to the quality and utility of locally offered programs never before available, once the certification/approval process is in place.

Whether through formal counseling programs like these, or in the normal loan underwriting process, our institutions work to ensure that borrowers understand their responsibilities and will be able to fulfill them.

Is Differential Regulation Appropriate?

The ANPR asks whether, before an institution with a lower safety and soundness or compliance rating undertakes a significant level of subprime or high-cost lending, the OTS should review the association's management and internal controls.

ACB believes that the OTS should undertake additional restrictions with great care, especially in defining "subprime" and "high-cost." ACB believes that the OTS and the other agencies possess the supervisory tools to review and monitor management and internal controls.[14] A rigid and over-inclusive rule along the lines suggested could discourage institutions from offering beneficial products that promote homeownership and strong neighborhoods.

As indicated in this comment's discussion of the Parity Act, ACB believes that state-licensed housing creditors should be subject to supervision at least as effective as that imposed on OTS-supervised institutions with respect to lending covered by the Parity Act. This is clearly not happening under the current regulatory scheme. Unlike federally insured depository institutions that are subject to regular and rigorous examinations, predatory lenders are often effectively beyond the reach of federal laws. The OTS should work to ensure that any new management or internal control requirements apply equally to all lenders.

How Should OTS Deal With Potential Lending Issues Raised by Thrift Subsidiaries or Affiliates?

The ANPR asks a variety of questions about the relationship between savings associations and any subsidiaries or affiliates that may engage in subprime lending. ACB recently surveyed some of our members about their activities in this area (survey attached.) Of the 79 institutions that responded 35.4 percent of them (or a subsidiary or affiliate) offer a subprime mortgage program. A slightly smaller number, 32.9 percent, refer borrowers who do not qualify for a standard loan product to special products. Those products may, again, be offered by the institution itself, an affiliate or an outside lender.

Those who have commented on predatory lending practices have observed that some victims have been directed to higher cost loans, even though they might have qualified for a prime loan. ACB is skeptical that workable regulations can be crafted to effectively restrict an institution's ability to refer customers to a particular product or affiliate.

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[14] The FFIEC guidance on subprime lending provides the supervisory tools necessary for the agencies to impose restrictions on institutions not operating in a safe and sound manner. (March 3, 1999).

Should OTS Impose Certain Due Diligence Requirements On Secondary Market Activities?

Many observers have emphasized the role that the secondary market has played in the predatory lending process.[15] So, it is tempting to hope that we can cut off the flow of funds by imposing a due-diligence requirement on securitizers and investors. Indeed, Fannie Mae and Freddie Mac have already taken steps, saying they will not purchase HOEPA loans and loans that, for example, involve financing single premium credit insurance.

How effective will these measures be? Recent testimony suggests there are limitations.[16] A loan that might ultimately be considered predatory may appear to a purchaser to be proper on its face. However, since some firms appear to make a large number of predatory loans, it may be possible to eventually reduce their access to the capital markets. The OTS experience under its agreement with Lehman Brothers, (in which Lehman agreed to "continue to include, in connection with its underwriting, loan purchase and financing activities, review procedures appropriate to the circumstances involved which seek to identify predatory pricing practices by its clients") might provide some guidance.[17]

One major indicator of predatory lending, according to testimony before the HUD/Treasury task force and the House Banking Committee, is an increased level of foreclosures. Though it risks stating the obvious, savings institutions should be cautioned against purchasing loans from sources that have a record of originating loans with much higher than average foreclosure rates.

If the OTS does impose some form of due diligence requirement on purchased loans, it should certainly differentiate between originators that undergo regular federal compliance examinations and unsupervised lenders. There is no indication that federally insured institutions have originated and sold any appreciable number of "predatory" loans and no reason to impose a burdensome due diligence requirement on institutions that purchase loans from them.

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[15] Tom FitzGibbons of Manufacturers Bank, told the HUD/Treasury joint task force on May 25th that, "We've connected the crook with the capital markets."

[16] Comptroller of the Currency John Hawke and Gary Gensler, Treasury Undersecretary for Domestic Finance, each shared their doubts with the House Banking Committee on May 24th. They said that securitizers could not reliably detect predatory loans by looking at loan packages. Excessive fees and outright deception by loan brokers are not always apparent in the loan files, they occur at the street level. Attorneys at the Chicago HUD/Treasury forum explained the next day that brokers sometimes falsify income data to make it appear that the borrower can service the loan. One attorney called broker-prepared loan documents he has seen "fiction."

At the House Banking hearing, Atlanta legal services attorney William Brennan was skeptical about the suggestion that if Fannie and Freddie increase their involvement in subprime lending that would weed out predators. He said they have no more ability to review loans than anyone else. He noted that their guidelines ban only a few practices, but there are many others frequently used by predatory lenders.

[17] Letter of June 30, 1999 from Lehman Brothers Vice President Karen C. Manson.

As we have suggested in other parts of this letter, increased enforcement of existing laws with respect to lenders who do not now undergo substantial supervision is likely to be a more effective way to discourage predatory practices. Increased FTC enforcement and state supervision of state-licensed lenders would be more effective and appropriate than relying on the secondary market to be predatory lending police.

Mortgage Lending Reform

The ANPR did not seek comments on proposals to reform the process for mortgage lending generally. However, some assert that simplifying the application and settlement rules could go a long way toward solving the predatory lending problem. While ACB supports simplification efforts, they are not a cure-all for predatory lending. Industry and policy makers have tried repeatedly to streamline this process, but no matter how successful they are, making the biggest purchase and taking on the biggest financial obligation in your life is going to be complicated. As indicated above, solid education and counseling can help borrowers learn enough about the process to understand whether or not they are being fairly treated.

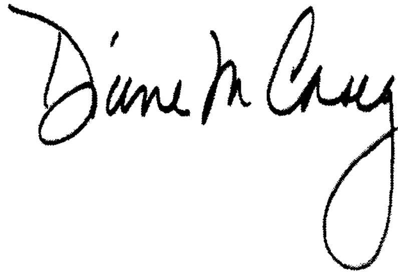
Conclusion

ACB appreciates the opportunity to comment on this important matter and commends the OTS for taking a comprehensive approach. In conclusion, ACB would like to emphasize the following points of our comment:

- Policy makers should avoid imposing over-inclusive regulations that would unfairly label legitimate loans as predatory or stigmatize legitimate loan terms;
- Many firms associated with predatory practices are not subject to rigorous examination and supervision, and OTS has a strong role under the Parity Act to help ensure that new and existing rules are effectively and equally applied to all mortgage lenders;
- It essential that all lenders be subject to the same rigorous enforcement of the rules, otherwise new rules will increase the burden on institutions that are now heavily supervised while failing to solve the predatory lending problem;
- Education and counseling can be an effective way to prevent predatory lending, and ACB and its members pledge to increase access to high-quality homeownership education and counseling;
- The Federal Reserve, rather than OTS, is the appropriate agency to define additional loans as high-cost, since Federal Reserve regulation would apply to all lenders under HOEPA;
- Policy makers should not count on secondary market due diligence or reform of the mortgage lending process to effectively prevent predatory lending.

If you have any questions, please contact Steve Verdier at (202) 857-3132 or Charlotte Bahin at (202) 857-3121.

Sincerely,



Diane M. Casey

Attachment

Results of ACB Survey on Subprime and Predatory Lending

ACB recently surveyed approximately of its members on the issue of subprime and predatory lending. The survey group included representatives who attended two recent conferences, as well as members of several ACB committee. A total of **79** institutions responded. These are the responses from the institutions (stated in percentage terms where indicated.)

Description of Institutions & Markets

Assets:

- **5%** under $50 million
- **11.4%** $50 to $100 million
- **30.4%** - $100 to $250 million
- **33%** - $250 to $500 million
- **8.9%** - $500 million to $1 billion
- **10%** - over $1 billion

Markets Served: **28** – *Urban* **53** – *Suburban* **38** - *Rural*

Responding Institutions' Lending Activities

Subprime Lending

Does your institution – or a subsidiary or affiliate – have a mortgage lending program that might be defined as subprime?

35.4% - *Yes* **64.6%** - *No*

Do you have a program to refer borrowers who do not qualify for your standard loan products to special products for riskier borrowers offered by your institution, an affiliate, or an outside 'allied' lender?

32.9% - *Yes* **67.1%** - *No*

Steering Regulations

Workable regulations could be crafted to restrict an institution's ability to steer customers to a particular product or affiliate?

22.8% - *Agree* **77.2%** - *Disagree*

Expand HOEPA Coverage: One legislative measure proposes **lowering** the HOEPA **APR** threshold from **10%** over T-rates to **8%** for first liens and **9%** for junior liens. The threshold for **points** would go from **8%** to **6%** for first liens and **7%** for subordinate liens. It would also **extend** HOEPA to **open-end home equity** loans.

As far as covering loans made by my institution or its affiliates, the changes suggested above would have:

60.8% - *No effect* **30.4%** - *Little effect* **6.3%** - *Substantial effect*

Restrictions on Specific Lending Practices

What is the typical level of points and fees in your mortgage loan products?

a) *Regular Loan Program*
- **74** - *0 to 2 points*
- **7** - *2 to 4 points*
- **0** - *over 4 points*

b) *Subprime Program (if any)*
- **28** - *0 to 4 points*
- **3** - *4 to 6 points*
- **0** - *over 6 points*

Do you have any loan program where **one-time up-front** *credit life insurance premiums are financed?*

22.8% - *Yes* **77.2%** - *No*

Does your institution ever make loans that:

Include mandatory arbitration? **11.4%** - *Yes* **88.6%** - *No*

Cannot be serviced by the reasonably foreseeable income/cash flow sources of the borrower? **10.1** - *Yes* **89.9%** - *No*

Include more than a 3 to 6 months interest prepayment penalty or other industry standard provision? **10.1%** - *Yes* **89.9%** - *No*

Could have negative amortization? **7.6%** - *Yes* **92.4%** - *No*

Predatory Lending Issues

Extent of Predatory Lending:

How prevalent is **predatory lending** *in your* **mortgage** *market?*

31.2% - *Rare* **55.8%** - *Low volume but growing* **13%** - *Significant*

How prevalent is unsecured 'payday' lending by 'storefront lenders' in your market?

22.4% - *Rare* **55.3%** - *Low volume but growing* **22.4%** - *Significant*

Warehousing lines of Credit:

Does your institution provide line-of-credit funding for any local finance companies doing subprime lending in your community?

0% - *Yes* **100%** - *No*

Are you aware of any local/regional bank providing such line-of-credit funding for subprime lenders with questionable business practices in your market area?

7.6% - *Yes* **92.4%** - *No*