FEDERAL RESERVE SYSTEM

Home Equity Lending Market; Notice of Hearings

[Docket No. OP-1288]

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Public Hearing; Request for Comment

SUMMARY: Section 158 of the Home Ownership and Equity Protection Act of 1994 (HOEPA)[1] directs the Board to hold public hearings periodically on the home equity lending market and the adequacy of existing regulatory and legislative provisions (including HOEPA) in protecting the interests of consumers. Consequently, as previously announced, the Board will hold a hearing on the home equity lending market and invites the public to attend and to comment on the issues that will be the focus of the hearing. Additional information about the hearing will be posted to the Board's website at http://www.federalreserve.gov.

DATES: The date of the hearing is June 14, 2007.

Comments. Comments from persons unable to attend the hearing or otherwise wishing to submit written views on the issues raised in this notice must be received by August 15, 2007.

ADDRESSES: The location of the hearing is:

The Federal Reserve Board, 20th and C Streets, N.W., Washington, D.C., 20551, in the Martin Building, Terrace Level, Dining Room E.

You may submit comments, identified by Docket No. OP-1288, by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

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[1] Pub. L. 103-325, 108 Stat. 2160.

- E-mail: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.

- Fax: (202) 452-3819 or (202) 452-3102.

- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

All public comments will be made available on the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Kathleen C. Ryan, Counsel, or Paul Mondor, Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-2412 or (202) 452-3667. For users of Telecommunications Device for the Deaf (TDD) only, contact (202) 263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

1. HOEPA

In 1994, the Congress enacted the Home Ownership and Equity Protection Act (HOEPA) as an amendment to the Truth in Lending Act (TILA), in response to testimony about predatory home equity lending practices in underserved markets, where some lenders were making high-rate, high-fee home equity loans to cash-poor homeowners. HOEPA identifies a class of high-cost mortgage loans based on the loans' rates and fees. Loans above HOEPA's price triggers require additional disclosures and are subject to substantive restrictions on loan terms. HOEPA is implemented by the Board's Regulation Z (12 CFR 226.32 and 34).

Section 158 of HOEPA also directs the Board to hold public hearings periodically on the home equity lending market and the adequacy of existing regulatory and legislative provisions for protecting the interests of consumers, particularly low-income consumers. Hearings were held in 1997, 2000, and 2006. Following the 2000 hearings and the receipt of public comment, the Board amended the provisions of Regulation Z that implement HOEPA. These revisions included extending HOEPA's coverage to more loans, enhancing disclosures for HOEPA loans, and expanding its substantive restrictions. The revisions took effect in October 2002.

In addition to the Board's general grant of rulewriting authority under HOEPA, Section 129(l)(2) of HOEPA also confers regulatory authority on the Board to prohibit acts or practices:

- In connection with mortgage loans—if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and

- In connection with refinancings of mortgage loans—if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower.

2. The Board's 2006 hearings

The Board's most recent hearings under HOEPA covered three broad topics: (1) the impact of the 2002 HOEPA rule changes and state and local predatory lending laws on predatory lending practices; (2) nontraditional mortgage products and reverse mortgages; and (3) informed consumer choice in the subprime market. Hearing panelists included mortgage lenders and brokers, credit ratings agencies, realtors, consumer advocates, community development groups, housing counselors, academicians, researchers, and state and federal government officials.

Consumer advocates and some state officials stated that HOEPA (and state predatory lending laws) are generally effective in preventing loans with abusive terms from being made for loans subject to the HOEPA price triggers. Some advocated that Congress should lower HOEPA's coverage triggers so that more loans are subject to HOEPA. Consumer advocates and state officials urged regulators and Congress to take action to curb abusive practices for loans that do not meet HOEPA's price triggers.

Consumer advocates urged the Board to prohibit or restrict certain loan features or terms, such as prepayment penalties, and underwriting practices such as "stated income" or "low documentation" ("low doc") loans where the borrower's income is not documented or verified. They also expressed concern about aggressive marketing practices that include steering borrowers to higher-cost loans by emphasizing initial low monthly payments based on an introductory rate without adequately explaining that the consumer will have considerably higher monthly payments after the introductory rate expires. Finally, some consumer advocates stated that brokers and lenders should be held to a fiduciary standard such as a duty of good faith and fair dealing or a requirement that they make only loans that are suitable for a particular borrower.

Industry panelists and commenters, on the other hand, expressed concern that HOEPA may reduce the availability of credit for some subprime borrowers. They stated that state predatory lending laws may also reduce credit availability. Most industry commenters opposed prohibitions on stated income loans, prepayment penalties, and other loan terms, asserting that these features could benefit some borrowers. They urged the Board and other regulators to focus instead on enforcing existing laws to remove "bad actors" from the market. Some lenders indicated, however, that carefully constructed reasonable restrictions on certain loan features or practices might be appropriate if the conditions were clear and would not unduly reduce credit availability. Fiduciary responsibilities would, in industry's view, create conflicts for lenders, who are responsible to their shareholders. Industry commenters also stated that subjective suitability standards would create uncertainties for brokers and lenders and subject them to litigation risk.

II. Information About the Board's 2007 Hearing

The June 14th hearing is open to the public to attend. Seating will be limited, however. All visitors must register at least 24 hours in advance for security purposes and may access the Board's online registration service at https://www.federalreserve.gov/secure/forms/hoeparegistration.cfm. Further information about the hearing, as it becomes available, will be posted on the Board's web site at http://www.federalreserve.gov. The hearing will begin at 8:30 a.m. and conclude at 4:00 p.m. (EST).

The Board will invite persons to participate in panel discussions on the topics discussed below. In addition to the panel discussions, the Board intends to reserve about one hour after the conclusion of the panels, at 3:00 p.m., to permit interested parties other than those on the panels to make brief statements. To allow as many persons as possible to offer their views during this period, oral statements will be limited to three minutes or less; written statements of any length may be submitted for the record. Interested parties who wish to participate during this "open-mike" period may contact the Board in advance of the hearing date at the telephone numbers provided in this notice, to facilitate planning for this portion of the hearings.

III. 2007 Hearing Discussion and Request for Comment

This hearing will examine how the Board might use its rulemaking authority under section 129(l)(2) of HOEPA to address concerns about abusive lending practices in the mortgage market, including the subprime mortgage market. The purpose of the hearing is to enable the Board to gather information to evaluate whether it can address issues about predatory lending in a way that preserves incentives for responsible lenders to provide credit to borrowers, particularly subprime borrowers.

The Board solicits comment on whether it should use its rulemaking authority to address concerns about the loan terms or practices listed below, and any others that commenters identify. Commenters are requested to discuss whether these terms or practices are associated with unfairness or deception, evasion of HOEPA, abusive lending, or are not otherwise in the interest of borrowers. In addition, commenters are requested to address whether the term or practice should be prohibited or restricted for all mortgage loans, only for loans offered to subprime borrowers, or other subsets of loans such as loans to first-time homebuyers, home purchase loans, or refinancings and home equity loans; only certain products, such as adjustable rate mortgages or nontraditional mortgages.[2]

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[2] Nontraditional mortgage products are mortgage loans that allow borrowers to defer repayment

Comment is also requested on the effectiveness of state laws that have prohibited or restricted the practices listed below (and others) and whether the Board should consider adopting similar regulations to curb abuses without restricting access to responsible mortgage lending.

A. Prepayment penalties. Consumer advocates state that prepayment penalties deter a consumer from refinancing the loan on more favorable terms and that consumers do not receive any benefit in return. Consumer advocates are also concerned about prepayment penalties that extend beyond the expiration of an introductory or teaser rate on an ARM, which deter consumers from refinancing to avoid payment shock when the rate resets. Consequently, some consumer advocates recommend that penalties be banned or restricted for such loans. According to industry representatives, however, prepayment penalties ensure a minimum return on the transaction if loans are paid off early. Industry representatives also state that consumers receive, in return, a benefit in the form of lower up-front costs or lower interest rates.

The Board requests comment on the following questions related to prepayment penalties:

- Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited?
- Would enhanced disclosure of prepayment penalties help address concerns about abuses?
- How would a prohibition or restriction on prepayment penalties affect consumers and the type and terms of credit offered?
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B. Escrow for taxes and insurance on subprime loans. Loans to prime borrowers typically include an escrow for taxes and insurance, while loans to subprime borrowers typically do not include escrows. Consumer advocates are concerned that subprime borrowers are not aware of, and may not be able to budget for, these expenses. They are also concerned that lenders quote monthly payments to subprime borrowers that do not include taxes and insurance, and these borrowers do not realize that they will have to budget separately for these obligations.

The Board requests comment on the following questions related to escrows for taxes and insurance:

- Should escrows for taxes and insurance be required for subprime mortgage loans? If escrows were to be required, should consumers be permitted to "opt out" of escrows?

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of principal and, sometimes, interest. They include interest-only loans and ''payment option'' ARMs where a borrower has flexible payment options with the potential for negative amortization.

- Should lenders be required to disclose the absence of escrows to consumers and if so, at what point during a transaction? Should lenders be required to disclose an estimate of the consumer's tax and insurance obligations?

- How would escrow requirements affect consumers and the type and terms of credit offered?

C. "Stated income" or "low doc" loans. In some cases a lender will make a mortgage loan without documenting or verifying a borrower's income; lenders may charge higher rates for such loans. Lenders state that these loans are appropriate for many borrowers, including those who are self-employed and cannot easily document their income or who choose not to. Consumer advocates state that many borrowers who could document their income are not aware that they are getting a stated income loan with a higher rate. They state that some brokers and lenders use "stated income" or "low doc" loans to perpetrate fraud (e.g., the consumer's income is falsified or "marked up" by a broker or loan officer and is not verified by the lender). Concerns have also been raised about the use of stated income loans with other "risk layering features" such as second-lien loans for all or part of the consumer's downpayment.

The Board requests comment on the following questions related to stated income and low doc loans:

- Should stated income or low doc loans be prohibited for certain loans, such as loans to subprime borrowers?

- Should stated income or low doc loans be prohibited for higher-risk loans, for example, for loans with high loan-to-value ratios?

- How would a restriction on stated income or low doc loans affect consumers and the type and terms of credit offered?

- Should lenders be required to disclose to the consumer that a stated income loan is being offered and allow the consumer the option to document income?

D. Unaffordable loans. Consumer advocates state that some lenders extend loans without adequately considering the borrower's ability to repay the loan. For example, lenders may qualify borrowers based on an ARM's introductory rate and not at the fully- indexed rate that will apply once the introductory rate expires. Lenders state that it is appropriate to make such loans in certain circumstances, for example, where the borrower is likely to be able to refinance the loan at a lower rate before the reset date. Other circumstances include those in which borrowers expect to sell their home within a few years, or expect a significant decrease in their monthly obligations or a significant increase in income, such as a borrower who is completing professional training. Because loans are frequently sold to purchasers who generally cannot be held liable for the loan originator's actions, and because the risk of default is spread out among investors in loan pools, some consumer advocates believe that there is insufficient accountability for making loans that consumers cannot repay.

Recently the Board and the other banking and thrift regulators issued guidance on underwriting nontraditional mortgage products. The guidance provides that:

> An institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.

71 FR 58609, 58614 (Oct. 4, 2006) (footnotes omitted).

Some have urged that lenders should be required to underwrite <u>all</u> mortgage loans based on a fully-indexed rate and a fully amortizing payment. Some have also advocated a rebuttable presumption that a borrower cannot afford to repay a loan if the borrower's debt-to-income ratio exceeds 50 percent and that such loans should be prohibited by regulation.

The Board requests comment on the following questions:

- Should lenders be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments?
- Should there be a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income ratio exceeds 50 percent (at loan origination)?
- Are there specific consumer disclosures that would help address concerns about unaffordable loans?
- How would such provisions affect consumers and the type and terms of credit offered?

By order of the Board of Governors of the Federal Reserve System, May 24, 2007.

<u>Jennifer J. Johnson (signed)</u>
Jennifer J. Johnson
Secretary of the Board