# TRANSCRIPT OF THE
# FEDERAL RESERVE SYSTEM
# CONSUMER ADVISORY COUNCIL

## THURSDAY, OCTOBER 25, 2007

The Consumer Advisory Council met at the offices of the Board of Governors of the Federal Reserve System, in Dining Room E, Terrace Level in the Martin Building at 20th and C Streets, N.W., Washington, D.C., at 9:00 a.m., Lisa Sodeika, Chair, presiding.

*Members present:*
Lisa Sodeika, Chair
Tony Brown, Vice Chair
Stella Adams
Faith Anderson
Carolyn Carter
Michael Cook
Kurt Eggert
Jason Engel
Joseph Falk
Louise Gissendaner
Patricia Hasson
Thomas James
Sarah Ludwig
Mark Metz
Lance Morgan
Joshua Peirez
Anna McDonald Rentschler
Edna Sawady
Faith Arnold Schwartz
Edward Sivak
Cooke Sunoo
Stergios "Terry" Theologides
Linda Tinney
Anselmo Villarreal
Alan White
Marva Williams

*Others present:*
Benjamin Bernanke, Chairman, Board of Governors
Randall Kroszner, member, Board of Governors
Frederic Mishkin, member, Board of Governors
Sandra Braunstein, Director, Division of Consumer and Community Affairs

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P-R-O-C-E-E-D-I-N-G-S

(9:04 a.m.)

CHAIR SODEIKA: Welcome to the Council meeting, Advisory Council meeting. I'd like to take a moment to acknowledge Chairman Bernanke. Thank you for being here. And Governor Kroszner, as well as Governor Mishkin, thank you and good morning.

I'd also like to, before we officially begin our meeting, just take a moment to acknowledge the recent passing of Governor Gramlich.

For most of his tenure at the Board, Governor Gramlich served as chair of the Board's consumer committee, Board's Committee on Consumer and Community Affairs, and in that role, worked with our team, members of our Consumer Advisory Council. During his tenure, the Committee proposed and the Board adopted important changes in the Home Ownership and Equity Protection Act and Home Mortgage Disclosure Act.

I'd like to just at this time take a few moments with a couple of members of our Council to reflect on Governor Gramlich's leadership and many contributions. And I think, Stella, you'd like to say a few words?

MS. ADAMS: Yes. I first met Governor Gramlich over the phone. I was recovering from a hospital stay and thought I'd read over the HUD and Fed HOEPA testimony as therapy.

(Laughter.)

MR. EGGERT: Or at least to get you back to sleep well.

MS. ADAMS: And I called the Fed to speak with the person, I had some questions about the testimony and I thought I would get a staffer and instead, Governor Gramlich came on the phone and spoke with me in excess of 30 minutes on my ordinary questions about HOEPA, as an ordinary citizen, someone who he did not know. He took the time out to kind of share his philosophy.

He truly was the people's governor, and he was the people's champion on consumer affairs, and he was a personal hero of mine. And so it is with great sadness that -- and he will be missed.

CHAIR SODEIKA: Thank you, Stella.

Kurt?

MR. EGGERT: I got to know, actually, Governor Gramlich before I came here,

when I was a young professor. And I got to know him not through phone conversation, but by reading his speeches. I was researching securitization and predatory lending. And so I sat down and read virtually every speech on the subject by everyone from the Federal Reserve Board.

And what was interesting is when you read his speeches or his writings on this subject, you get a sense of the man because they showed a great understanding not only of economics but also of the effect on real people of the policies that he was discussing. And when I got to meet him in person, I found that even more so in person. So it was a great honor to get to know him.

CHAIR SODEIKA: Thank you, Kurt.

Well, I would also like to mention that today, this October meeting, marks the last meeting for ten of our Council members, and I would like to acknowledge and thank all of you. Two of our members could not be here today: Deborah Hickock and Don Currie. This is their last meeting, as well as Stella Adams, Faith Anderson, Carolyn Carter, Kurt Eggert, Anselmo Villarreal, and Marva Williams, and myself.

And I will say that it has been absolutely an honor and a privilege to participate in the Council and thank all of you and also welcome my partner here, co-chair Tony Brown, who will be our chair next year on the Council.

MR. BROWN: Big shoes to fill.

CHAIR SODEIKA: Oh, thank you.

And so if anyone would like to make a few remarks on your last meeting, please feel free to do so.

MS. ANDERSON: I would just like to say that I have really enjoyed it. And I believe the first year that I was here, all I did was read. I would read on the plane. I would read when I got to my hotel room. I would read after dinner. And then after the Wednesday meeting, I would still be reading preparing for today's meeting, but it was really a very great educational experience, especially meeting all these folks here.

And I want to also thank the Board staff because they made everything so accommodating. They gave us great synopses of the various regulations and had very helpful questions that we had great discussions. And so I hope, too, that we were able to give you a lot of insight on what was going on.

But I would also like to just add that I know we are in a time where we want to

give, we want to protect consumers and give a lot of disclosures, and we just need to make sure, like with the steps that you have done with consumer testing on privacy and open-end lending, that we make sure that we give effective disclosures. Because, as you can tell from what has been going on in subprime lending, to give them all disclosures in small fine print doesn't really help the consumer. So I just would like to add that, as you look into closed-end lending. And again, I would like to thank you for the wonderful opportunity.

CHAIR SODEIKA: Thank you, Faith.

Stella.

MS. ADAMS: I just want to say what a pleasure it has been -- I said I wouldn't cry but it may happen -- what a pleasure it has been to serve for these three years and represent my communities, rural communities, and African-American communities on this board.

It has been a daunting task, but I have to say that there has been so much change. I think we've seen a complete change in membership of the Governors during the time that I've been here, but I think it's been for the better of the community. And so we're excited. I think now we have the people's Board as opposed to just the people's Governor. So I'm really excited about that.

And I'm grateful for the staff. They have put up with me, and they have been tremendous. I have known Sandy for so long and she does great work, and Tina and Jennifer and Kyan and Sheila are just amazing.

And I have learned so much. The thing I'm going to miss is the same thing that Faith talked about, all the materials that I can take back. So thank you for allowing me this opportunity to serve.

CHAIR SODEIKA: Anselmo?

MR. VILLARREAL: I also would like to echo that it has been an honor for me to be part of this committee for the last three years. It's just such a great group of great talent that, I mean, it has truly been an honor.

Also, I would like to mention that all of the information that I have been able to receive has made a difference in my local community. I work in a small town in Waukesha County in the state of Wisconsin, and it's typical for me to be more active in committees. However, all the information and the great challenges that we're facing are so overwhelming, that my work is pretty much concentrated on one community. But I do want to thank you and assure you that the Waukesha community and, in particular, the Latino community in Waukesha County is better off

thanks to the great work of this committee, the Board, and of course, the excellent staff of the Fed and I know the support that we have received, so thank you very much.

CHAIR SODEIKA: Carolyn.

MS. CARTER: I wanted to -- it's been a great honor to serve on this committee, and I want to thank the staff for their kindness, attention, and helpfulness. I would like to thank my colleagues on the Council for their courtesy and for their lively exchange of views. I think that is a diplomatic term.

(Laughter.)

MS. CARTER: Diplomats use that. And I thank the Governors for listening to us.

And I hope that the Council can function for the Governors as an early warning system, to alert you to problems that can be prevented before they become disasters. I think that when Council members report problems to you that they are seeing, these are things that you probably won't find in bank examinations, but they are real things and it gives you the opportunity to make corrections, take steps before the trickle becomes a torrent.

As I leave the Council, you've got some very big and important initiatives before you. I commend you for your leadership in starting the process to look at regs under your HOEPA authority. I think that's very, very important. You've also embarked on an ambitious and extremely complicated review of the open-end credit rules, something else that is of enormous importance to consumers. And, as you finalize these initiatives, I urge you to avoid half measures. If a practice is unfair, I urge you to prohibit it. If it is deceptive, I urge you to prohibit it. Half measures plus hope, I don't think will solve the problems we're seeing.

Chairman Bernanke said that there has been a misalignment of incentives in the subprime mortgage market, and I think that has definitely been true. The market may self-correct, but it seems to be doing so only at risk of global economic security and only after having harmed many, many homeowners.

So, I urge you to take appropriate measures, but not half measures over the next years as you continue with this initiative.

CHAIR SODEIKA: Kurt.

MR. EGGERT: I would also like to echo everyone's thanks to the great Board staff, who have been such a pleasure to work with. This has been a great learning experience. It's

like a graduate course in consumer finance, with great tuition rates.

(Laughter.)

MR. EGGERT: And I would also like to commend the good strides that the Board has taken recently.

And if I could leave with one message, it would be that consumer protection is not a zero-sum game, as some have viewed it, where everything you give to consumers you have to take away from somebody else. Instead, as we have seen in the last year, robust consumer protection is important for the stability of the system. And so I commend you in your efforts to find the consumer protection that we need.

Thank you.

CHAIR SODEIKA: Marva.

MS. WILLIAMS: I also would like to thank the Board as well as the staff for the excellent materials and insightful perspectives on community development issues. As many of you may know, I changed jobs while I was serving on the Council, and my new job has me working much more intensively in lower-income and minority communities. And it is my hope that over the next few years that the Board will continue to make the lives of people who are less fortunate a primary concern when looking at regulations regarding community development finance. I think that many of these disinvested neighborhoods are a result of various economic patterns, but I think that it also reflects a real failure of public policy to provide the kinds of tools that are needed in those communities to regenerate themselves.

So, thank you so much for the past three years. I have learned a lot also, and I have also been incredibly impressed with my colleagues on the Council from other industries and community organizations. Thank you very much.

CHAIR SODEIKA: Mike.

MR. COOK: Lisa, since you didn't mention my name as one of the people leaving, I guess I'm going to --

CHAIR SODEIKA: Oh, Mike.

MR. COOK: -- be staying for another three years.

(Laughter.)

CHAIR SODEIKA: You were so active yesterday, how could I forget? I'm so sorry.

MR. COOK: Although I would love to and I've really enjoyed it, it's been a fantastic opportunity. I think it's a situation where you took a risk on including somebody in kind of the nontraditional world in your group. I hope it has been as beneficial for you as it has for me. I've really enjoyed it, and the professionalism of the staff and the participation by the Board has been very impressive. I would just like to thank both groups for allowing me to participate in this.

Thank you.

MR. BROWN: As Lisa said, this is also her last meeting. And if I may, on behalf of our colleagues, thank Lisa for her leadership, keeping us on time and on task. Madame Chair.

CHAIR SODEIKA: Okay. Speaking of staying on time --

(Applause.)

CHAIR SODEIKA: Thank you. We'll get to work now. In our first topic we're going to be discussing the Home Ownership and Equity Protection Act. We'll begin the meeting on HOEPA.

In June, the Board held a public hearing under HOEPA to discuss certain practices in the home mortgage industry, including prepayment penalties, escrowing for taxes and insurance, stated income loans, low documentation loans, and the borrower's ability to repay. Based on information gathered through the hearing and public comments, the Board anticipates proposing rules under HOEPA this year.

Yesterday, members of the Community Affairs and Housing and the Consumer Credit Subcommittees discussed various issues related to the Board's HOEPA authority.

We felt yesterday that we had ample input on this subject, so we're actually going to take from this time until 11:15 to our break. So it is a long period. I would just say that if you have to excuse yourself throughout, please go ahead and do so. But we're going to cover this over the next couple of hours and at this point, I will turn to Committee Chair Stella Adams to begin the discussion on HOEPA.

MS. ADAMS: Thank you, Lisa. Good morning.

A fourteenth-century Arab historian once stated that a tax on people's property removed the incentive to acquire and gain property. And so with that, it is our hope that we will inform the Board so that they can protect the community and protect property rights for individual homeowners.

We have divided this section up and we're going to -- I'm going to lead discussion

on questions one, two, and five. But I want members to feel free to chime in at any point on any issue that they have related to these questions. I'm going to ask because we have an hour, we have two hours to kind of get this done, but we need to address all of the issues facing the Governors while they are here, that we're succinct in our statements.

If the Governors have questions, no matter where you are in the queue, the Governors come first.

GOVERNOR MISHKIN: Is that because we paid for breakfast?

(Laughter.)

MS. ADAMS: So with that, I'm going to open up the discussion around question one. If proposed rules apply to the subprime market, should subprime be based on borrower characteristics; loan types, for example, hybrid ARMs; loan terms, such as higher-cost, HMDA reportable loans; or loans with high loan-to-value ratios; or some other standard?

And I'm going to ask Mark if he will open up the discussion on this question.

MR. METZ: Thank you, Stella. There has been a lot written, there has been a lot discussed about what is subprime and how you define it. What I would put forth is a definition which I think is as clear and easily comparable, is to look at price as a proxy for what is subprime and to consider the APR as being the equivalent of price.

And with that, make a recommendation and actually make a recommendation that the Board considers the law that currently exists in North Carolina, which is basically a two-prong test for determining price. The first prong of that test is basically the HMDA standards and the thresholds under HMDA as tied to Treasuries. And then the second prong of that test is whether the rate, whether the APR is more than 1-3/4 percent greater than the average rate for prime loans, as published in the Freddie Mac survey, as reported in H.15.

So, with those two standards, if the loan meets those two criteria, that would be considered subprime, and it would be subject to additional protections. In terms of additional protections, I would caution not to go too far, but use what is reasonable.

MS. ADAMS: Okay.

MS. SCHWARTZ: I think that's a great suggestion in that when you are originating a loan, wherever you work or whatever bank lender or non-bank lender you are, it's important to know from the beginning of the process where it falls in, so that you follow the right rules.

I do caution to look hard at the rates in the HMDA definition if it is done that way, because in 2005 less than half of the book of business would have been picked up in the current HMDA definition, based on short-term rates being so low and APRs being much lower. So, that's my only thought there.

A compliment to the Board and to the interagency guidance a while back was that the definitions used in subprime, which were pretty much characteristic of loans in that market, whether it was late payments on mortgages or trades and other things, that actually did a pretty good job capturing the majority of books of business as well. So just historically, you've done a pretty good job by your current definition.

MS. ADAMS: Carolyn?

MS. CARTER: I want to address some of the alternatives that were mentioned in the question that we haven't discussed. I strongly urge the Board not to try to define subprime, if you define subprime, on the basis of borrower characteristics. Many prime borrowers are put into subprime loans, which is one of the worst things about the subprime market, and that would fail to capture those.

I also strongly urge you not to base it on loan-to-value ratio. That would mean that people with low incomes sitting on big equities are not given these protections until they are flipped through refinancing after refinancing down to the low loan-to-value ratio. So I think that that would be a very harmful choice.

I think, I agree that it should be based on loan characteristics, and rates should be primary as, I think the last speaker pointed out, there are some problems with the HMDA analysis because the pool of loans that that selects changes in very weird ways. Glenn Canner has explained that at previous committee meetings.

I would favor a certain number of points over a Treasury bill, plus possibly adding all loans with certain subprime characteristics, which was one of the other possibilities that was mentioned in the question.

MS. ADAMS: Are there any other -- Alan?

MR. WHITE: I think another approach to defining subprime is obviously to define what prime is. And an important message that perhaps the Board can begin sending through the means of this rule is that there are mortgage products that are safe and sound and that are preferred as the affordability products for American homeowners.

And so I think the Frank bill takes this approach to some extent. That is to say, these rules will apply to all mortgages except those that we are carving out as being prime safe mortgages that don't need a lot of regulation because they are so low risk. And that would be, you know, your 30-year, fixed-rate loans below certain price thresholds and excluding more exotic products, you know, maybe regardless of either the pricing or the credit profile of the borrower. And that way, you would take things like option ARMs, negative amortizing loans and put them into your prime bucket. So I think there may be some merit to the approach of defining prime and excluding that from the regulation.

MS. ADAMS: Are there any other comments on this particular question? Terry?

MR. THEOLOGIDES: Just a word of caution, I think. And I don't disagree with the comments that have been made so far. But I think that the other thing that bears mentioning is to be mindful that outside of prime, there really is a dearth of liquidity right now for many mortgage products, not all of which would be considered unsafe or unsound. And so I think care needs to be taken in crafting a definition to make sure that it's accomplishing the consumer protection goal, but not necessarily capturing a wider net at the very time when liquidity outside of the prime sector is so impaired.

MS. ADAMS: Thank you. Are there any questions from the Governors?

Okay. We'll go on to question two. What would the practical implications for consumers, lenders, and investors be if the Board restricted prepayment penalties on subprime loans in all or in certain situations?

Ed.

MR. SIVAK: Thanks, Stella. I think that there is actually a place for prepayment penalties if they are structured appropriately. And by structured appropriately, what I mean is that on any ARM, regardless if it is prime or subprime, I know we're talking about subprime here, but a prepayment penalty should not extend to the reset period. And so I think that there needs to be a 60-day period. I think all prepayment penalties need to expire 60 days before any reset on any ARM. And in addition to that term, there should be a rigorous notification process in advance of the reset.

So for example, what that would mean is that at 90 days the borrower would receive notification in the mail that in three months your loan terms will change, per your agreement, and what that means is your monthly payment will go from $800 to $1,200 a month. To avoid this increase in payment, you must contact your lender, number, at X, you know, whatever that number

is, to refinance. And then note, please note, you have a prepayment penalty, per your agreement, attached to this loan and if you refinance before this date, you will get hit with this penalty amount. And then after that date, however, this will expire. Essentially, that notification probably should be at 90 days and at 60 days, you could drop the prepayment language because it will have expired if that term is in place.

So, I think having the expiration date for the reset period and then the notification process. I think those coupled together are important.

MS. ADAMS: I see Faith, and Faith, and Kurt.

MS. ANDERSON: I just wanted to add that the prohibition of prepayment penalties is not that new to certain industries. For example, federal credit unions, we cannot have any prepayment penalties, but we are able to offer mortgages to our members. So I just wanted to point that out, that it's not that exotic.

MS. SCHWARTZ: Well, this has been talked about for a long time. And Ed, I thought your comments were right on. As a tool, it can be used appropriately and if markets function appropriately, that should be a price break for the borrower all the way through. It's hard to know what the impact would be with the wide-scale elimination of that tool in the market. Today, maybe there would be no impact because the market is not functioning, so it's hard to know what the rate rise would be.

But, historically, even though states had eliminated them, so we already know that in some states they have eliminated them and the market does function well. But what was paid for by Wall Street and the investors through to the lenders or wholesalers was a significant price or a fee break and how that was passed through to the consumer on the other side is mixed, at best, if it was marked up or not. But certainly, there was a price break for expected certainty on something lasting two years or three years as a payment versus one year.

So, I think we have some history on pricing on that, but it's hard to know what the impact would be wide scale.

MS. ADAMS: Kurt, Alan.

MR. EGGERT: Like everything, I think one of the ways to think about this is we want to force the market to compete based on effective price shopping by borrowers. And so the question for the Fed should be, is this an area where borrowers can effectively shop and rationally choose prepayment penalties in order to reduce the cost of the loan to them or not? And I think it's

interesting that the market where you would think you would trust most of the rational decisions of borrowers, which is the prime market, doesn't have prepayment penalties. I think that tells you something about the rational desires of borrowers who are good at planning and protecting their financial interests.

It's interesting that the market where prepayment penalties were pervasive, the subprime market, is one that has been, you know, selected in some part because the people in that market haven't been quite as good at handling their financial affairs as prime borrowers, or for whatever reasons. Not all subprime borrowers are in that category, but many are.

And so when you segment the marketplace into, you know, the best shoppers in one area and they don't get prepayment penalties, and the other shoppers do, makes you concerned that this is not an area that people are choosing for rational price shopping reasons.

I also think the prepayment penalties are so -- I think very few borrowers can effectively make the decision. For me, I get somewhat better and it's worth it to be locked into the rate. I think that's a very difficult decision to make. And I think that you could look at studies of how often subprime borrowers actually got a price break, based on a prepayment penalty. And I think if you could look at that, you would see that the price differential rarely gets down to the borrower and instead is absorbed other places.

MS. ADAMS: Alan.

MR. WHITE: Yes, I think more specifically there are two empirical studies on this so-called price tradeoff, one of which the Center for Responsible Lending found absolutely zero retail price concession for prepayment penalties. And the other was the one by, I think, [Anthony] Pennington-Cross, I forget the authors, but at any rate, showed about a 12 basis point break in price, basically a negligible tradeoff in price at the retail level.

So what prepayment penalties have done is basically provided rent-seeking opportunities for originators. And what originators have done is incorporate a prepayment penalty to get the break on the wholesale side, not passed that through, and you know, as a result, achieved a higher commission or earnings, or gain on sale, whatever the case may be. And obviously, the secondary market has been very hungry for these because of the secondary market's hunger for yield. But the secondary market can survive without prepayment penalties just fine, as it has in 10 or 12 states where they are banned.

And I think that there are also studies that more generally have looked at states

like North Carolina that not only banned prepayment penalties, but have a number of other restrictions on subprime and have specifically looked at the price question. All right, in addition to seeing whether credit dries up, which it doesn't, has subprime credit increased in price? And they haven't been able to find that effect based on the impact of state laws.

So, my own view is you ban prepayment penalties in the subprime market, you're going to squeeze out some of the rent-seeking and some of the yields. You're probably not going to affect the retail prices independently. You know, retail prices are going to change for a lot of reasons. I don't think banning prepayment penalties is what is going to drive up prices for subprime loans.

MS. ADAMS: Thank you. Sarah?

MS. LUDWIG: I would urge you very strongly, for reasons already cited, to ban prepayment penalties on subprime loans.

I come from a state where we have a state law that bans prepayment penalties after the first year, that's New York. And until the last couple of years, I would say because of federal preemption issues, we had a really, I think constructive lesson that we learned from the impact of our state ban on prepayment penalties. We didn't have abusive prepayment penalties in New York state. Very simple.

MS. ADAMS: Mark?

MR. METZ: I agree that there has been abuses in prepayment penalties. I mean, particularly on some loans, I think as Ed described where you got maybe a two-year loan and you're locked in and you're sort of trapped in your loan, and then the rate goes up significantly. However, I would argue that there are banks that do make prime loans with prepayment penalties, and there is an economic justification for a lower rate. Also, the bank tries to recapture its costs for those loans.

And I agree, it needs to be clearly disclosed that you are paying more, you're getting -- excuse me, you're paying less but you are being locked in. And if that is properly disclosed, I think it is done in places in the prime market, and I would caution you to be careful not to make it too broad.

MS. ADAMS: Tony?

MR. BROWN: I want to speak in favor of either a ban or some restrictions. And I guess the question asked, what would be the implications to lenders and investors or lenders and borrowers?

I'm no expert in the capital market, but the broader question is, do prepayment penalties protect the investors' yield? And I guess we're seeing a meltdown in the secondary market to know that it's not necessarily prepayment penalties that protect investor yields. And so I don't know to what degree of runoff would cause some dilution of yield. But if there is a practical analysis, perhaps that is it.

And Kurt had mentioned that the prime market, that the portfolio prime markets have only about a 3 percent prepayment penalty where subprime loans have about a 70 percent. So that, I guess, is the business rationale.

If prepayment penalty is eliminated on certain situations and they weren't outlined in a question, I guess there had been some question that the subprime product should allow the borrower to graduate and graduate into a prime product. And so, if the borrower's risk profile has improved to the extent that they can benefit from a lower-cost loan, then that borrower should not be penalized in order to seek a lower-cost loan, which I would think then would help ensure that the customer that is seen to be less risky has had a chance to move into a prime product.

MS. ADAMS: Thank you and I'm going to take -- oh. I was going to take the last word on this one. Go ahead, Kurt.

MR. EGGERT: I'm sorry.

MS. ADAMS: And Carolyn, was that you?

MS. CARTER: No.

MS. ADAMS: Okay. Kurt, go ahead.

MR. EGGERT: Well I just wanted to, I thought Tony made a great point about the purposes of, one of our goals in regulating the subprime market is to allow the graduation of people from the subprime market into the prime market. And thus, putting people into lower-priced loans, which are easier for them to afford, and so we have a more stable housing stock and that's a good thing.

One of the differences between the prime market and the subprime market, as far as prepayment penalties, and why I don't have a problem with prepayment penalties in the prime market, is there, if you're looking at what the purpose of the prepayment penalty, by and large, it's to protect the lender against dropping interest rates. Because if they're in a prime loan, they don't have a reason to refinance, unless prime rates drop. And so that's what you are protecting against.

In the subprime market, one of the primary purposes of prepayment penalties is to

lock them into the subprime rate, is to keep them from getting to a prime loan if they can qualify. And that's a much more pernicious lock than any lock in the prime loan and one that the regulators shouldn't encourage. We should want people to be able to move from the subprime to the prime market, if their finances and credit ratings warrant it.

MS. ADAMS: Tom?

MR. JAMES: Yes. I just wanted to talk about another effect that they have. They are a classic restraint on alienation, which under the common law was always something that, certainly in equity, was to be avoided at all costs. One of the effects they have is often times to lock borrowers into their current lender. The current lender will extend new financing only if the consumer deals with the lender. And in that way, the lender protects market share, I think, unfairly and anti-competitively protects their market share and, of course, eliminates competition.

MS. ADAMS: Thank you. I'm going to take the last word, although my point has been made by Tony and Kurt. But I want to reiterate the purpose of the subprime market was really to give a second chance at credit access to borrowers who had demonstrated, who had poorly performed in the prime market. Your own studies show that subprime borrowers who pay on time improve their credit to reach the prime market within 12 months. So that means that you are punishing good credit behavior with a prepayment penalty, and most of the prepayment penalties are in the two- to three-year range. You are punishing good behavior by locking people into the subprime market.

Once they are in the subprime market, with these prepayment penalties, they don't get out. And so we're setting up a separate and unequal, two separate and unequal markets.

And so I encourage you that those borrowers who have improved their credit, they should have the opportunity to get out and get the benefits of improved credit performance by not having prepayment penalties allowed on subprime loans at all. And I am strongly advocating a ban on prepayment penalties in the subprime market.

With that, we will move on. We're moving on pretty good to question five, which will be another robust discussion.

What are the most important characteristics for determining whether a borrower will be able to afford to repay a loan? For example, underwriting to the fully indexed rate or fully amortizing payment. What would be the practical implications for consumers and lenders, if lenders were required to take those considerations into account when making a subprime loan?

And I'm going to ask Patty if she will start this discussion.

MS. HASSON: Thank you, Stella.

I believe strongly that the Federal Reserve should look at not only the ability to pay, but the ability to sustain home ownership. I think that's gotten long forgotten. The clients that we're seeing coming in, not only with ARMs and other problems, we're seeing people with 30-year fixed that are having difficulties making payments. In an environment where health-care costs are going up, where one broken heater away from making a payment. There are no savings. And I think a very frightening statistic that I recently looked at for another presentation I had to give is that the 401(k)s and the people we are seeing in delinquency right now have dropped 43 percent. People are using their 401(k)s to save their home. So the implications for the future and what will happen in retirement for these families is frightening.

So, I would ask you to look at the fully indexed rate. If you choose not to look at the fully indexed, there has to be a point where you are looking further out that this individual can sustain the home, because there is a lot of other costs that are impacting. And if you think about somebody making $30,000 a year in the best of circumstances, getting into these mortgages at a 5 percent increase, that's $1,500 a year. Many of these payments alone are going up $200. They're already going to be negative.

So, I would urge you to look at that. I recognize that some people may not get into homes based on that, but I think if we're looking at sustaining home ownership, it's something we need to consider.

MS. ADAMS: Mark?

MR. METZ: Happily, I agree with many of Patty's comments. I also support the underwriting to the fully indexed rate. I think the key, and I'm not sure how you do this with the way the market is, I think you're trying to align the interests of the borrower and the lender, much like happens in portfolio lending, where you want that borrower to perform, you don't want to have to foreclose. And to the extent that you can align those interests, you are better off.

MS. ADAMS: Marva?

MS. WILLIAMS: I also agree that ability to repay the loans should be paramount. One of the characteristics of predatory loans is that there is no assessment of the borrower's ability to repay. So a payday loan is based on the consumer's next payday. An auto title loan is based on the equity in their car. A refund anticipation loan is based on an anticipated tax

refund. And so there is no assessment of their ability to repay, which I think is of primary importance when making loans and underwriting loans.

MS. ADAMS: Cooke, did I see?

MR. SUNOO: Thank you. I agree heartily with my colleagues in terms of looking for the ability to repay the loans. What I am a little concerned about, very concerned about, is that as we try to reform the system and look at ways that we do that, that what we think is a magnifying glass on the borrower actually, well, the analogy, if you were to use a magnifying glass on a bright sunny day and you start to burn that borrower.

What I am talking about specifically is we'll sometimes look at the problem and say, you know, the problem is these no doc loans, low doc loans, etcetera, stated-income loans. The problem that I have with stated-income loans is that in our immigrant communities, quite often we're dealing in the cash economy. We work, in my particular program in Los Angeles, with micro businesses. Small businesses, micro businesses deal in cash. The IRS doesn't like it. They don't report their incomes, they have no record of it in a traditional sense. Does that mean they don't have the ability to pay? It does not. Does that mean that anybody who comes in and says I make $100,000 a year ought to be funded? Absolutely not.

What I want to be very careful about is trying to define too tightly what the definitions of income or the proof of income ought to be. We have a dry cleaner that buys a thousand hangers a month or whatever it might be and yet his income doesn't reflect the fact that he's processing a thousand garments. But we can see his records of his supplies costs. The gardener, by the number of accounts that they might have.

The Wall Street Journal earlier this month published the report that said -- and this segues a little bit into the ITIN loans -- a lot of the ITIN loans are combined household incomes, some of which is reported per the ITIN and the IRS. But commonly, these households have cash incomes as well that they combine together. On the ITIN loans, the history has been that their default or their 90-day delinquency rate is one-half that of the prime loans in the marketplace. The ITIN loans have a 90-day delinquency rate of one-half that of the prime loans and one-twentieth of the subprime loans.

So what we're looking at is measuring income, but measuring it very carefully because these ITIN loans are very, very carefully underwritten, and a lot of them, the majority have unreported or cash incomes that are part of the mix.

So, use that magnifying glass, but don't burn the thing you're looking at. Thank you.

MS. ADAMS: Thank you. Carolyn -- I'm sorry. Tony, Carolyn, Sarah, Faith, and Kurt.

MR. BROWN: To the Governors, I don't know if I have a particular recommendation other than say perhaps approach the issue carefully, which I know you will.

I remember the days as a former banker and I would negotiate with consumer groups who would question, why do banks underwrite on a front-end ratio and the back-end ratio and felt that a borrower would put more emphasis on paying their mortgage and so there should just be one ratio. And I bring that up because of the comments made that if the rate changed and the inability to pay utilities or the inability to pay a car note begins to affect if you are allowing more income to go towards servicing your mortgage.

Clearly, ARMs have been the way for borrowers to lower their cost of borrowing. It has enabled individuals to buy more home. And I think that has sort of been an important benefit. If you were to underwrite it at the fully indexed rate, I guess the unintended consequence could be a reduction in credit availability, which begins to have an even bigger impact on a very soft housing market.

So, I seem to lean where the problem is. I don't know if there is one thing that you can do to solve it, but I think there is an issue at the point of sale. Again, at the point of origination. And I don't think that brokers, generally, are motivated by their fiduciary responsibility or if they have no fiduciary responsibility to the borrower. I think at the point of sale, it's about how much money I can make in originating this loan.

And so the comments that deal with some type of broker disclosure on how much they would make from this transaction, how they are paid from this transaction and by whom, would perhaps provide the borrower a better position to decide what is the best product for them.

MS. ADAMS: Thank you. Carolyn, Sarah, Faith, Kurt, Alan.

MS. CARTER: I think that establishing an ability to pay standard is very, very important. I would like to take off from Patty's point, though, about evaluating the ability to sustain home ownership. And I urge the Board to consider going beyond not just looking at the fully indexed rate, but rather look at the maximum rate that the adjustable rate could adjust up to, over at least the first seven years, which I have read is the average time a person keeps a home.

We're in a low interest rate environment now, and so maybe we're not thinking about the crisis that can be produced by rising interest rates. But back in the 1980s when I was a legal services attorney in Cleveland and the interest rates went through the roof, we had just thousands of homeowners who were losing their homes because they had adjustable, actually, it wasn't even adjustable rates, but they were -- anyhow, they were losing their homes. The interest rates had skyrocketed. And that could happen again.

In addition, the fully indexed rate is really a fictional rate because the borrower will probably never actually be charged that rate. That's the rate that will be in effect at the end of the initial period, if interest rates don't change at all, which is a very unlikely event. So, it seems odd to measure the ability to pay, based on a payment that the borrower will probably not ever be asked to pay. In addition, we have seen a lot of loans, subprime loans where the fully indexed rate is lower than the initial rate, even measured right at the time of closing. That's because we've seen many of these loans where there is a fairly high rate at the time of loan closing. So it certainly wouldn't make sense to qualify the borrower on the lower of two rates because it would be bad to build into the rule an assumption that the fully indexed rate is the higher rate.

But more fundamentally, the fully indexed rate understates the borrower's exposure. I see Governor Kroszner. Did I not -- you looked like you didn't understand.

GOVERNOR KROSZNER: Yes, I didn't quite follow how the fully indexed rate would be lower than the introductory rate.

MS. CARTER: And what I could do is, in a day or two, I can send you some samples.

GOVERNOR KROSZNER: Thank you.

MS. CARTER: I think that will make it clearer than my trying to talk it through.

But more fundamentally, the fully indexed rate understates the borrower's exposure and especially since, right now, we have a very, very weak disclosure of what the worst-case scenario is for the borrower, the Truth in Lending disclosures of that are very, very weak. That means to me that the system isn't really accounting for that risk, and I submit that that is a very significant risk that should be taken into account and taken into account in the ability to pay analysis.

MS. ADAMS: Thank you. Sarah?

MS. LUDWIG: Does anybody else here think it's strange that we are, sort of collectively across the country, clamoring for an ability to repay standard? I mean, it seems very

ironic. We're in a crisis, so we have this opportunity to actually restore basic, fundamental, sound lending principles. And it seems the core to that is an ability to sustain a mortgage. And how we get to that, we have to work out, but it seems like that principle needs to be front and center.

All of the abusive lending practices that we have seen for the last ten years, because this is not new, the crisis and the level of it I think is unprecedented, and we're sort of jolted in recognizing how much things have escalated. But the common thread running through all of the abuses for the last decade has been unaffordability to the borrower. Underwriting standards seem to have been thrown out the window, and it's time to, I don't know, close the window.

So, it seems like it would make sense to me and to the groups that we work with that the Federal Reserve adopt a standard of ability to repay across the board for all loans. It's just a really basic principle of sound underwriting. And we also think, to Cooke's point, that ensuring or requiring that lenders verify that affordability does not preclude access for people with nontraditional forms of income.

So, I think there is a way to craft the ability to repay standard, make sure that people who don't have -- well, that's broad enough so that verification can accommodate different income sources.

MS. ADAMS: Faith?

MS. SCHWARTZ: Yes. I wanted to link a little bit of the stated income to the ability to repay also, and I think there's a way to get at both of them and be effective. And the limited income documentation being nontraditional income, with bank statements, cash flow, other forms of identification that there is evidence that someone has been paying, is current, and not always in the credit system as robustly as some others. I think there is a way to make sure that all the people that are in stated-income loans can still qualify if there is more evidence of how you can get there, and I think there is a way to do that and historically, I have seen that done.

So, my only other observation is I think Tony mentioned something I think is important. ARMs have been around for a long time. If they are always going to be indexed above fixed rates, and that's only in this rate environment, let's just say today, with a flat-rate environment of short and long rates, then you really preclude that opportunity and not --

So, my only point would be, think about, I believe five years for someone who wants to get into a mortgage or has a reason to refinance, is reasonable. Because I don't think everyone thinks they're going to be in their house for 30 years. I think those opportunities and

options in worst-case scenarios are reasonable to think through stressing like, that that payment has to qualify over a five-year period, however you get to that formula.

And so that's just my thought on that. Thank you.

MS. ADAMS: Kurt?

MR. EGGERT: In reading this question, I was struck by the question, what are the practical implications for consumers and lenders in this instance? And I wanted to say a word about the forgotten figure in this, which is the investors.

The assumption with securitization is that investors have been able to depend on rating agencies and the people securitizing loans to rate the product and to give the investor an idea of the potential loss and risks involved. And what we have seen in the last year is that that system doesn't work very well if the rating agencies are trying to rate, essentially, unstable loan products. If they're trying to rate risk-layered products, if they're trying to rate stated income, they're trying to rate loans where the borrower hasn't shown an ability to repay, and so what you do, if you don't require the ability to repay or proven ability to repay, is you pump these unstable loans through to investors with a proxy of rating agencies that I think are not capable of establishing the risk.

And so if we require the ability, proven ability to repay, you will help not only the borrowers, who will lose fewer of their homes, but I think that would be a great benefit to investors, who would then be more able to rely on the ratings, be more willing to invest in these loan products and so be more willing to fund the loans to the borrowers that we're worried about.

MS. ADAMS: Alan?

MR. WHITE: I suspect that this repayment ability issue of the items on the menu for HOEPA rule is probably the one on which the Fed would be the most reluctant to intervene in the market, for understandable reasons. I do want to, therefore, start my comments by talking about what has actually happened in the market, left to its own devices and in particular, what has been happening since this crisis has hit.

And the perception has become generalized that subprime loans have been badly underwritten. I think there have been a lot of statements made, including statements by the Fed, that the market is going to correct itself. That's sort of a general statement. Making that a little more precise, that investors are going, in the future, to make sure that subprime loans, if they are made, are made on a sound basis. I am very skeptical about that.

I think that the evidence, and I brought some material for the meetings yesterday,

and I have some extra copies, several articles written in the last month or two, that suggest that that is not happening, certainly to the degree that it needs to happen.

The volume of subprime lending has gone down dramatically not so much because underwriting has tightened, but because property values have stopped increasing, so that the value isn't there for more lending to be made against.

The second major phenomenon that we have seen just in the last really month or two is that suddenly investors have become so skeptical about the information from the underwriters and the rating agencies that they're just saying, well, we're not going to buy because the information that we thought that we could rely on we can't rely on anymore. But that is a temporary phenomenon and that will go away, I think, in fairly short order.

And the fact is, no doc loans are still available. No doc loans to subprime borrowers are available. They are mostly drying up, but no doc loans are certainly available to people with high FICO scores.

The exploding ARM product, the fundamentally dangerous product of starting people out at a rate that is not sustainable, that's being changed from a 2/28 and 3/27 to a 5/25 product. And so in other words, we're putting off the day of reckoning, and I think Chairman Bair of the FDIC astutely referred to that as kicking the can down the road.

So, there are some temporary fixes being put into underwriting, but as far as I can see, some of the basic fundamental problems with underwriting are not being fixed by the market, and I think that there is an appetite for yield in the capital markets that will cause all of these products, these high-risk products to come back. And they may be priced a little higher, but the market is not going to solve the problem that is leading millions of people to lose their homes.

And so I really would encourage the adoption in this HOEPA rule of a general standard that subprime loans, and we're going to exclude business loans because HOEPA and Truth in Lending don't cover business loans, so the issues about entrepreneurs taking risks and having no visible means of support, that's what America is all about and that is fine.

The HOEPA rule is about homeowners who are either borrowing money to buy their house or taking cash out of their equity for consumption purposes. And those people should not be taking out loans that they haven't demonstrated that they can repay with their current income over a reasonable term of the loan.

So, I would really urge the adoption of a broad, general standard similar to what is

in the guidances, but through the reg making it applicable to the entire market, obviously, not just the regulated institutions, because I don't think the market is going to solve this problem.

MS. ADAMS: Thank you. Tom?

MR. JAMES: I just couldn't agree more with the market not being able to solve this problem, at least the way it is structured right now. And I just kind of wanted to address the broader issue in terms of HOEPA and the kind of police and regulatory function that I think is intrinsically built into that aspect of HOEPA, which is kind of different than the traditional safety and soundness doctrine that the Fed has followed historically.

And in the sense that you are policing the marketplace under HOEPA, to the extent that you don't require things like, basic things like ability to repay, the result I think will lead to the market producing products which we see all the time, certainly when we are policing in the states, products and behavior that are fundamentally there so that people can't repay. They are products that are designed so people cannot repay.

And what that does, eventually, is trap people in unsustainable economic environments. We have, you know, two million people going into foreclosure this year. I think that's a low number from what we're seeing on the street. We have people locked into products for which they were never intended to be able to repay. And they were structured and designed that way and certainly sold that way on the street.

So, I just don't think there is any way around a fundamental rule on the policing end that you have got to have a product which the consumer can repay. And you have got to have a product that the least sophisticated consumer can repay.

So when you start layering things like prepayment penalties, which are really a very, very complex bet where the downside of the bet is almost always skewed against the consumer, certainly in the 70 percent subprime consumers who took that bet, I'll wager you that no one really understood the downside. And in most cases, they're betting against the house, and there is no upside for the consumer. These products, like prepayment penalties in that environment, will lock someone into a situation where they will never get out of debt, which is simply inappropriate from a policing standpoint.

It may not be inappropriate from a safety and soundness standpoint because certainly, to an extent, institutions can profit greatly from people who can't yet crawl their way into a better economic position, with better negotiating power, but from a policing standpoint, it's a royal

disaster.

MS. ADAMS: Yes, Edna and then Ed.

MS. SAWADY: I would like to lend my support with all my colleagues to the ability to repay standard. And just point out another component of the ability to repay, which is the additional debt that consumers may undertake in addition to the mortgage payment. We're talking about a span of many years, and I would suggest that some consideration be given in the spirit of financial literacy to point out to consumers, just in terms of guidance, what is their capacity for additional consumer debt on top of the mortgage they are already undertaking?

A few months ago, I came across a few statistics that were pretty interesting and a little bit alarming to me because for decades we have assumed that consumers look at their mortgage as their primary debt obligation and that is the first one they will pay. And some statistics recently are showing that the gap is so, for many consumers in some segments, the gap is so broad to what they can pay or should pay, that they simply give up on it. And they choose to protect their credit card payments over the mortgage payments.

So that is, I think, a statistic that we have not seen in decades before, which raises even further the public policy obligation to consider the ability to repay standard. Thank you.

MS. ADAMS: Ed?

MR. SIVAK: I want to make two points. First is directly speaking to the question when this was posed to our mortgage department, they basically said, you know, don't underwrite at the teaser rate, which we termed the initial rate. And in terms of what other characteristics are important for determining whether a borrower would be able to repay, they looked at the jump from a rental, this being a first-time homeowner situation, they jump from a rental payment to a mortgage payment. If there was a significant, like if someone was paying $600 a month and then they were going into an $1,800 mortgage, that was a red flag. That needed to be considered in the underwriting in terms of whether they would really be able to repay, especially if there were dings on the credit history at $600 a month in rent.

And then the other piece that they mentioned is the presence of assets or reserves. That was caveated, with the experience that they're having now recently is that there are a lot people coming that don't have reserves.

So I don't -- I guess I'm just throwing that out there as something that is being heard from the field. I don't know that I would incorporate that as important in terms of how we

structure this ability to repay.

The second point I want to make is speaking to Tom's point about the policing. There's a lot of, I mean, I think one of things that the Fed does well, has a track record of, is regulating their members. You know, that is, in Sandy's testimony you see the fact that there are only five referrals, you know, to DOJ in the last year. There is something to be said about that.

And as we're having this conversation, you know, there are 17 large independent mortgage companies that generated a half million loans last year -- 39 percent of the high-priced market who this conversation may or may not affect, at least at the same level that it's going to affect the entities that they are regulating. And so I guess I would like to propose, I don't know how this would happen, that some of these companies undergo a Fed exam and see what the outcome would happen. Could they stack up to fair lending exams? What would happen? Could they stack up to a safety and soundness review? And so I think that is something we need to really think about as we're talking about the mortgages.

MS. BRAUNSTEIN: I'm sorry. Can I make a --

MR. SIVAK: Sure.

MS. BRAUNSTEIN: I just want to say, along those lines, we launched, have launched a pilot program this year where we are looking at non-depository affiliates or subsidiaries of bank holding companies in just that regard, looking at Truth in Lending, fair lending, and some other regulations. And we're doing this in conjunction with the OTS, the FTC, and with the states. And they are looking, the states are looking at several of their independent mortgage companies and doing full exams. The OTS is looking at non-thrift subs, and the FTC is working with us on several of these entities.

So you know, we are doing exactly what you are talking about and we think it's very important.

MS. ADAMS: All right. Terry, Joe, and then Kurt will be the last. Oh, Patty will be the last person.

MR. THEOLOGIDES: I concur with my colleagues that repayment ability standard makes a lot of sense. I think, in terms of, in most cases, what is the right measure of that. I think that's a debt-to-income ratio, and I think it makes sense to do it at the fully indexed rate.

I would caution about layering in additional tests like how high could that rate conceivably go, depending on what happens to interest rates or what other factors could come in. I

think that goes beyond an ability to repay to sort of a much more difficult standard of a certainty of repayment ability which I think has real implications at access to credit. And I think that in terms of basic safety and soundness, I think that the long history of ARMs I think would bear out that using a fully indexed rate gets you to where you want to be, without having to burden borrowers with every possible iteration of what could happen in the future as being a standard for allowing them into the mortgage market.

MS. ADAMS: Joe?

MR. FALK: I'm not going to defend some of the practices that have gone on in the last couple of years. Clearly, there has been sort of, to use a Fed term, an irrational exuberance in these markets. But I think the challenge for the Board and the staff is a pretty high one, because we're looking for a sense of balance. What we have been talking about today is how many loans we're not going to make. If not, how do we promote the effective and responsible use of credit and promoting home ownership and promoting responsible lending practices?

There has got to be a way to allow exceptions to some of these rules so that for all of those story loans out there that none of us will ever figure out the personal circumstances and the unique situations that consumers find themselves in. We're never going to come up with every particular unique set of circumstances that rule the day for a particular individual.

And because many here have already talked about hard and fast rules, one wonders whether part of the balanced equation should include some responsibility for consumers. I'm not suggesting that fraud, misrepresentation, unfair and deceptive trade practices should be allowed. They shouldn't. But consumers also have a role in this to be responsible, to learn about their products, to understand the ramifications of their choices, and quite candidly, as unfortunate as it sounds, the right to make a mistake, if certain circumstances dictate that that's the unenviable result.

MS. ADAMS: Kurt?

MR. EGGERT: When we're looking at the effects of this, you know, we need to look at the whole market from the borrowers to the investors and everybody in between. And if you look at that market, the two parties that are primarily interested in the quality of the loan are the borrowers, who risk foreclosure if a bad loan is made, and the investors, who are stuck with the bad loan once it is made.

The participants in between, in the pipeline -- from the originators, the brokers,

the originators, the securitizers -- primarily benefit based not on quality of loans but on quantity. And that's been the problem is that the incentives to the pipeline are to get as many loans through as possible. Now there are some market-driven limitations on them that they don't want to completely risk their reputation by making bad loans, but as we have seen, that limitation hasn't been that stringent and a lot of bad loans have been made.

Alan says, well, the rating agencies will figure this out, but I'm not so certain that the market will easily correct. And I think what will happen is that investors, once they get back in, will view this as a market where they can't identify the lemons. That they know that some bad loans are being made. They don't know which ones they are. And so how they will respond is by demanding higher rates from everybody because they are not sure which are the borrowers who have an inability to repay and which aren't.

By demanding higher rates from everybody, they hurt all borrowers. The people that can't repay will be even less likely to be able to repay with higher rates. The people who can, still face the higher rates. And so, the way to benefit all those borrowers is to demand a shown ability to repay, squeeze out the lemons, and to make the market work more efficiently. And that would benefit both the borrowers and the investors.

MS. ADAMS: Patty?

MS. HASSON: I just wanted to comment on Edna's comment about people are paying their credit cards prior to their mortgage. It goes back to sustaining home ownership and sustaining life. People, you cut up your credit card or you don't pay your credit cards, you're not going to have access to it. So people are using it as a budgeting tool to sustain, you know, pay for their health care, pay for other costs and they are juggling. So I think that is one of the reasons you are seeing that.

And on the credit card line, I would like to say that I believe within the last year, everybody went to a 60-month amortization. Everybody thought the sky was going to fall, that people couldn't afford those payments. And as we've seen, people are figuring that out and, you know, paying that minimum payment at 60 months. And that came about as an ability to pay. You know, people looked at that and said you've got to be able to pay that back in 60 months.

So, I think we have to take that lesson into this market and look at housing also around ability to pay.

MS. ADAMS: I'm going to have the last word on this subject and then pass the

ball to Kurt. Lisa, if that's okay to just pass.

It is sound, it is safe, and it is an assumption that consumers make that no one would lend them money if they didn't think they could pay it back. It is irresponsible for the market not to make sure that there is an ability to consummate a contract that is entered into with the consumer. The ability to repay is a fundamental business practice. This is, I've never even had an economics course, and I know that I'm not going to lend money to my brother if I don't think he's going to pay it.

(Laughter.)

MS. ADAMS: I mean, we learned that in kindergarten. And so when the market, and I'm going to refer you all back to the transcript of the October 2005 CAC meeting where I strongly urged that we put in place some brakes on this. And it wasn't this Board, so there's no fun in it for me to say I told you so.

(Laughter.)

MR. EGGERT: But I told you so.

MS. ADAMS: But I told the entity so.

I was informed that macroeconomics weren't involved in here. I said, well, this is an untested and unproven market, when we were talking about the subprime market being securitized. It hadn't seasoned and we didn't know whether this was a sound market, but it certainly didn't look sound then. And it has proven -- I was proven right. I should be a capital market analyst.

But anytime the International Monetary Fund says that we need to regulate the mortgage industry, I think that that's what we ought to do. And we should not punish consumers. We cannot expect consumers to be, to do anything more than basic, sound understanding and principles. And that if they enter into a contract, that we make sure that it's a contract they can understand. But they do walk into that transaction expecting that no one is going to put them into a loan that they can't repay. That's an assumption. You assume that the bank -- we fear the lender.

We go in saying, please tell us that we have met the standards to be able to qualify for home ownership. And so we assume that when the lender says yes, that we have met the standard to be able to be a homeowner, not for the short term, but for the long term. That is the standard, that ability to repay, and the ability to sustain, as Patty talked about.

And I just urge the Board, we're really not asking anything to codify, except to codify a basic principle we learned in kindergarten. We're asking you to just say safe, sound,

rational, that you don't lend money to people when you don't expect them to be able to repay it in the manner in which they contract with you to do.

MR. EGGERT: So Lisa, we have until 11:15 for this portion?

CHAIR SODEIKA: Yes, we do.

MR. EGGERT: Okay. So I'm taking over the chairing of the next portion of the series of questions. And I see this as the basic underlying philosophical argument is what role in regulating the subprime market should the Fed take? To the extent that the Fed doesn't take the laboring oar, the underlying, the subprime market will be regulated by and large by the ratings agencies.

And so the question is whether increasing the baseline of regulation by the Fed will help or hinder the market. And that is the question that you are charged with answering and we're charged with helping you try to answer.

So to begin that, I would like to turn to the remaining questions for discussion and the first one being, should consumers in the subprime market be presented a choice to escrow taxes or should lenders be required to establish escrows for all or certain types of loans? And I would like to turn to Carolyn first.

MS. CARTER: Thank you. We urge the Fed to require escrow for at least for subprime loans. And looking at the escrow situation in the subprime market in the past several years is a very curious thing to look at because the escrow is very common, it's standard in the prime market. The standard in the subprime market is not to require escrow, which is the exact opposite of what you would think rational lenders would do, since their failing to require borrowers who are likely to be cash-strapped to place into escrow just doesn't make sense. No lender would tell a borrower to save up your monthly mortgage payment every month for 12 months and then pay me all the mortgage payment in December. They know that they would never get their mortgage payment. Why is this happening with escrow?

Well, I submit there are several reasons. One is the go-go environment, where lenders knew they either had to make loans or they would go out of business. There was a scramble for market share. And so, as it has been pointed out by other speakers, volume origination was the goal, and affordability fell by the wayside.

Second, I'm sorry to say that failing to include escrow facilitates bait and switch. Just for example, a client I saw several years ago had bought a home. He was fairly low income. He

bought a home and had gotten a prime loan. His brother-in-law had helped make the down payment. Then a subprime lender came to him and said we have a proposal for refinancing and did a little chart showing your payment now and your payment under us and you're going to save money. And the payment now included escrow. The payment under us did not include escrow. And the really scary thing is this was done with software. This was not the loan officer's own little handmade chart, and it was a major national lender.

Even when it's not so blatant, I submit that lenders gain a competitive advantage by being able, maybe not with a chart, but being able to get the borrower to focus on the low, no escrow payment and that that competitive advantage drives out escrow in the subprime market.

Finally, another reason that could explain this counterintuitive pattern with escrow in the subprime market is that failure to pay, make the insurance payments, triggers the lender's ability to force place insurance. And lenders tend to force place expensive insurance that they profit from.

So, we support requiring escrow, allowing non-performing -- a loan without escrow is likely to become a non-performing loan. Allowing non-performing loans to be made hurts consumers. It hurts neighbors, neighborhoods. It hurts lenders. It hurts the economy.

I would not object to some opt-out feature of a required escrow, but it would be, if the consumer were allowed to opt out at closing, that would mean you hadn't made a rule at all. You would not change anything because the closing is just not an occasion when a consumer is going to actually be able to exercise choice. If you allow an opt-out, I urge you to do that only after the consumer has demonstrated an ability to make these payments over a substantial period of time.

MR. EGGERT: Mark.

MR. METZ: Yes. I agree with much of what Carolyn just said. I think that the taxes or the escrowing for taxes and insurance goes back to the prior discussion, and it's really an underwriting issue. And being a responsible underwriter and looking at someone's ability to repay as part of that underwriting decision, again, to repeat what I said before, you underwrite at the fully indexed rate and you also underwrite people for taxes and escrow.

So, I completely agree that it's a good thing. It should be done. I think it's a good thing for subprime. It's probably also a good thing for first-time homebuyers.

I think there is an economic piece in this though, too. For certain loans, probably prime buyers, escrowing may not be the best economic decision for every borrower, so I would want

you to have some flexibility there and have borrowers to have some flexibility there.

I think most lenders, and this goes back to my point before about trying to align interests of the borrower and the lender, I think most lenders prefer escrow because borrowers perform better. And I think most lenders would say we make money on escrow. The only issues we have are just making sure that our systems can work. And there are sometimes some difficult, believe it or not, some difficult systems issues, but if you can overcome that hurdle, I think most lenders would be in support of that.

MR. EGGERT: Faith?

MS. SCHWARTZ: Yes, we've had a lot of agreement on this subject in our committee meetings yesterday. And so I would also recommend, it's a good opportunity for the Fed to require escrowing on nonprime loans, subprime loans, with an opt-out. I think this is one that helps lenders be sustainable and they have better-performing loans. I think the market has not, there are lenders, I know we have tried to get escrows on loans at the front end and on the back end and have risen them in penetration, but you know, it is 50 percent of the market and not 100 percent.

So I think the more we can keep borrowers' cash flowing and paying their taxes and insurance, or helping them do it, the better. But the opt-out is important. Choices are important for people in all of the markets. So I think that's -- protect the first-time homebuyers, do some other things to restrict, where you really need to show it, and certainly underwrite them all with insurance and then escrowed taxes in the qualifications.

GOVERNOR MISHKIN: Can I ask a quick question on this? Because this is the first time somebody has mentioned opt-out, and there seems to be a lot of agreement so far in terms of this issue of requiring escrow.

So was there also agreement on this issue of allowing people to opt out or not?

MS. SCHWARTZ: No.

GOVERNOR MISHKIN: That's why I wondered. And if some of the people who disagree with that could let me know why, so I get a little bit better picture of that. Because so far, there has been so much agreement and I would like to --

(Laughter.)

MS. SCHWARTZ: Is there a way of opting out that makes sense?

GOVERNOR MISHKIN: I would like to get a little bit of action going on here.

MR. EGGERT: Excessive agreement makes us uncomfortable.

GOVERNOR MISHKIN: Yes.

MR. EGGERT: Don't worry. We'll take care of that.

GOVERNOR MISHKIN: You know, if there is too much agreement, then why should we have this meeting?

MR. EGGERT: Okay, Tom, Stella, and then Louise.

MR. JAMES: Well, to answer your question, back in the 80s, there was, we passed what we thought was a consumer-friendly law in Illinois which required lenders, now and at the time, to respect the choice of consumers to refuse to escrow their taxes because we were aware that the lending institutions were making a tremendous amount of money on the float, and we thought it was a good idea if consumers had the choice of being able to do that.

Now, of course, certainly taxes are one of the few things that can defease the lender's secured position. And so they have a vested interest, and so do those investors who are buying on the secondary market, staring at those three As, that this is really a secured investment. And if those taxes don't get paid, this is really not a secured investment.

So, I think, I never saw really a very unusually wealthy customer who demanded escrow. We had a series of cases, the Stern case was one of them, where we actually had to litigate the question as to whether or not that law should be enforced. And of course, the Supreme Court in Illinois found that it could be enforced, that the bank had deprived the individual who wanted risk to invest their money instead of escrow and committed a consumer fraud violation in the process.

But the first time I saw the non-escrow as a business practice was ten years ago when a family walked in with a loan from First Alliance Mortgage Company. And I was shocked because I had never seen a routine closing that didn't include insurance and tax escrow as a matter of protecting the security interest. Here I was staring into a loan and of course, I called my banking department and said, have you got any other complaints? And they sheepishly said, yes, 40.

Anyway, that was the first time I saw the non-escrowing, the non-protection of the security interest as a lending practice. And it came as a complete shock. I thought, who is going to buy these mortgages on the back end because they are subject to losing the security interests. I wonder whether or not this ever came into the calculations of underwriters with respect to that. I imagine not.

Certainly in the subprime situation and certainly at the closing table, I think is an inappropriate place to have a homeowner opt out. Being an advocate of having the choice to opt out,

I think at the closing table is the wrong time. Too many things happen. Almost nothing gets noticed there. People are under way too much pressure just to get things done, back to their normal, daily routine.

Certainly, if you want to go out, you know, a taxing cycle, where the consumer is fully aware that a tax bill is coming and it's a concern, and then they have a choice, that's a perfect place, or maybe the second taxing cycle. But not in advance.

MS. SCHWARTZ: I would just add that Freddie Mac and Fannie Mae don't require escrows under 80, so there are safeguards you could put in to opt out. So the market does have some standards around escrow.

MR. JAMES: And I am really talking more about --

MS. SCHWARTZ: High LTV.

MR. JAMES: Yes.

MR. EGGERT: Stella?

MS. ADAMS: I would absolutely prohibit opting out of escrow and insurance for the subprime market. The reason people are in the subprime market is because they have shown or the reason people should be in the subprime market, if the market is working efficiently, the reason people are in the subprime market is because they have shown they do not have the discipline to manage credit, to sustain a prime market rate. So we need to impose the discipline of taxes and insurance through escrow, at least in the subprime market.

I believe escrowing taxes and insurance should be required for the entire market, but it functions in the prime market as routine. I say anything that is in the prime market as routine should be extended -- why should those folks not have it, especially when it imposes upon them hardship?

The reason I believe that this is so critical in the subprime market that we have this escrow and that you can't opt out of it, because it's just going to be in the stack of papers they sign that day and they're not going to know they did.

The reason I believe it is so important is because we have a situation that Carolyn talked about, where good loans are chased into bad loans by this low payment. And the payment causes a flipping of the loans to occur because you don't realize that this tax bill is coming up and then you go, you've got an $1,100 or $1,200 fee or else the state is going to put a lien on your house. And so you are forced to refinance or get an advance from the lender for those taxes. Or the

insurance comes up, you're not aware that you have to have it, the lender advances those fees and they own the insurance company. And let me tell you, forced place insurance is often three or four times the cost of what you could get in the marketplace. I have seen where, even in a prime situation, where the lender let the insurance lapse so that he could enforce place insurance.

We have got to have escrow for the subprime borrower as a protection for the subprime borrower, as well as for the investor, and it is critical.

If you want, in the prime market, where people have shown and demonstrated, in the prime market you have demonstrated your discipline. If you want to opt out in the prime market, you have earned the right to do it. But you have shown that you do not have the discipline if you are appropriately in the subprime market.

MR. EGGERT: Okay. Louise, and then I'll give Joe the last word.

MS. GISSENDANER: I don't know whether I am in agreement with the prime market versus the subprime market, but I will say that it's really, really important in terms of, particularly first-time homebuyers, who really don't understand totally what they are looking for or facing, that they do not have the ability to opt out. It's been a tragedy when we receive calls to try to figure out how folks can pay these tax bills, insurance, and things like that they have not budgeted for, because they didn't understand in the first place that they didn't have to do that. They thought that their dollars were being placed in escrow to pay these expenses.

And again, over time, just as you have had before, for example with the insurance, the PMI, where you give a person maybe after five years or so the opportunity to demonstrate, as you've already said, their effectiveness in being able to handle their mortgage efficiently, then maybe that's a possibility. But I am in total agreement that at the settlement, that is not a time to provide an opportunity to opt out.

And so, I am really one of those folks who really do feel after much demonstration in the market, that it's really important that we keep escrowing those taxes and also insurance to ensure that folks are able to take care of those obligations.

MR. EGGERT: Joe?

MR. FALK: I feel like I'm living in Big Brother House 12 because at the end of the day, I have an awful lot of confidence that individual consumers, individual folks who are reading these documents, and they do read documents, on average, can make informed choices and decisions.

And so I am one of those that will disagree with my respected members here. I think there should be a choice. I think consumers should be able to opt out. I think that at the end of the day, there has got to be more promoting responsible use of credit, rather than limiting and the government telling everybody what they should do and making choices for them that cannot be ruled here inside the Beltway. We'll never find every combination and permutation of every individual circumstance. You're just never going to have that choice.

So my view is, responsible, disclosed, but definitely opt out.

MR. EGGERT: Okay, let's move on to the next topic, which is, should stated-income loans be restricted for subprime loans? Or alternatively, would a disclosure about such loans adequately address this issue?

And I would like to turn to Faith to kick off the discussion.

MS. ANDERSON: Okay. When we had our discussion yesterday, I was mentioning that, when we were talking about the non-traditional ways that folks save money, there are people who won't go to a financial institution because they are just not used to financial institutions. And so when we wanted to require documentation, you didn't want to make it so limiting that you are taking a segment out of the market who are able to purchase a home, but just not through the traditional method of just looking at their W-2s and their tax returns.

MR. EGGERT: Who wants to jump in next?

MR. SUNOO: You know, a lot of things aren't record-kept in ways that are traditional. And I think that the stated-income loans, the more you try to canonize it and put it into a box and say, well okay, fine, if they don't have an IRS tax return, then let's go to A, B, C, or D, the more trouble we're going to get into here.

The idea I mentioned, you know, the dry cleaner and how many hangers a month he buys, well, you know, he's not buying those hangers to give away. So you can sit down with the underwriter, if the banker is a little careful, they can go down and they can take a look at the business and they'll known what is going on.

Wire transfers home. A tremendous number in the immigrant population, tremendous numbers of people wire tremendous amounts of money home. If they do it every month and they have a cigar box full of receipts, it shows a regular payment habit.

So, you know, the fear of trying to canonize this stuff scares me a lot.

MR. EGGERT: Mark and then Carolyn.

MR. METZ: Thanks. A couple of points. I think, number one, I think these need to be properly disclosed. I think consumers need to understand if they are providing less documentation that they may be paying a higher rate. And they need to understand that trade-off.

Again, I think this is an underwriting issue as well. They still need to be responsibly underwritten. I support sort of more rigor around the verification of income. But also to Cooke's point and others' point, let there be flexibility about what will be acceptable.

And again, if you properly disclose it and have rigor around the types of things you will accept, maybe the gold standard being tax returns but other things, you know, receipts, whatever it may be. As long as that can be documented by the lender, I think that works.

MR. SUNOO: It does make the job of the lender more difficult.

MR. METZ: Yes.

MR. SUNOO: It does make it more difficult.

MR. EGGERT: Carolyn.

MS. CARTER: I'm sorry to have to disappoint Governor Mishkin again, but I think you're going to find we're sort of on the same track on this discussion also.

(Laughter.)

GOVERNOR MISHKIN: Actually, one of the things that is so valuable about this enterprise is that we get people from very different viewpoints. And actually, one of the remarkable things here is that frequently people start to understand the other positions and we actually can come to some agreement on things. So one of the great values of this Council is exactly this.

So I don't actually mean it should always be.

(Laughter.)

GOVERNOR MISHKIN: But I did sense in that case, that there sometimes actually are disagreements and we, at the Board, really need to understand them.

So having agreement, I think, is actually a good thing and not a bad thing.

MS. CARTER: So I was going to say the fact that the subprime, that no doc loans and stated-income loans have grown in the subprime market is, again, counterintuitive. It shows the same sort of dysfunction that we have already discussed and probably results from the pressure to originate loans in order to preserve market share.

I favor a requirement that there be third-party documentation of income. And I

recognize fully that many people won't have W-2s and that there are other ways of documenting income. I favor a rule that required the best and most appropriate documentation.

Sometimes, well in our discussion yesterday, we spent a little bit of time talking about business loans. And I think business loans are a red herring. It could be that you might have authority under HOEPA to regulate business loans. Because even though Truth in Lending is limited to consumer loans, that language in 1639 doesn't have those words in it. But I would suggest that the Board treat that as an academic question and just make the policy decision that we're going to focus on consumer credit business loans. I think they're a different animal. Underwriting them is a whole different ball game. There are different risks. And the problem that the Board ought to be focusing on and I think we're all focusing on is the subprime market and consumer lending.

One reason that was suggested in the committee, or actually in an earlier meeting, that why lenders have an incentive to make no doc loans is that it shaves their costs just a little bit and gives them a slight competitive advantage. And that tells me that if the Fed doesn't prohibit this, that it will start creeping back. Because once the markets settle down, that incentive will then push lenders again towards shaving those costs, as well as the incentives to originate loans.

MR. EGGERT: Faith and then Alan.

MS. SCHWARTZ: I know we talked a little bit earlier about this. I think stated-income and limited doc loans or alternative documentation loans are slightly different and, I think, what we've had in the market for many years and it's bled across all markets, in prime, Alt A, and nonprime as just stated income without supporting documentation. But they might know an employment, so if it's reasonable that's where pieces of stated income are.

But there is a large population of people in stated-income loans for that efficiency issue or quick to close with less documentation that really can be documented as some other alternative sources. And if it is not W-2s, perhaps cash flow, bank statements, receipts of hangers, and other such methods. And I think it's really important to think through alternative documentation as a source of documenting people's ability to repay. And you might be able to get at this in a different way and not limit credit to all populations.

MR. EGGERT: Before I turn to Alan, I just wanted to add that mandating documentation is a form of consumer protection in that you had, before the market kind of shut down, you had a lot of borrowers who thought that they were getting documented loans, who were able to document, maybe even provided their documentation, but instead were getting no doc loans

and paying a higher interest rate.

At a certain point, lenders were being told by the secondary market, we want no doc loans and we're willing to pay more for them. So if the Fed doesn't regulate and say we want documentation to provide more stability and soundness for the whole system, you'll have the secondary market, which may provide the complete opposite message: We want no documentation loans, even for people who can provide it. And I think Alan has something to say about that, too.

MR. WHITE: Yes, I think both the no doc loan problem and the escrowing insurance problem are examples of collective-action issues, where most lenders, if you ask them, would prefer not to be doing them, or at least not to the extent that the market started doing them. But if the competitor is doing them, you pretty much have to, but we'd all be better off if we didn't sort of thing.

I think there clearly is a place for alternative documentation, and I think the reg can be written in a way that requires reasonably available third-party documentation, and you can use language to that effect, that allows the kind of the small, community development, alternative population lending. I don't have much sympathy for the sort of the convenience notion that, let's not bother with underwriting, just charge me a little more for not underwriting my loan. Right? I mean, that's how we got where we are today.

And as far as the market, I can tell you that stated-income loans weren't gone for very long. Because here is something from a major bank that says, good news travels fast, stated income is back. This is dated October 14th. Last week or the week before.

(Laughter.)

MR. WHITE: And I went and looked up online the guidelines that this bank has for brokers. And they even have a program that is like a limited documentation program and this is all about pricing, this stuff Kurt is talking about, because in this program they want evidence that you have the income. They just don't want to know how much it is.

So they require that you submit, for example, if you are on Social Security, your Social Security statement, but the loan officer will black out the dollar amount of your income. And that is in their program guidelines.

So, you know, this kind of nonsense has to be regulated out of the market. And I don't think the market is going to take care of it.

MR. EGGERT: Stella?

MS. ADAMS: In the words of President Ronald Reagan, "trust but verify."

(Laughter.)

MS. ADAMS: Again, basic, you know, we have to be able to verify. This is fundamental stuff.

MR. BROWN: Stella, I'm going to tell your friends you quoted Ronald Reagan.

(Laughter.)

MS. ADAMS: It's okay. Trust but verify is a good fundamental, again, sound fundamental basic stuff. And there are ways to provide alternatives. Most people have some form of documentation of the income that they have.

There should never be an opportunity to just state an income, and I am appalled that you can black out what that income is so that I can just accept the inflated. I mean, we have to talk about, we have to put it on the table, the number of inflated incomes that many times borrowers did not see.

In my practice, I had a couple who had the documents, where they had filled out an application and provided the W-2s, and provided the bank statements of what they had on account and what they had. And they had their copy of the handwritten one they submitted. And when they got to the closing table, when they got home and read through the documents, the application that was actually submitted had inflated what they had in their bank accounts, had inflated what they had as income. And they contacted the originator and said this isn't right. And they said oh, don't worry about it. And it was a stated-income loan and they absolutely could not afford, could not afford the loan that they had.

And for me, as a housing counselor, the worst thing in the world is to have to say to someone, you have to sell your home. There is no way you should be in this house. You can't afford this house. There is no, you know, if you took on two more jobs, I couldn't keep you in this house. And that's the level of inflation that went up.

And we really have to regulate the market. Where we see abuses, we must stop the abuse. And where the abuses are common sense-based that you can stop the abuse. It just doesn't make sense.

I looked at the Daily Show -- Jon Stewart had a segment where he had a guy who did a stated-income loan, was explaining the stated-income loan. And he had written down that Oprah was his cosigner.

(Laughter.)

MS. ADAMS: And it was pretty effective in talking about how ridiculous some stated income loans were. So again, trust but verify.

We don't want to drive stated-income loans out of the market, because it does serve a particular niche for a lot of communities. But those communities can, they are hard-working communities, and those people can document, through some alternative means, their income. And we should insist that they do so. Bank statements, again bills that are paid on a regular basis. Those are methods and those should be included with the underwriting package.

MR. EGGERT: Governor Kroszner?

GOVERNOR KROSZNER: Just a quick question that relates both to this discussion and to the previous discussion on ability to repay, and it was sparked by a comment that Cooke had made.

My understanding is that in many communities, although formally one person may be the legal owner of the house and legally required to make the repayments, there is often a large network of family members who are actually effectively providing insurance for payments and sometimes actually making those payments, and also sometimes living in the house. And so, I want to make sure, or I just want a quick discussion to make sure that we are able to take that into account both in thinking about documentation of the income because it may not, the relevant piece of income may not be the individual's income but a larger group of people's income, and also how that would fit into the ability to repay standard.

MR. SUNOO: Yes. Often you are talking about multiple wage earners in a household whose income goes towards the payment of debt, but only a single or a couple of people that are actually on title. So that is common practice.

I think the reason that, and I mentioned the success of the ITIN loans is that what has happened there is that in that situation, there may be a number of folks in that household that do not have the ITIN record, yet they contribute.

And I think the whole thing kind of plays out that those ITIN loans are so, people are dealing with them so nervously that they are being very careful and that's what ought to be happening when you're dealing with a special case. And consequently, they do have the 90-day delinquency rate that is one-half of the prime loans in the marketplace today.

So, the answer to your question. Yes, there are broader wage earners in the

house, and those incomes are taken into consideration, but they don't all appear on title.

MS. GISSENDANER: I'd like to weigh in on that because we do have an ITIN program as well. And basically what we've seen happen is it's very hard to tell the difference really, in terms of who necessarily is paying what, because of the cash. But again, we go by the receipts. We go by the bank statements because lots of times the money is really actually placed into one account. So, that's how, and we do intensely underwrite those ITIN loans as well.

So we have had a great deal of success with that, and we agree with the fact that those loans, because we do watch them very carefully, because we're fairly new into this, and we have not seen the delinquency and the issues that are occurring in other parts of the market.

MR. EGGERT: Okay. Patricia and then Faith and Stella.

MS. HASSON: Are you for this point?

MS. SCHWARTZ: Yes.

MS. HASSON: Okay. Go ahead of me then. Okay?

MS. SCHWARTZ: Okay. I just wanted to add something. I think your point is an excellent one, Governor Kroszner.

And there are many people, I believe, in the stated income world that are paying their mortgages by people in their house, extended family members. I happen to know two very well that are doing that. And there is no other way those people could get on the mortgage and make those payments because they wouldn't qualify because of other issues on their credit or ITIN.

MS. ADAMS: Again, I think the real key to this discussion is the intense underwriting. The intense underwriting is why this program is successful. And again, I have to reiterate, it's the basic fundamentals of verification, the intense underwriting, the rigorous, I would imagine, rigorous underwriting that is done to make sure that these products are successful.

And so we have to make sure that we build a fundamental platform that says ability to repay, some type of verification, and we're flexible about what that verification is, but that we expect there to be rigorous underwriting of these products. Otherwise, it would fall outside of appropriateness under your rules.

MR. EGGERT: Okay --

MS. HASSON: Kurt, I just wanted, I guess the point that I was going to add was that to Stella's point, trust but verify. Many loss mitigation departments get that. Most of the loss mitigation, we have to get proof of income. Many of the state programs that, you know, people go

to for assistance in this situation, they have to give proof of income. So, it's kind of ironic after the fact that we're supplying proof of income, but not in the beginning.

MR. EGGERT: Reagan also used to say, "Pray to God but row away from the rocks."

(Laughter.)

MR. EGGERT: That's other sound advice. I'll give Carolyn the last word, then move on.

MS. CARTER: I agree that these somewhat nontraditional forms of income should be accommodated, but I want to caution the Board that there is a danger here. And in many of the loans we see that are unaffordable, there is fictitious renter income on the loan applications. And I bet that some of the case stories that others could describe here involve loan applications that are filled out in one way by the borrower and then fictitious rental income is added, or fictitious payments of $1,000 a month from a nephew, or falsified gift letters that my Aunt Julie sends a letter saying I am paying $5,000 toward the closing costs or the down payment. In fact, there were schemes in Baltimore of property flipping that were based on falsified gift letters where the people involved in the schemes had it all worked out on how they would get those.

So there is a whole lot of danger there, and you need to make sure that you're not opening a window that then the whole truck drives through.

MR. SUNOO: You know, there is fraud available in any context, Carolyn. And to single out that one area and to say that well, declared income is especially vulnerable, I think, does a disservice to the upside of that.

So I think that the idea if somebody files false papers in any kind of a situation, for a prime loan, that happens.

MR. EGGERT: Okay. I'd like to move on. We have two remaining topics, and I would like a fairly brief discussion about the early Truth in Lending disclosures and then finish up with yield spread premiums. And so I'll turn to Alan for the first topic.

MR. WHITE: I think the proposal that seems to be up for discussion is the idea of requiring the detailed Truth in Lending disclosures about a mortgage loan be delivered for refinancing loans, as well as purchase money loans prior to closing, as well as at closing.

The fundamental problem, and this has been debated for 15 years at least in various contexts, usually convened by HUD on the subject of mortgage reform, the problem is the

timing of the disclosures is only half of the issue. And the reason disclosures don't work and shopping is basically impossible in the subprime mortgage market, the real reason is not so much the timing, but the fact that early disclosures are meaningless and are usually inaccurate.

And so unless and until the Fed is willing to take on the issue of what a good faith estimate means and what accuracy is and to require re-disclosure when terms change prior to closing, it's really not going to be very useful to require what the market is essentially doing anyway.

It is apparently the fact, it has been my experience, and I think everybody on the committee yesterday confirmed, that even though it's not legally required now, mortgage lenders uniformly send out the preliminary disclosures at the stage of application. Within two or three days after the application, they will send out the Truth in Lending disclosures and the so-called good faith estimate, which is the HUD requirement, and they are somewhat overlapping. But those don't have to be accurate. They'll disclose a fixed product and then you will get an adjustable product at closing. You'll get a 5 percent rate on your first disclosure and it will be 8 percent at closing. There is really no legal sanction for that at present.

So, this is not a useful avenue to pursue unless and until the pre-closing disclosures, and it could be 24 hours before closing, but pre-closing disclosures are given that have to reflect the actual terms of the transaction.

MR. EGGERT: Tom?

MR. JAMES: Yes. I think that is fundamental, again. The biggest problem here, of course, is bait and switch, which we have seen in all of our large investigations. And I think you could look at the settlements that we had with Beneficial and Household, and again with Ameriquest. Always a very fundamental part of those settlements is the pre-closing disclosure which is counted back from closing, not counted from the application.

And you've got to have tolerances. You've got to have firmness. You've got to have an offer that is set in stone within the tolerances that can't be changed without prior disclosure to the consumer becoming committed. If you don't do that, you haven't solved the problem. You've just given it lip service.

MR. EGGERT: Okay, let's move on to the yield spread premium issue. And I'd like to turn to Joe to kick that off, since I think he has something to say on this.

(Laughter.)

MR. FALK: Well, thank you, Kurt, for putting me, the little mortgage broker from Miami, full fledged on the hot seat here. But I'm going to miss all of our ten folks that are going to be leaving us, but I'm going to especially miss my good friend Stella who, all of a sudden left the room. Where did she go? I'm saying nice things about Stella.

But the reality is that the mortgage origination industry is a business. And the last time I checked, the role of business is to maximize revenue and minimize expense, right, within a business context. And what challenges us, me as a mortgage broker, is that we really feel that the yield spread premium debate, the YSP issues widely reported in the press is really form over function.

All originators today originate or they act in the same capacity when dealing with a consumer because of the deconstruction of the market, widely reported, automation in the market, the rise of the securitization issues, candidly all originators kind of do all of the same functions. But yield spread is that indirect compensation that is earned only on broker transactions. They are in fact costs and fees that are financed into the interest rate. That is what a yield spread is.

It is unfortunate that in 1992 HUD came out with a rule that created an artificial, in our view, differentiation between what is a broker transaction and what is a lender transaction. And it is interesting to note that this definition is very different under Truth in Lending and the definition of who is a creditor.

It's a classic inequity of disclosure parameters for direct competitors in the marketplace. So when people shop for a loan, they go to a bank or a broker or a lender, consumer finance company, shop on the Internet, there is no way to practically differentiate between who is a broker and who is a lender and who, ultimately, is acting in which capacity, depending upon the product line that a consumer selects.

Consumers are in fact confused about the disclosure of yield spread. And that ultimately is not good for business. The facts are that lenders earn SRP, gain on sale, their indirect compensation for the financing of costs and fees, but lenders are relieved, pursuant to the HUD rule, from disclosing that very amount.

I was very happy yesterday, Tom, when we were talking in our subcommittee that you selected a mortgage broker, right, for your loan. So if a leading consumer advocate in this country, all right, selected a mortgage broker, then clearly, SRP is not unsavory, illegal, immoral, and the only purpose of it is to harm consumers. And I believe other consumer advocates here have

selected the use of mortgage brokers and have gladly paid the yield spread because the bottom line is that the costs and fees associated with the loan from the mortgage broker was a better deal, a combination of product, price, and service, than the corresponding loan that was offered by the lender which was shopped.

The facts are that there are many depositories, credit unions and others who routinely act as mortgage brokers in transactions today and disclose yield spread when they act in that capacity and don't disclose yield spread when they act in a different capacity.

You know, when I talk with some of my mortgage broker friends, they tell me, Joe, why is it that we are singled out for incredible criticism when we actually disclose our indirect compensation, when the store next door offers exactly the same product and does not disclose their indirect compensation? And so you can have two stores right next to each other, ultimately offering different products with different disclosures, sometimes acting in different capacities. Unfortunately, in today's world, there are not clear demarcation lines between these competing channels of distribution.

MR. EGGERT: Okay, we just have a couple minutes left.

MR. FALK: A couple things. Let's talk about what would happen if you ban them.

If you ban yield spread premiums, let us be clear, you will hurt consumers who want to finance costs and fees because they won't be able to only if they choose a mortgage broker.

Two, you'll destroy small business because mortgage broker businesses are, by and large, entrepreneurs, small business folks who have less than ten employees who compete directly with the banks.

Number three, you will tilt the competitive balance from small mortgage origination companies to the large banks and lenders, as if they are more socially responsible than small business folks working in local communities.

It's not going to solve the problem of upselling, charging more, adding prepayment penalties only for one gain, because lenders will continue to do it with no disclosure, when mortgage brokers are responsible for disclosure.

I fear that banning yield spread will ultimately change and shift the chairs on the deck of the Titanic, forcing little mortgage brokers to become net branches or lenders without ultimately solving the problem that you are trying to solve today. Form over function. Let the

competition work. Thank you.

MR. EGGERT: Okay. Since you have named Tom, I'm going to let him respond. Then Sarah, and I'm going to give Marva the last word before we break.

MR. JAMES: All right. I knew I was in trouble yesterday. I got onto the elevator and before anything, and I'm back from Chicago, and I'm tired, I got on the elevator, I'm going to the meeting, and Joe is on the elevator. By the time we got off, we're in a raging argument about yield spread premiums, which agreed with everybody else on the elevator I'm sure.

Anyway, yes, I used a mortgage broker.

(Laughter.)

(Applause.)

MR. JAMES: Why? Because actually they quoted me the best deal and because when I called them up, I said, hi, this is Tom James, this is an attorney general and I want a deal.

(Laughter.)

MR. JAMES: So yes, the major problem, I think, or the major concern with yield spread premium of course is the classic case when we were investigating somebody and I would get a file and I would see a yield spread premium in combination with discount points. So, somebody took the trouble to buy down the rate and then jack the rate up again. A completely irrational act by any consumer. There it is staring at you on the HUD-1 settlement statement.

The thing is, most consumers, unlike me, do not know how yield spread premiums work. They do work in very, very peculiar circumstances, when you happen to be assistant attorney general is one of them, and where maybe there is a 100 percent LTV and a lot of other circumstances hit just right, they are appropriate.

For the vast majority of people, I think, consumers that I see in my daily practice, they don't have a clue what a yield spread premium is. It's generally used to upsell the loan, to give the consumer a worse rate than for which they qualify. It's generally seen, always seen in the nondepository, state-licensed residential mortgage broker universe. And people don't know what it is. It is disclosed once on the HUD-1 settlement form, off of the line items, to the side, with something that goes POC YSP. And I could go through thousands and thousands of occurrence witnesses, i.e., consumers, asking them, do you know what POC YSP is? And all I get is a blank stare.

People don't know what they are. They don't know what they are useful for. At a

bare minimum, they should certainly be moved into the line items on the HUD-1 settlement statement so at least people look at them as a cost to them, which they truly are. They should be explained, at minimum, as a bump in the rate. Are you making this choice rationally? Do you want a higher rate to have this mortgage broker broker the loan for you? And can you not afford to pay the broker up front? And if you can't afford to pay the broker up front, can you afford the mortgage?

So upselling is the big thing. Disclosure almost impossible. Understanding the nature of the transaction, I think you're back with that 3 percent, in the prime market, who do understand how to place the bets with the prepayment penalty. And they should certainly, the yield spread premium should certainly be counted into the APR.

MR. EGGERT: Okay.

MS. SCHWARTZ: I just would like to clarify one thing. I would agree with Tom. Yield spread premiums should not coexist with discount points, and most lenders, prudent lenders do know that and don't do discount points with yield spread premiums. There's a broker fee, maybe, on the front end and/or the back end, but the way yield spread premiums function is buying up and buying down rates. At 6 percent, it's a discount. At 7 percent, it's par. At 8 percent, it might be 101. And if the borrower can't pay the broker, that yield spread being paid on the back end, that's how brokers do get paid. That's true in the prime market, as well as the subprime. They're across the market.

My only other observation is that what we've done is to ward off that issue of borrowers not knowing, is put a one-paragraph, eighth-grade language disclosure that is sent out upon the receipt of the application to say, did you know that you are paying your broker a yield spread premium? And this is at a higher rate. And it forces the issue to be discussed if at point of sale they didn't understand it. I do agree also, they don't understand it. But the point is, the transparency is what is necessary. And not charging discounts, yield spreads, that's incorrect.

MR. FALK: But not for the competitor, consumer finance company, or lender right next door.

MR. EGGERT: Sarah?

MS. LUDWIG: Yes, just quickly. You know, our experience very much coincides with what Tom described, except I would say I have never met a borrower with a subprime loan that we have dealt with who knew or understood the nature of the YSP. They have been rampantly, widely abused in the subprime market to get people into higher rates than they

would otherwise qualify, bottom line.

And you know, we've been talking to lending institutions about the problems with YSPs in the subprime market for about nine years. And the chorus response that we've received from lenders has been, yes, we're aware that YSPs are abused. We have no problem with seeing them outlawed across the board, but only if they are outlawed across the board because, you know, the sort of invocation of level playing fields and other such metaphors we hear, because they say that we don't want to jeopardize our broker base and we don't want to lose our competitive advantage with the brokers with whom we work.

Therefore, if YSPs are going to be banned, it needs to be blanket.

MR. EGGERT: Okay, Mark, Alan, and then Marva, and then we're done.

MR. METZ: Very quickly. Joe, I just take exception with one of the things you said about lumping brokers and banks together. I think there are clear differences.

We do use a lot of brokers, but I would say that the customers understand when they're dealing with a broker versus coming through a bank channel.

MR. EGGERT: Alan?

MR. WHITE: I think the real problem with yield spread premiums is that they give the broker pricing discretion on the interest rate on the loan. So if there was no pricing discretion in the system, I wouldn't have a problem with yield spread premiums.

But the reason there is not symmetry is that the broker in a wholesale loan can and has discretion to increase or decrease each customer, you know, all other things being equal, increase their interest rate. And I think it's really a fair lending issue. And I think, if you're not going to look at this as a HOEPA issue, you really need to look at YSPs as a fair lending issue because it's really a way to have pricing discretion. And, I think, a lot of lenders are disavowing any responsibility for what the brokers do with their prices. And that's just not right.

MR. FALK: But they continue to pay their own in-house loan officers incentive-based compensation.

MR. WHITE: But their in-house people do not have the same pricing discretion.

MR. FALK: I would beg to differ with you.

MR. EGGERT: Okay, and I'll give Marva the last word.

MS. WILLIAMS: Thank you, Kurt. This issue of subprime, and in particular, subprime predatory mortgage lending is a very complex issue that is, I think, an unfortunate

convergence of market and consumer issues as well as social factors. But sitting here today, this year as the 30th anniversary of the Community Reinvestment Act, I ask myself how this environment might be different if CRA were relevant. Although there have been some changes to the Community Reinvestment Act over the past 30 years, it has not kept up with the financial services industry. It doesn't reflect the bifurcated financial service industry that we're currently seeing. It does not explicitly address race, and it does not cover many of the kinds of home ownership loans that we're talking about.

And so I think that we've moved from a position of wanting to provide access to credit for lower-income consumers and communities to a need to provide access to appropriate and affordable credit.

And so it is my hope that perhaps next year that this Council might look at this issue of community reinvestment and in a way that is not just sort of building on the current infrastructure, but really kind of building up from the bottom. In the best-case scenario, what kinds of protections do we want to provide low-income and minority consumers and communities?

MR. EGGERT: Thank you, Marva.

CHAIR SODEIKA: Thank you, Kurt and everyone, for that very robust discussion.

We're running just a little bit behind, but we have a ten-minute break and we'll regroup at 11:30 to discuss Reg Z.

(Whereupon, the proceeding went off the record at 11:18 a.m. and went back on the record at 11:34 a.m.)

CHAIR SODEIKA: We are going to get started, if everyone would like to take a seat.

Okay, we'll continue our meeting by discussing issues that have been raised in public comments on the proposed amendments to Regulation Z, which implements the Truth in Lending Act, otherwise known as TILA. The proposal primarily focuses on the rules for open-end credit accounts that are not home secured, namely general purpose and retail credit card plans.

The goals of the proposed revisions to credit card disclosures are to aid consumer decision-making and increase competition. To achieve these goals, the Board's proposal seeks to ensure that consumers receive key information about the cost of credit card transactions in a way they can understand and in formats they can use and at times, points in time that would be most

helpful.

Members of our Depository and Delivery Systems Subcommittee discussed this topic, and so we're going to ask Faith to take the lead on this discussion. There you are, Faith. Thank you.

MS. ANDERSON: Good morning. Based on the comments that were received on the Reg Z proposal, I think some of you may have heard that the Board has received 2,500 comments. And they actually received quite a few comments from consumers. And so we're going to be discussing some of the issues that consumers have brought up in their comment letters.

And one of them is that under Reg Z currently, for a change in terms, a lender can change terms if they give 15 days advance notice. Under the proposal, the Board is looking to extend that from 15 days to 45 days.

And while they also have that out there, consumers are concerned that if they receive a change in terms which raises their interest rate, they want to be able to have the option to opt out so that they are able to pay their balance off at the old current rate and no longer use their credit card for purchases. And so one of the questions that we were asked is whether issuers have to provide consumers with the right to opt out if their interest rate changes, whether it is due to a delinquency or a default. And if an opt-out is allowed, what is the time period that a consumer would have to pay off their balance?

I'll start off with Carolyn.

MS. CARTER: Thank you. The question that Faith has described is just one piece of the much larger issue, which is the role of change in terms. And in my view, the unlimited ability of credit card lenders to change the terms of the agreement makes a mockery of disclosures.

In fact, at our committee meeting yesterday, there was prediction by industry members that if this new 45-day rule requirement for imposition of a penalty rate was imposed, that lenders would evade that by not having a penalty rate. Then they don't have to disclose it up front. Instead, what they do is when the consumer defaults, they change the terms. They issue a change of terms notice and then impose the higher rate that way. So that is just one example of how allowing unfettered changes of terms means that the disclosure regime, which is what Truth in Lending is built upon, is really built on sand.

So, we urge the Federal Reserve Board to restrict lenders' ability to change terms much more than the proposed rule has done. The 45-day rule is very important. Increasing the

advance notice period to 45 days and applying it to penalty rates is very important, but we urge the Board to go farther.

Requiring the creditor to allow the consumer to close the account and pay off the debt at the previously agreed-to rate would be one piece of the needed reform. Some state laws already require this, and some big creditors comply with this as a matter of course. So I think it's something that the industry can do. It's something that the industry should do.

Now, if that right is, if the Federal Reserve Board decided to require that right, I would strongly urge you to require a very clear disclosure of the fact that the consumer has an opt-out right and how to exercise it. I recently got a change in terms notice, two pages, very dense, hard for me to understand. I still haven't really figured it out. It referred to opt-out. It didn't say how to opt out. It didn't say whether they would accept my opt-out. It didn't say whether they would cancel my card if I exercised my right to opt out. So it was completely ineffective. If you want to create an opt-out right, you need to require a very clear disclosure of that.

MR. METZ: I've got some comments. I guess in thinking about this, we support the 45-day time period as well. However, there are some clear exceptions where we would ask for that, and those are situations with respect to penalty or default rates. The idea being that at the time you sign up for your credit card, we disclose to you, if you pay this late, we are going to increase your fee. In certain instances and, for instance, in my bank, we give two grace periods. We give a grace period, and then we increase the rate after the second late payment. We've already disclosed that up front. We're just saying we want to be able to go in and enforce that without having to then give another notice.

The other exception would be where we offer certain low introductory rates, for instance, zero balance transfer rates that expire after a certain time period, say six months or a year. Again, we don't want to have to go out and re-disclose that that period is expiring. I mean, we have clearly explained that that is sort of the contract, that is the benefit of the bargain that the customer got, and we don't want to have to disclose that again.

And I would apply these same concepts in terms of an opt-out. We issue cards under Georgia law, which is a situation where the state law does permit opt-outs. We permit that. I agree with Carolyn, the disclosure should be clear about that and how a person goes about opting out. But the idea being, again, if you don't like this new rate, you can opt out, close your card, and pay off the rate.

In terms of the time, we talked about this a little bit yesterday, in terms of the time that a person could have to pay off their card, we have an unlimited time. As long as they perform and make at least the minimum payment, we don't have a quarrel with letting that go further.

But again, in terms of the opt-outs, they should not be permitted to opt out because again, that's part of the original agreement. If you do things that harm your relationship with us, we should be able to increase your rate. We don't have universal default provisions that affect your relationship with other creditors. We're really just the contract between us and the customer.

MS. ANDERSON: Josh.

MR. PEIREZ: Thanks, Faith. Let me say I am still surprised in a HOEPA discussion that we had references to Big Brother, two quotes of Ronald Reagan, Oprah, Jon Stewart, and a fifteenth-century Arab scholar quoted. And unfortunately, I don't think I have anything so profound to add as to Regulation Z, although I have been struggling for the last hour.

But Governor Mishkin, I think it has been bizarre, both in the last discussion and in this one, in that there is a lot of agreement on a lot of points. But we do have a yield spread premium-esque issue coming up at the tail end of this discussion, so we will get there.

On this particular issue, though, I would really echo Mark's point. I think that to us, change in terms means that it is something that was not part of the terms of the contract at the time the contract was established. We have no problem with moving to a 45-day period for disclosing those types of changes in terms and believe that that makes a lot of sense.

The move from 15 to 45 days implicitly probably means moving from a one billing cycle to perhaps a three billing cycle, but certainly two billing cycle time horizon, which I think makes sense and gives consumers an opportunity for things that they were not previously notified about to decide to shop around.

And one thing quite different from the mortgage area with credit cards is that it is quite easy to find other products and move around. You have to make it about as far as your mailbox and you can get there.

The other point, though, that I would make in addition to that distinction between what has been previously disclosed versus changes that have been told to you and are solely based on your behavior as a consumer that you were pre-notified about, or I think Mark's example where it's just the expiration of a particular term that has been disclosed to you with a clear time horizon on

when that terms expires up front, is just to address Carolyn's point head-on about changes in terms in general.

And I think it's important to recognize that it's a pretty rare type of product that is offered to consumers that exists almost in perpetuity as an unsecured form of credit provided to a consumer where consumer behaviors can change and consumer circumstances can change dramatically over the period of time where consumers have their card. And so there does need to be the ability for an issuer to be able to go in and change terms. However, if the issuer is doing that on something they have not told the consumer, I think it strikes an appropriate balance to give that consumer 45 days. We support an opt-out. We also like the Wachovia practice of allowing the consumer to pay that over the time that it is necessary to pay it off, as long as they are making those payments. And we support that as well.

MS. ANDERSON: I would just like to add that, for giving the consumer the right to opt out, it should not be if they are delinquent on their account or if there has been a default because then obviously they have violated the terms of the agreement. But as long as they have continued to make the minimum payments, then that would be fine.

And I also wanted to point out that for smaller financial institutions, because we don't mail out our statements all at the same time on the same days that we could service members and not get bombarded with calls on the one day when all of our members had received their statements, we send it in staggered cycles. And so currently right now, even though only 15 days notice is required to be given, we actually give at least 30, if not 45 days before we would implement a change in terms.

And so by extending it to 45 days, you are actually hampering smaller financial institutions because they won't be able to react as quickly to changes in the marketplace. And so if you kept it at 30, then we would at least maybe be giving 60 days notice or 75 days notice. But if you gave the 45, we would actually, in some cases, be giving as much as 90 days notice.

And so I just wanted you to keep that in mind, that not all lenders send out all their statements at the same time where they could just implement it, mail it out January 1 and January 16, they're able to have a change in terms be effective.

MS. ANDERSON: Stella?

MS. ADAMS: I'm not a participant in this. And as you all know, I loathe credit cards, but one of the things that I think is fundamental is I don't believe you should be able to

unilaterally change terms on an agreement. I think that an agreement should have a certain -- I mean the cards have an expiration date that they are issued on. And they say this card expires and you get a new card. I think at least for the length of time that you have that, until that expiration date, the terms of the agreement should be set. Now if that includes a default rate, fine. But I think that there should be disclosure. I think that this ability and again, it's the abusive subprime credit cards that are the problem, where universal default is there, where payments have to be received by 10:00 a.m. on the morning of the 15th and then the mail comes at 2:00 in the afternoon and it's late and you're imposing. These abusive practices that trigger changes in terms, I believe have to, you know, I just don't believe you should be able to unilaterally change terms in the middle of a contract period.

That being said, I would support the 45-day notice, and I think it should extend to all changes in terms because those credit card agreements are so teeny tiny in print that I don't know that people know that the zero percent expires at six months and that a new rate will kick in. And so they should be noticed that that change is coming up.

MS. ANDERSON: Kurt?

MR. EGGERT: I think one of the crucial terms where we are concerned about change in terms is a default rate, where somebody is late on a payment and so the rate goes up. And that is a term that can be disclosed up front, in fact, is disclosed up front. But I think the up-front disclosure, while important, is not sufficient. You should, when somebody is shopping for cards, they should know what the default rates are so they can choose among cards based on the default rate if they feel like they will have, go into default or have the possibility of doing that.

But I think it is crucial that when they are faced with default, that they get a notice of what it's going to be, and they get the notice with enough delay before the default rate kicks in that they can do something about it. That they can shop for another card. That they can have some time to pay off the card or they can deal with the default rate.

There is something called a sticky default where people tend not to move away from their preexisting condition as much as they would fight off a new condition. And if you have people say, oh, now I'm paying a higher rate, I think that they would have less of an imperative to get out of that rate than if you say, in 45 days or however long we give them, your rate will increase. That would motivate people to do something about it to fix the problem.

So, I think defaults at the time of shopping are good, but I think the -- or disclosure at the time of shopping is good, but I think disclosure at the time before the default rate

kicks in is also crucial.

MS. ANDERSON: I just wanted to add, in case some folks don't know, but under the proposal, any change in terms are now going to have to be on the periodic statement right in a box and so there won't be an insert. So hopefully, consumers will see that there is a change in terms because it's going to be right on the front of their statement.

Patty?

MS. HASSON: I believe that the 45-day notice should be given and a default rate shown. The clients that we see are not aware of it. They have no clue that they are in default when they come in and they have four or five credit cards. So wouldn't it be amazing if they got that default rate on all of those cards in a disclosure, and surprise, surprise, they might come see us before they're filing bankruptcy, where 1 percent to 2 percent are now entering debt-management plans prior to bankruptcy? It's not working. So let's give them the opportunity to see what is happening earlier in the process through that default rate that they can recognize and seek the help that they need.

MS. ANDERSON: Mike.

MR. COOK: Okay, I'm sorry, Faith. I just want to echo a couple of thoughts here. I think it's very good that we're looking at the 45-day disclosure requirement. I think it's fantastic that we're looking at putting it on the front of the statement. Many times there are many other inserts that are also included in a statement as well, and it gets thrown away associated with it. So being on the front of the statement is critical. And I think that's very important.

But last, I think it's, I would urge the Board to take a look at what the opt-out actually says. I, like Carolyn, received a recent notice and actually, because of this issue, attempted to figure out how to opt out. And after about over an hour of looking at it and trying to figure out, I couldn't figure it out, how I was supposed to opt out, what the repercussions for opt-out was. So I would encourage you not to just say, okay, there is an opt-out here and it takes a lawyer to interpret it and many times they can't, in the case of Carolyn. I'm not an attorney.

But if it is not reasonable for the average consumer to understand, it's unacceptable then.

MS. ANDERSON: And then Josh.

MR. PEIREZ: Thanks. I think I am going to miss all the departing colleagues.

But one of my, I think, sorest points is going to be that when I first joined, Stella

came up and said, oh, you're the credit card guy. And now she calls me Josh.

(Laughter.)

MR. PEIREZ: And I thought I was this close to getting her a card, but we'll have to do it by phone or travel now.

But I do just want to touch upon Stella's expiration date point for a second. I think people are aware, but the expiration date on the card actually has no bearing on the expiration of the contract. It's purely a security feature to avoid having cards that exist forever, even if there has been fraud on the account. And so, you know, a separate point from whether there should be some period of time where terms can't change, which I think is the underlying point that Stella is making, but I don't think the expiration date provides any proxy for that. And in fact, those have been shrinking for security reasons. So, I don't want to get accused of the wrong mis-practices.

The other thing I think is just to echo Mike's point on opt-out clarity. You know, we fully support that, and I think we've seen great research from the Fed recently on different disclosures and formats. And so we would love to see the Fed undertake something like that in terms of what the opt-out should look like because we agree that it should be meaningful and the consumer should understand that in opting out, that means you can't go use this card tomorrow. And by the way, you still have to keep paying the balance, which I think is the key point, and how to do it. So we support that as well.

MS. ANDERSON: Now I'm going to switch over to the next topic, which has to do with weekend holiday due dates and length of the grace period.

Truth in Lending does not require that credit card issuers give a grace period, but most credit card issuers do. They give a 25- to 30-day grace period or 20- to 30-day grace period to pay off the balance without incurring a finance charge. And there is this mailbox rule right now that if a lender does give a grace period, that they must mail the periodic statement 14 days before the grace period ends. And usually when the grace period ends, that is the due date for the payment.

Consumers have noticed that the grace period has been reduced to around 20 to 25 days. And so they have complained that by the time they have received their statements, you know, if it's spent five days in the mail, that they have to immediately turn around and make a payment. And they are also concerned that lenders may be purposefully making the due date a weekend or a holiday so that they incur a late fee and then the penalty APR kicks in.

And so the questions that we have been asked to review are should issuers be

permitted to set due dates on weekends or holidays only if the issuer receives mail and posts payment on those days or at least the next business day, so that there is no late payment or penalty APR that is incurred?

And I just wanted to add that lenders usually set the payment due date, whether it's 21 days after the cycle ends or 30 days, but they don't go around and say, okay, we're going to make it this day because that happens to be Memorial Day weekend or Thanksgiving Day weekend. And so you cannot prohibit that a due date not fall on a holiday or weekend because that would be burdensome to constantly be looking at the calendar and that is not the intent of lenders anyway. So I was wondering if anyone else would like to comment on due dates on holidays or weekends and the grace period.

Mike?

MR. COOK: I would only say it may not be the intent of lenders to have it fall on those days, but I don't think we can confidently say that all lenders are in that boat where their intention would not be for it to fall on those days. So maybe a better solution is that it has to then qualify to post the next business day following that holiday or weekend date so that a systematic change is not needed in many institutions that are honest like your own.

MS. ANDERSON: Mark?

MR. METZ: Actually, I would agree with Mike's point. That is our practice, where it comes on a weekend or a holiday, we post it on the next day. We also are okay with the 25-day period for grace.

MS. ANDERSON: And I also do just -- oh. Go ahead, Carolyn.

MS. CARTER: This is another area where there was a lot of agreement. In my position, it is deceptive for a lender to state a due date as a holiday unless the lender is either receiving mail on that day or is going to post payments received the next mail day as if they had been received on time.

I wouldn't favor prohibiting holiday due dates because first of the problems Faith mentioned, but second, that would mean that the due dates would be jumping around a lot. And another problem that the committee really agreed on is that due dates that jump around are really bad. Some consumers are on automatic payment systems, and then when the due dates jump around, everything falls apart. And many creditors already will credit a payment when it's a holiday due date is received on the next business day. But the issue is we need to bring the rest of the industry up to

this standard.

Better yet, I would suggest, is requiring use of the postmark date. That, I think would be doing creditors a big favor because there is a lot of consumer antagonism that is generated by the fact that consumers lose control over when their payment is received. It creates a lot of consumer anxiety, especially given the draconian consequences of late payments. Just a very simple slip and a very tiny amount of, a very minuscule amount of lateness can have very significant consequences. Since the Internal Revenue Service accepts postmark dates, I think that the credit card issuers could too. And I think it would ultimately make the environment better for credit card issuers because consumers wouldn't be so angry all the time.

(Laughter.)

MS. CARTER: And Stella will then get her card.

MR. PEIREZ: If that's all it takes, Stella, we'll work it out.

??????????: But how do you rent a car? That's what I just want to just add. I don't use it very often, but every once in a while we need it for renting a car.

MS. ADAMS: We don't have credit cards. So I have to make sure I have three or four days worth of money.

MR. PEIREZ: I would echo some of the comments. I think we certainly support what Mike has said about having the next business day be the posting date if the due date would fall on a weekend or holiday. That makes perfect sense, frankly.

And we also think, though, the point that Carolyn is raising about if there are those lenders out there who are just every month changing the due date, like regularly to try to facilitate having consumers miss those dates, we think that that's probably a practice people should be looking at. It's not something we endorse. It's not something we think makes sense. And certainly, when a payment is due is sort of a critical term for a consumer to know and shouldn't be something that changes all the time. Because I think a lot of people, more and more, are regularizing their payments and trying to do it all at the same time. And they have their stack of bills and they know what day of the month they're going to go open them and pay them and so we support that.

We also philosophically support Carolyn's point about postmark dates, although I am told that some issuers have trouble dealing with that, so I would have to ask them to comment on that. But I think the broader point is some sort of trigger where a consumer has certainty that if they act by a certain time, they are protected. And to the extent that we can find a way to do that,

certainly for an Internet-based payment or a phone-based payment, you should be able to measure that with certainty, even if it's difficult to handle envelope postmark dates.

But we would really like to know if that is feasible as a solution because that would give a consumer absolute certainty as to when they have met their payment date and whether they have triggered other consequences. Because, you know, we really think, I think to Carolyn's point that to the extent that consumers are frustrated about missing payment dates when, in fact, they thought they made them and made efforts to make them, that is something that is not good for business.

MS. ANDERSON: In the proposal, we're going to add another quick question. The Board requested comment on that 14-day period -- whether it should be increased to longer time periods so that consumers have sufficient time to receive their statements and mail their payments to ensure that payments will be received by the due date.

And so we did have discussion yesterday on whether the 14 days should be increased to a different time period. And so, Kurt?

MR. EGGERT: In looking at the grace period, the 14 days, I think the Board is interested in whether it should recommend to Congress that that period be lengthened. And I think it should be lengthened. I think if you look at the industry standard, which apparently was 25 to 30 days, now has shrunk to 20 days, I think that standard shows that 14 days is not enough time and that the industry recognizes that a longer period of time is useful and necessary.

But the problem with having a shorter mandated time is it's hard for consumers to shop based on grace periods. And so you could have some credit card issuers who are doing the right thing and giving them a longer period of time, competing with ones who are enforcing a 14-day grace period and that's it. And that's not a level playing field. One of the things that the regs should do is force credit cards to compete based on price in very transparent ways, but the grace period differential is not a very transparent way of competing based on price. And so increasing the floor, as it were, to a reasonable level, I think would help consumers manage their affairs and also compare cards more effectively.

MS. ANDERSON: Josh?

MR. PEIREZ: I just want to express at least my understanding of the 14-day period, which if I am wrong so be it. But it's not actually a defined period for a grace period. It's the defined period by which an issuer must mail a periodic statement, if there is a grace period. So the

grace period could be 30 days, 20 days, 80 days. The rule is that I have to mail a periodic statement to the consumer at least 14 days prior to when that grace period would expire. So the fact that grace periods themselves have shrunk, if true, is not relevant, ultimately, to the 14-day trigger. If anything, it's really the same point.

Ultimately, whether I as an issuer have a 30-day grace period or a 20-day grace period, all that this rule provides is that 14 days before the end of that period, I have got to mail that out. So whether the grace period is shrinking or not is an irrelevant point.

I also think it's important to note that for a grace period, there is always this assumption that it is kind of like, well, you only have the 14 days. But people may have gotten, even if you had a 14-day grace period, because as an issuer that is ultimately the shortest grace period I could have because of the trigger of having to mail the notice before it would expire, the reality is that I am going to have transactions that have a much longer period of time where there was no interest accruing, certainly for those transactors who equate to roughly half, depending on when you do your survey, of accounts, because those people will have been making transactions throughout the entire 30-day billing cycle. And so those transactions on day one receive the full 30 days, plus whatever period of time there is to pay the bill.

So to us, this 14 days has been in place since 1974 and, if anything, the technological opportunities to pay your bill faster have increased, not decreased since that time. So we really see no reason for shrinking that period today. We also don't think it needs to be increased. We think it's a reasonable period of time.

MS. ANDERSON: Mike?

MR. COOK: I realize that this may not be a statistically significant sample, but a review of my own credit card statements would indicate that the average time from the time I mailed the payment to posting was in excess of seven days, on average. It was like 7.3 days on average from the time I mailed the payment to the time it posted to my credit card account.

Now you think about that the statement has to be sent out 14 days is the current requirement. There may be many institutions that aren't, that are giving significantly longer times than that, but it's the exception that we have to address here. It's not maybe the large institutions that are complying. It's the ones that are running right down to the last 14 days to trigger that late default, to trigger that late penalty, to trigger it into the next tiered pricing that would go into effect.

I would sure encourage not to shorten it. Obviously, it should be lengthened, in

my view. I also looked at my utility bills and the time frame that utilities give, and I couldn't find one that gave less than 25 days from the time of the statement date on the utility bill to the time that the payment was due.

So, I find it strange that on something like this that should be addressed and I'm not even for sure that utilities have a requirement what they have to give, but in this case where we do have a requirement, that we have set the threshold so low.

MS. ANDERSON: I'm going to move on to the next topic, which has to do with payment allocations.

And Truth in Lending, again, does not cover this issue, but what typically happens is that lenders allocate payments to the lowest APR that is charged to the consumer. And so, for example, you'll have instances where consumers will receive zero percent balance transfers, and so they'll move their balances over to that credit card and then sometimes they might not realize that they are charged an APR, an interest rate for purchases, not realizing that all the payments that they make first goes to the zero percent transfer balance. And so there is that issue of consumers not understanding how that works.

And so we have been asked, should credit card issuers be prevented from allocating payments to the lower APR balances? Carolyn?

MS. CARTER: I think the credit card issuer should be prohibited from that. And I'm less concerned about in the Fed's proposed rule, the proposal focused on the effect on the grace period. I'm more concerned with the effect on interest rates.

And this is, I'll give an example that I think shows why I'm concerned. Let's say I get a credit card and in the first months I take out, and let's say cash advances are 20 percent, a 20 percent interest rate on cash advances and 5 percent on purchases, which is somewhat unrealistic, but it makes the example simpler. And the first months I charge $1,000 in cash advances and I make a $1,000 in purchases. And then every month after that I make $1,000 in purchases and I pay $1,000 a month. So, I've used this card mostly for purchases. I've been told I have a 5 percent interest rate for purchases, and I'm going to be paying 20 percent because of the payment allocation rule. Because the lender will attribute all of my payments to the 5 percent and none of my payments to the 20 percent to the one-time $1,000, 20 percent extension of credit I got. And that to me makes the disclosure of the interest rates deceptive.

To me, this is an invisible way that creditors can increase the cost of credit. I

think that your consumer testing showed that disclosures were ineffective. In our committee meeting yesterday, I think we agreed that a daylong seminar for consumers about what is happening with this would still leave most of the consumers feeling somewhat bewildered as they left the room.

There is plenty of precedent for regulating payment allocations. The Uniform Commercial Credit Code, which was drafted in the 1960s and adopted by a number of states, regulates payment allocation. And many of the states that didn't adopt the Uniform Commercial Credit Code regulate payment allocation. Those rules no longer have any significant effect because of federal preemption. But when the federal laws preempted all these state laws, they didn't replace, the federal agencies didn't replace these protections with anything else. And as a result, the industry has moved to these payment allocation rules that disfavor consumers.

So, for those reasons, we would urge the Board to prohibit payment allocation systems that apply all the payments to the low-rate credit first. The proposed rule you have, as I said, focuses just on the effect on grace periods, and it's also too narrow because it only applies when there is an initial rate and it's for cash advances or balance transfers. It's just a very teeny subset of the problem. So I would favor stepping back and taking a look at the whole problem and trying to take a broader approach.

MS. ANDERSON: Mark?

MR. METZ: I guess I disagree with Carolyn on that point.

I do think this is a difficult thing to disclose. I think the evidence has shown that there have been some difficulties in trying to do that. I would encourage the Fed to keep at it because this is an important thing for issuers. And I will give a different example.

A common practice right now in the credit cards, this is obviously a very competitive business, is zero balance transfers. And there are many banks that give zero balance transfers. And the situation is they will allow you to transfer a balance up to your credit limit. So you can transfer a balance if your credit limit is say, $10,000, you could transfer a balance up to $10,000. So to pay for that, new payments, new purchases are charged at the contract rate. Now, let's not automatically assume the contract rate is going to be 20 percent. Assume it's going to be 7 percent or whatever, depending on your credit. So what lenders are doing is in effect giving an interest-free loan for a certain period of time and in return, you know, earning a fee or earning money basically to offset that. So it's an economic sort of choice that people have.

I think it's, again, I think it's a difficult thing to disclose, but I don't think it should

be outlawed. I think we should work harder at disclosing it so people understand what they are getting.

You know, again, I think there are certainly instances where -- let me stop. There are instances where banks require minimum payments. I'm not in favor of that. I'm also, from the bank side, borrowers are not limited from going to the zero interest rate for a certain time and then moving that to another credit card. I mean, there are people that do shop and take advantage of that.

MS. ANDERSON: Josh.

MR. PEIREZ: I am going to echo some of Mark's comments. I think that, you know, maybe as a compromise, we could outlaw yield spread premiums and allow this practice.

(Laughter.)

MR. FALK: I was about to say something nice. I need some friends in this room, but now I'm not going to do it.

MR. PEIREZ: I think that similar in some ways to Joe's discussion earlier, but here, I think the issue is that consumers are given on a credit card, really multiple products in one. The ability to get cash advances, the ability to transfer balances from higher-interest cards to lower-interest cards, the ability to make purchases over a period of time, they may receive insurance protection. They may receive any number of other features and benefits, depending on their cards.

And there are literally tens of thousand of permutations in this country of the various options that are out there. And core to that is the ability for banks to recognize in offering the products that these different features and, effectively speaking, different products on the same card bear different costs and have different benefits to consumers and are therefore priced differently.

And it's also perfectly rational behavior for them, and something that should be understandable to consumers even if we are not yet at a point of having a disclosure we are all comfortable with, for a bank to choose to have a consumer pay off those areas that are of the lowest rates first. And there is nothing unfair about that, in my mind. I see nothing about that that is inconsistent with the great values that are offered to the consumer on the various products.

And I think, to take Carolyn's example, that consumer should pay more than the $1,000 each month or should buy a little less each month to start chopping into that other balance. And there are things we can do to try to educate the consumer about that fact.

But we can all come up with different examples of why this practice is great for

Consumer A and why it really harmed Consumer B. At the end of the day, what we need to work on is making sure we get a disclosure the consumers understand, so that they can act rationally and make the right decisions.

MS. ANDERSON: And I would just like to add, I know in the mortgage industry you have those exotic mortgages and the option ARMs, which are also difficult to explain, but they are not banned or outlawed. And so I would request that you don't prohibit that lenders are able to allocate the payments to the lowest APR. Because obviously from our standpoint, it obviously makes great economic sense, but also as folks here have mentioned, you know, those consumers are receiving a zero percent interest-free loan, I mean, which is great. And also, as Josh mentioned, we just probably need to work on those disclosures so that they are easier to understand and also to educate consumers that maybe if you do have a zero percent balance transfer credit card, that you don't use that for purchases. You use a different credit card for purchases.

And also, if it was prohibited that lenders couldn't allocate to the lowest interest rate first, it would take out small lenders, because they wouldn't be able to afford it from an economic point of view.

Ed?

MR. SIVAK: Having been one of those people that transfer the balance, the biggest disclosure was on the second bill, when I figured I would start paying down that higher interest rate and it was, basically it was blocked, you know, because that lower rate was there first. You know, I was much younger. I didn't know that that's how it would go down.

But what I'm saying is, I guess I'm agreeing with Carolyn's point that once you see the economic impact of it, that's the biggest disclosure. And if there is a way to basically structure your payments so you can start paying down the higher balance first, I think that that's a good thing to have in place. And quite frankly, if it's not cost-effective, that product will go away. And so, if that's the outcome of a policy change like that, that is what it is.

MS. ANDERSON: Patty?

MS. HASSON: I, too, did a balance transfer. I did a 1.9 percent balance transfer for life, with no balance transfer fee. Guess what, folks? They don't do those anymore. And I think the important thing to note here is that I get, I would say twice a month, a mailing asking me to do another balance transfer or encouraging me to use that card. I get e-mails because I pay online, so they got my e-mail address, encouraging me to do a balance transfer, because they are not making

money on me, I'm happy to say.

So, you know, I think that it is a practice that is used to get you. It's a marketing expense to get you in to transfer to that card. And then what they're doing is trying to get you to use that card for purchases to make money. That's fine, but let's be honest. That's what it is.

So, I think that if you make an agreement that you are going to give somebody a certain rate on a balance transfer, give them that rate and let them pay out at that rate under whatever terms that you agreed to. I do think that there is a distinction, and it's being used as a ploy to get people further in debt and to make more interest.

MR. MORGAN: Don't make a late payment, Patty.

MS. HASSON: Oh, I don't. I could probably do a whole dissertation on due dates because I have seen this for real. And I think that the other is, again, it's out of practice. It really is.

MS. ANDERSON: Kurt.

MR. EGGERT: I hope that there is not a requirement that we each discuss our own credit card use --

(Laughter.)

MR. EGGERT: -- in order to be able to talk here, because I am not going to do that.

But I think what we've seen in this is to some extent the market for some of these products is segmented into two parts. You have the people who understand what is going on, for whom it is often a great product. They can get a zero percent loan for a while. And the other group of people are people who don't understand it, who end up paying more for a product than they thought they would because they just fundamentally didn't understand it.

And if I had to guess, I would guess that it's probably at least 50 percent are in the latter category. That we have a smaller number of people who really get it and use it in a rational manner and a larger number, and please correct me if I am wrong in this because it is just a guess, but a larger number of people who don't understand how these products work and how their payments are applied. And any time you have a large number of people who don't get it and the existence of these products is based, in some part, on assuming that some people won't get it, I think we have a problem. And I think we have to deal with it.

MS. HASSON: Can it just -- I do think that there is a large population who don't

understand it, and they are in credit counseling now. And I'll give up my 1.9 percent rate for those clients.

MS. ANDERSON: Does anyone else have any comments? Thank you.

CHAIR SODEIKA: Well, thank you, everyone. Now it is time for our Members Forum. As many of you know, during our meetings we have the privilege of hearing from one of our Council members on programs and initiatives at their organization. And for this meeting, Alan White will provide us with a presentation.

A little background on Alan, just before you get started, Alan. Alan joined the faculty of Valparaiso University School of Law as an assistant professor, this fall, teaching Commercial Law and Civil Procedure. Before heading to Indiana, he was a supervising attorney at the North Philadelphia office of Community Legal Services.

He has also been a fellow and consultant with the National Consumer Law Center in Boston. Alan has represented low-income consumers in mortgage foreclosures, bankruptcies, student loan disputes, real estate matters, and consumer fraud class actions.

And I will now turn things over to Alan.

MR. WHITE: Thanks. Okay, I have a microphone on. Can everybody hear me? Excellent.

Okay, so I thought about giving you a presentation about the mission and work of Valparaiso Law School, but it seemed more interesting to talk about Community Legal Services where I have worked for 23 years previously and did a lot of work involving foreclosures at the street level on a day-to-day basis.

So, Community Legal Services is the civil legal service provider for the City and County of Philadelphia, a city which has about a quarter of a million poor people in it. And our mission was and is to represent, in civil matters, civil legal matters, those poor folks in a whole range and variety of problems.

And the eligibility guideline limited us for representing people with income of $25,000 or less for a family of four. And to do that, okay, here are some demographics, the vast majority being black and Hispanic. And in the neighborhood I worked in, almost exclusively black and Hispanic and considerably disproportionately female client population. And to represent all those folks we had 44 lawyers, 40 paralegals, and two social workers and thank God for the social workers.

Okay. Now, the work I did obviously was focused on housing, consumer, and mortgage home ownership problems, in particular, but of course, focused on all sorts of legal problems. And the housing slice of the pie is about a third of the cases that we handled, and that includes not only home ownership problems but landlord/tenant and public housing problems as well. So there is really quite a range of legal issues and then public benefits. Obviously, consumer, utility, family law, other kinds of legal issues.

So, here is Philadelphia seen from 20 miles out in space. And one of the striking things about Philadelphia is that it's a row house city. And the row houses end right at the city line. So you wouldn't actually need the green boundary to see where the city ends and the suburbs begin. So we can zoom in a little bit and you see all these neat and tidy rows of row houses. Almost all of the housing stock in Philadelphia is owned housing as opposed to rented housing. We do have a public housing authority and some rental units, but it's very unlike Washington and New York and some other cities, in that regard. Most of our low-income clients, many of them, not most, but many of them were homeowners.

So my office was right up there in the corner near Broad and Erie, and there we are. It's a storefront office open for intake three days a week, and there's usually 30, 40, or 50 people in the waiting room waiting to be seen and interviewed about a whole variety of legal problems and sometimes not particularly legal problems.

So this is a row house. This is what the neighborhoods in Philadelphia look like. The one on the left, you will notice, has aluminum siding on it. The tin man got there, and that will become relevant when I start talking about mortgage finance and the emergence of subprime lending in Philadelphia. So and these are houses that, let's see, here are the values, are typically sold, these are 2002 values so they've gone up a little, not that much. Typically in the red dots are houses worth less than $25,000, and you bring in the orange and yellow, you're going up to $75,000. But still, very inexpensive housing for a large urban area. And of course, apart from Center City, where you see the very high values, and the upper northwest and upper northeast, more affluent neighborhoods.

This is a chart showing the home ownership rate in Philadelphia by income and over time. So the first bar – well, you see looking at the progression of the four bars at each income level is that home ownership in Philadelphia did not particularly increase from 1980 to 2003. Rest assured that subprime lending did increase during that time period. And so the causal relationship that has sometimes been asserted clearly did not bear out in Philadelphia.

Also interesting is that even at the lowest income levels, we have almost 50 percent home ownership rates. Home ownership, obviously, is a very important aspect of wealth building, especially for low-income communities.

This is a slide -- you know, I forgot to credit these to The Reinvestment Fund. My current version of the slide presentation has the little -- these I borrowed from Ira Goldstein at The Reinvestment Fund, who does wonderful work and some of it for the Fed in Philly.

So, the red bars are people who have no assets at all. At all. No financial assets, no real estate assets. The sort of tan bar are people whose only asset is a home. And then the blue bar are people who have all kinds of assets, like most of the people in this room, both real estate and financial assets. And the little green bar are those people who live in New York City and rent and have all kinds of financial assets, but no real estate.

So you can see the importance, for people who do have assets of any kind, of real estate, especially at the low-income levels, the lowest-income slice. More than half of the people who have assets at all, their only asset is their home, obviously.

This is a title history that tells the story of a particular client, a homeowner, a low-income homeowner that we represented, and the history of the mortgages on her property and how the mortgage industry evolved during the time I had been practicing. She actually bought her house in 1980, about two years before I started at Community Legal Services, but this client paid $7,500 for a house. I think she paid cash. But it was probably more typical for African-American female homebuyers to get either an FHA or a VA loan. That would typically be how homes would be financed, very small, $5,000, $10,000, $15,000 loans. And obviously, usually at market rates or close to market rates.

And we can see that access to credit was never a problem for Miss Harding. When she needed to borrow money, she could borrow money because she owned a house. And we have the All State Discount Builders, these are the tin men. So these people came around in her neighborhood and every other neighborhood and offered to do home improvements. I don't remember if her particular home improvement was getting aluminum siding, but it wouldn't surprise me. So at any rate, she borrowed $5,000 or $6,000 from a finance company. These were typically high interest rate but low-fee loans. You know, in the 20 to 25 percent range, but with really no points.

And you had a series of these until, boom, in 1993 the subprime market emerges.

Right? It started actually with a portfolio lender, Commercial Credit. But by 1995, she was borrowing $29,000 on a property which the city assessed at $5,000, meaning that they thought the market value in 2002, was about $15,000. So by 1995, she has a $29,000 mortgage, which is about 200 percent of the value of the property from a, what's the term, self-distribute, yes, from a company that essentially originates in order to securitize mortgages. IMC, which is not with us anymore. And then we had a couple other. I really like the irony of the name of the company called American Mortgage Reduction, which was in the business of flipping people and increasing their mortgage debt.

But this was really a very typical story for our clients whose home equity was eaten away and then some through these cash-out refinancing loans, typically not purchase loans. I put in the presentation the facts of a couple of cases, individual foreclosure cases. I'm not going to go through them in great detail, but they are sort of illustrative of an actual individual story of the kind of cases that I handled, my colleagues handled.

The first one was in 1998, early in the subprime wave, and kind of typical of very high fees, of totally pointless refinancing where the homeowner was looking to get cash and ended up getting $500 in refinancing subsidized loans from the Housing Finance Agency and some utility bills. You know, it was one of those loans, you looked at the settlement statement and looked at the client and said, why did you do this? And you know, she was really unable to explain it.

And then I had one, a more recent one from last year, Mrs. Haliburton. And that's her with her row house on Roosevelt Boulevard. This was an option ARM, a little more typical of the go-go the last couple of years. And of course, she is on a fixed income, and they qualified her at the initial payment and so forth. And fortunately, after she testified in Congress, the lender agreed to put her into a reverse mortgage, which was obviously a much more suitable product than an option ARM to somebody on a fixed income.

So, just to give you a sense of the scope of foreclosures, these are the tens of thousands of black dots representing foreclosures filed in the city of Philadelphia in a four-year period from 2000 to 2003. Every single one of these is a residential foreclosure.

We obviously were not in a position to help all of those people. Here's another illustration, kind of the same concept, but just shows areas with high concentrations of foreclosures, sufficiently high that neighboring property values were dramatically, significantly affected, pretty much distributed all over the city but especially moderate income in working-class neighborhoods.

The sort of the north core of the city is the poorest area, and there isn't that much foreclosure because there was just not that much financing in that area. We're really talking about working-class people. You know, police officers and school teachers and janitors and so forth.

This is a neighborhood where there has been sufficient foreclosures and tax foreclosures and disinvestment and abandonment that the city has just had to resort to tearing down a lot of abandoned houses. So that those used to be rows of row houses. And that's what certain neighborhoods of Philadelphia are starting to look like. And there is no expectation that it's going to get any better anytime soon.

So what do we try to do at Legal Services to deal with this, other than trying to represent 10,000 people one at a time? A couple of things. There is -- okay, so there aren't very many of us to deal with the individual cases. And one of the least favorite parts of my job, obviously, was dealing with the 50 or 60 people who came in and telling 30 or 40 of them that we weren't going to be able to help them. So, we did set up a predatory hotline and referral network with private lawyers to handle cases. In 2004, the city sheriff agreed to postpone a series of sales and try and reach out to homeowners and get them to come and get help. We made efforts to influence state legislation and regulation of mortgage brokers, got the city to develop some better, more suitable loan products, subsidized loan products offered typically through banks to kind of meet the credit needs that subprime was poorly meeting, particularly the need to get small loans for home improvements. We did some class-action litigation, some training of housing counselors, and so on.

And so the concluding slide is this roller coaster, sort of my personal observation of the experience of representing low-income homeowners in Philadelphia over the last 25 years. It really felt in the 70s and 80s that there was forward progress being made and, you know, incomes were rising, home ownership was rising, there was access to credit. And the period in the 90s really was devastating. And we saw this not just in Philadelphia, but in Atlanta, and Chicago, and any other city you would care to name, Washington, D.C., I suppose, that all that building of assets and home ownership has really started to reverse. And so the impact of the current crisis is really something that we felt on a day-to-day level, at a street level, over a long period of time, much longer than just the past two years.

So, okay. I did want to add one thing that we haven't really had a chance at this session to talk about, dealing with existing foreclosures. Obviously, the HOEPA discussion relates

to trying to prevent bad mortgages from being made in the future. But I think it's really continuing to be a critical issue month after month that new levels of foreclosures are being reached on a monthly basis.

In August there were 240,000 of them, and I have noticed that Chairman Bair of the FDIC recently made an announcement, made a statement that servicers in this industry really need to do a lot more to deal with existing loans and existing homeowners in modifying those on a much larger scale. And I really would like to call on the Fed to join that sort of spirit and statement and call on the servicing industry to do something about the homeowners who are now facing these kind of problems that are just going to escalate certainly for the next year or two.

Okay, thank you.

(Applause.)

CHAIR SODEIKA: Thank you, Alan. I just want to take a moment to recognize all of our subcommittee chairs who have done such a wonderful job really bringing this agenda to the front page here and also in leading all of the robust discussions. Our current subcommittee chairs are Stella Adams of the Community Affairs and Housing Committee, Faith Anderson of the Depository and Delivery Systems Group, Marva Williams of the Compliance and Community Reinvestment Group, and Kurt Eggert of the Consumer Credit Committee. Thank you all so much for all of your leadership this year.

And we will now turn to our vice chairs who become chairs of the subcommittees to give an update on the plans for future meetings and topics for future meetings.

So, if I can start with Community Affairs and Housing, Ed Sivak, for your report.

MR. SIVAK: Thanks, Lisa. Given the foreclosure issues that have been raised, there has also been foreclosure rescue scams that are out there, so we're going to be talking about those. We're looking to see what's being done to prevent those and work with those.

We're talking about, we'll look at an update of HOPE, which is a project to look at counseling capacities, specifically on the workouts of people who are in trouble with their current loans.

We also are raising the issue of REO properties and the rising inventory of foreclosed housing in cities like Philadelphia as well.

Also, we want to look at, as one of our briefing materials, the GAO study that looked at the impact on investment versus owner properties as well.

So, a theme of foreclosure is going to be at our next meeting.

CHAIR SODEIKA: Thank you. And on the Depository and Delivery Systems Committee, Mark Metz.

MR. METZ: I've got a number of topics. Two are a continuation of topics we discussed yesterday. The first of those is best practices to protect federal benefits from garnishment orders. The second topic is prepaid debit cards and stored-value cards, the fees that are associated with that and the disclosures and the requirements that go along with those.

And then three additional topics, the first is the FACT Act. The second is Internet gambling, and the third is the Maloney bill and certain disclosures that are required with respect to point of sale and ATMs.

CHAIR SODEIKA: Thank you, Mark. And our vice chair, Dorothy Bridges, isn't here with us today, so I will ask Marva to report on your committee.

MS. WILLIAMS: Okay. Compliance and Community Reinvestment Committee talked a lot about spending time over the next several months and also before the March meeting in setting an agenda for next year and to begin to identify community reinvestment compliance and regulatory issues within the context of community building. And part of that would be a review of recent research on community, industrial, and rural development.

There is also an interest in exploring small business lending issues as well as the enforcement of the service test. And then last, there is an interest in the role of the green economy and sustainable development and community reinvestment.

CHAIR SODEIKA: Thank you, Marva. And for the Consumer Credit Committee, Faith Schwartz, please.

MS. SCHWARTZ: Thank you. We would like to speak about the risk-based pricing study on the FACT Act from the Fed. We believe that at the next meeting, we'll have a fair amount to talk about with either the proposed rules or final rules that the Fed issues on HOEPA.

We wanted to have a further discussion on the closed-end --

MS. BRAUNSTEIN: It won't be final rules.

MS. SCHWARTZ: It will or it won't be?

MS. BRAUNSTEIN: It will not.

MS. SCHWARTZ: March? Okay, sorry. How disrespectful.

(Laughter.)

MS. SCHWARTZ: Closed-end credit reviews, some further discussion there. We had some discussions about credit scores and how they may get impacted by renting a credit score, or the integrity of the score is making sure that we maintain integrity there. And anything else that arises over the quarter.

Thank you.

CHAIR SODEIKA: Thank you, Faith. I think the more we talk about HOEPA, the more we come into agreement. And we had so much agreement today, we're finished a little bit early.

Thank you very much everyone, and now we will adjourn for lunch which, as you know, is right down the hall.

(Whereupon, at 12:38 p.m., the meeting was concluded.)