Before the Massachusetts Division of Banks regarding

Amendments to 209 CMR §§ 32.32, 42, 40 High Cost Mortgage Loan Provisions

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On behalf of our low-income clients, the National Consumer Law Center[1] thanks the Massachusetts Division of Banks for proposing amendments to current regulations which constitute an incredible leap forward in combating predatory lending directed at low income and elderly borrowers.

We are pleased that the Division of Banks recognizes the gravity of the predatory lending problem in Massachusetts. This is a problem that existed for many years prior to the passage of the federal Home Ownership and Equity Protection Act (later adopted in Massachusetts), which has since grown exponentially. We saw these problems in the 1980s, Congress and the Commonwealth recognized these problems in the early 1990s. It is obvious from the substantial testimony presented in national forums that these problem loans continue to grow unabated.[2] Indeed, the Commonwealth has pursued enforcement actions against at least two major subprime lenders.[3]

Although information about subprime loans is not formally collected by any government agency, there is ample evidence that there are real problems in the mortgage market. For example:

- Between 1980 and 1998 the rate of home foreclosures in the United States increased by 384%. That means that even though interest mortgage rates were almost twice as high in 1980, as they were in 1998, almost four times the number of homes were foreclosed upon in 1998 as in 1980. [4] More significantly, the foreclosure rate is substantially higher for subprime loans than for prime loans.[5]

- This increase in foreclosure rates cannot be traced to the increase in homeownership rates, which was only about 3% during the same period.

The problem is that too many home loans are being made for purposes that have nothing to do with the home. Too often these loans are being made with terms that are inherently unconscionable -- that increase the costs of homeownership and the risk of loss of homeownership to the borrower.

I. INTRODUCTION

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA’s provisions are triggered if a loan has an APR of 10 points over the Treasury bill for the same term as the loan, or points equal to more 8% of the amount borrowed.[6] Subsequently, Massachusetts adopted HOEPA in its entirety.[7]

It was hoped that this Act would reverse the trend of the past decade, which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, experience over the last five years has shown that while HOEPA has made a start at addressing the problems, there are still yawning chasms of unprotected borrowers subject to the abuses of high cost home equity lenders.

The three most significant problems with HOEPA:

1. HOEPA does not in any way limit what the lender can charge as up-front costs to the borrower. It is the excessive, combined fees -- in closing costs, credit insurance premiums, and points -- which deplete the equity in abusive loans. These excessive, combined fees are charged over and over, each time the loan is refinanced. And with each refinancing, the homeowner’s equity is depleted by these charges because they are all financed in the loan. The effect of this situation is to encourage lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.

2. The interest rate and points and fees triggers for HOEPA are too high, causing many abusive lenders who want to avoid HOEPA strictures to make high cost loans just under the trigger. The effect is that there are no protections whatsoever against these very high cost loans.
3. HOEPA does not apply to open-end loans. When HOEPA was passed in 1994, there were few predatory open-end mortgage loans being made. In the past six years, that picture has changed. It has become apparent that open-end credit provides another vehicle for mortgage abuses. There is no longer any reason to exclude open-end mortgage loans from HOEPA’s coverage. More importantly, unless open-end loans are brought within the scope of HOEPA, the failure to regulate them will simply push the bad actors into that market.

But, otherwise, HOEPA is grounded upon an excellent premise: the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By adopting HOEPA, the Commonwealth recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

The Division of Banks has proposed changes to the Massachusetts HOEPA which close the loopholes described above. NCLC strongly urges the Division promulgate § 32.32 in final form with NO CHANGES to certain provisions and limited amendments to others.

II. THE APR TRIGGER SHOULD BE LOWERED

The Division proposes to lower the APR trigger to 8% for first lien mortgages and to 9% for second. NCLC supports this action.

Substantial information is now available on pricing and losses in the subprime mortgage market. These data suggest that interest rates at either 8 or 10 points above comparable treasuries are unnecessary to make credit available to homeowners representing a reasonable range of foreclosure risk. There should be serious concern regarding borrowers who do get loans at such high rates. There is every reason to apply HOEPA’s special protections to what is now the very high end of the price range for subprime mortgages.

The range of interest rates charged to subprime borrowers is very broad, especially compared to the range in the conventional mortgage market. Professor Cathy Lesser Mansfield studied the loan data for over 1 million loans that were securitized between 1995 and 1999, and found that:

The rate range for the subprime loans we looked at increased between 1995 and 1999, with a range in 1995 between 5.00 and 17.99%, and a range in 1999 between 3.00 and 19.99%. For Green Tree Financial, one of the lenders we looked at, the range of rates in 1999 alone was between 4.00% and 19.99%. By contrast, the range of rates in the conventional market was never more than 2 percentage points. [8]

With 30-year treasury bond rates fluctuating between 5 and 7% during the same time period, subprime mortgage lenders charged as much as 13 percentage points above comparable treasury rates. On the other hand, the median subprime mortgage rates were typically 4 to 5 percentage points above comparable treasury securities, so that the bulk of subprime lending was being done well below the Treasury + 10% HOEPA trigger. [9] Reducing the trigger to Treasury + 8% will not substantially reduce the availability of subprime mortgage credit.

Moreover, those loans that are written at such high interest rates are highly likely to have predatory features, and/or to involve borrowers at very high risk of default and foreclosure, for whom HOEPA protections are especially important. Professor Mansfield’s data suggest that even a reduced cutoff of Treasury + 6 points would affect fewer than 25% of loans made in the 1995 to 1999 period. [10]

The presumed justification for charging a higher rate to one subprime borrower than another is the credit risk, i.e. the risk of loss in the event of default and foreclosure. This risk is numerically small, even in cases of subprime mortgages of relatively lower credit quality. While there may be an increased risk of default, the risk of actual loss is small because subprime lenders require lower than conventional loan-to-value ratios. Consequently, there is usually plenty of equity to cover losses in the event of foreclosure. This result is borne out by the facts. Typical subprime lenders experience annual loss rates below 1% of the their loan portfolios. [11] Subprime mortgage lenders concentrating on the most risky borrowers still report modest losses. For example, Aames Financial Corp. reported in February 1999 that its actual annual losses as of 12/31/98 were 1.08% of the serviced portfolio, and it estimated cumulative (i.e. not annual, but over the life of the loan pool) losses of 2.7% of the balance of loans securitized. A more conservative lender, New Century Financial, reported in March 2000 that its current loan production was a mix of about 25% “C” category loans, 20% “B” category, and 55% “A-” or “A” categories. [12] New Century did not provide annual loss information, but the foreclosure rate was about 2.5% and recoveries on foreclosures ranged from 63% to 100% (on reinstated loans) suggesting a loss rate below 1%.

Standard and Poors estimates that a pool of “C” quality loans will have a foreclosure incidence rate of 3.6 times the rate for a conventional mortgage pool, and about 2.5 times the rate for an A- subprime pool. [13] Of course, actual subprime mortgage pools are composed of a mix of loans of different credit quality. One can infer from both the S&P ratios, and the actual loss experiences of lenders, that foreclosure losses on “A”- loans would range between .5% and 1%, and losses on “C” loans would range between 1.25% and 2.5%. In other words, losses on C loans are 2.5 times as high as the losses on A- loans, with the weighted average loss for all categories around 1% a year. Thus, a spread between the subprime lender’s best interest rate for “A-” borrowers, and its highest interest rate for “C” borrowers, would only need to be around 2 percentage points to cover higher annual losses from foreclosures. [14]
The variance in interest rates charged to subprime borrowers (more than 10 percentage points) is thus much larger than the variance in loan losses across the spectrum of subprime mortgages. If higher rates for some borrowers were meant only to compensate for the increased losses expected, the rates should be no more than 2 or 3 percentage points higher for C loans than for A- loans. The wide range in interest rates seen among subprime mortgage borrowers therefore suggests extensive price discrimination (i.e. charging different rates for similarly situated borrowers). [15] It also suggests that there is no need, from an efficient market standpoint, to facilitate or even tolerate mortgage lending at rates higher than 8 percentage points above comparable treasury rates.

If, in fact, the subprime mortgages made at rates over a “treasury + 8%” formula are priced well above the corresponding risk of loss, borrowers paying such rates are probably not shopping for credit, do not have adequate information about credit costs, and are most vulnerable to predatory practices. Borrowers paying such high rates are also most likely to have marginal ability to repay at best, and to have obtained their loan primarily on the basis of their property value. HOEPA’s prohibition on asset-based lending is appropriately targeted to this group.

There is ample evidence that lowering the trigger to 8% above the Treasury rate is appropriate.

III. THE POINTS AND FEES TRIGGER SHOULD BE LOWERED

Division sets the points and fees trigger at 5%, down from 8%. There is ample evidence that this action is appropriate in Massachusetts. Indeed, the Attorney General’s office produced expert evidence that the charging of more than 5% in points grossly exceeded the industry wide standards when seeking injunctive relief against First Alliance Mortgage Company. [16] This evidence is substantiated by information published by the Federal Reserve Board. At least regarding the home purchase market, fees and charges averaged less than one percent, specifically, .72%, for 1999 and for the first five months of 2000. [17]

Further, the Division allows an exception to the 5% cap for bona fide discount points. This exception makes the cap all the more reasonable and justifiable.

IV. INCLUDING OPEN- END, HOME-SECURED TRANSACTIONS UNDER THE REGULATIONS IS OUTSTANDING

Open-ended loans secured by the home are coming into vogue with lenders. They are presently exempt from HOEPA coverage. The Division’s proposal to eliminate this exception is incredibly important in plugging the HOEPA holes. NCLC presented evidence both at the 1997 and 2000 Federal Reserve Board HOEPA hearings showing examples of how open-end credit was structured to avoid HOEPA liability. This practice has continued unabated.

TILA does not require disclosures in open-ended transactions to be as clear and complete as to the cost of the loan as it does for closed-end loans. The disclosure information-gap between the two is wide and provides an incentive to lenders to jump at structuring their home equity loans as lines of credit. Open-ended transactions can be as abusive or more so than closed-end transactions. Many of these home equity lines of credit are spurious and, arguably, designed to evade HOEPA coverage.

Major lenders are engaging in the use of open-end loans to avoid HOEPA. Loan documents from two of them reveal this practice. See loan documents attached as Exhibits 1 and 2. If these lenders are structuring their loans in this manner in one state, it is likely they are replicating this in every state in which they do business. In both situations, the lender made a large closed-end loan which was under the HOEPA triggers and on the same day or shortly thereafter made a smaller home equity line of credit that was over the HOEPA trigger.

In one situation, Mr. And Ms. Conner of Lakeview, Ohio thought they were getting one loan. Instead, they received two loans: one large closed-end loan for $69,113.14 with an APR of 15.27% and points of 7.4%, just under HOEPA coverage. See Exhibit 1. At the same time and for no apparent reason, Beneficial added a second loan in the amount of $16,480 at 19.650%, above the HOEPA APR trigger, and charged $480 in points. This line of credit includes a prepayment penalty. The second situation shows a remarkably similar transaction where the borrower obtained a large closed-end loan and within less than a week, the same lender constructed a second home equity line of credit. Exhibit 2 reveals that the open-end loan amount was $12,900 at 22.9% APR. Of the $12,900, $900 or over 7% of the loan constituted points.

V. THE POINTS AND FEES TRIGGER SHOULD INCLUDE ALL POINTS AND FEES

The loopholes to the points and fees trigger encourage abusive lenders to avoid HOEPA coverage by padding excluded charges, selling credit insurance, and failing to add in the yield spread premiums paid to brokers. The three-part standard defining which fees and points are included in this calculation is cumbersome and difficult to understand. [18]

For example, this trigger does not include “reasonable” charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor. Fees for appraisals performed by unaffiliated third parties are not counted if only the direct cost is passed on to the borrower. On the other hand, such a fee is counted if the cost is padded. Determining what is a “reasonable” fee for purposes of triggering coverage, however, is a difficult burden for consumers to meet.

Consumer advocates are reporting that predatory lenders are now attempting to make loans with just a little less than 8% in points and fees, rather than complying with HOEPA. In many instances, they charge large fees that are not presently included in the HOEPA coverage trigger.
Ms. N. from Denver, Colorado paid $8,539 in settlement costs for a $93,000 mortgage (about $86,000 amount financed.) Some of the settlement costs were excluded from the TILA finance charge, and some were not counted as “points and fees” for HOEPA purposes, so that the lender took the position that no HOEPA disclosures were required. The loan included a proliferation of “junk fees”, such as closing fees, document preparation fees, courier fees, “processing fee”, and the like. The loan included a prepayment penalty that would otherwise be prohibited by HOEPA. WMC refinanced a conventional first mortgage and paid an IRS debt, all so that Ms. N could receive about $10,000 in actual loan proceeds. She also faces serious difficulty in repaying this mortgage on her limited income. Her loan documents are attached as Exhibit 3.

In addition, credit insurance can be a big ticket item in each individual loan. Nationally, consumers spend as much as $6 billion per year on credit insurance, often with little understanding of what they have bought. Because it is so profitable for both the creditors and insurance industry, the pressures to sell these products are enormous because of the huge commissions realized by lenders.

To illustrate the high cost of single premium insurance, consider the example of Mrs. P of Durham, North Carolina. In December 1998, she entered into a typical cash-out refinancing subprime mortgage for $76,000. She paid over $11,600 in credit insurance premiums, for insurance that would last for 5 to 7 of the 15 years of loan repayment. This credit insurance constituted 16% of the amount financed of the loan. In addition, $600 of total origination fees were attributable to the prepaid credit insurance premium. Mrs. P also will pay over $18,000 in interest over the life of her loan on the insurance premiums. These loan documents are attached as Exhibit 4.

Credit life, credit disability and credit loss-of-income insurance have very low loss ratios. Subprime mortgage borrowers rarely make a separate, considered decision to purchase this product. Credit insurance sometimes provides lenders with a substantial portion of their profits. The same minority homeowners are paying the high cost of single advance premium credit insurance, while predominantly white homeowners with conventional mortgages are offered the less expensive monthly premium credit insurance products, which are often sold separately from the mortgage transaction. It is hard to see what business justification there can be for not offering monthly premium credit insurance, as a separate purchase, in the subprime mortgage market.

The true cost of credit to the borrower equals the sum of all of the points, fees, including credit insurance costs. In their Joint Report to Congress in July 1998, both HUD and the Federal Reserve Board proposed that the definition of the finance charge be expanded to include all costs the consumer is required to pay in order to close the loan, with very limited exceptions. At the very least, this approach should be adopted for the points and fees trigger. Given the egregious nature of the predatory practices which Congress sought to reduce by the passage of HOEPA, the points and fees trigger should be all inclusive. The current swiss cheese approach assists high rate lenders in avoiding coverage by encouraging them to unbundle the costs involved in extending credit or to pad the fees that are presently excluded from the definition to more than make up for slightly lower points and fees that are counted toward coverage. There are no circumstances under which 8 or even 5 points in fees and costs, no matter what their basis, are appropriately added to a home equity loan which already carries compensation to the lender in the form of above market interest rates.

Finally, the current approach makes compliance by creditors more difficult. Ken Logan of First Bankshares testified at the 1997 Atlanta HOEPA hearing that this was the “primary” question for his mortgage banking firm. HUD and Treasury made this same recommendation in their Joint Report issued on June 20, 2000. We agree that this definition should be streamlined.

Instead of reiterating the current definition of points and fees, the Division could take the more appropriate step of including all points and fees in the trigger.

VI. IF THE DIVISION DOES NOT ADOPT AN ALL-INCLUSIVE RULE, SEVERAL CHARGES SHOULD BE ADDED TO THE POINTS & FEE TRIGGER

A. Credit Insurance

As noted in Section IV above, single premium credit insurance products are expensive for the consumer and a profit center for the creditor. Such premiums should be included in the trigger.

B. Yield Spread Premiums

Yield spread premiums should be counted in the points and fees trigger because “all compensation paid to mortgage brokers” payable by the consumer at or before closing must be included under the Act. Lenders making HOEPA loans, if the yield spread premium is counted, argue that the premium is not paid by the borrower (a position which is indefensible as the borrower clearly pays the premium through the higher interest rate) and that the payment is not made at or before closing. Creditors most often pay the brokers their premiums at or before closing, as disclosed on the HUD-1 Settlement Statement. The consumer,
therefore, pays this fee at that time through the funds advanced by the lender which the consumer then repays to the lender over the course of the loan via the higher interest rate.

All financed closing costs are essentially “paid” in the same manner. Just like the payment of yield spread premiums, the consumer pays all of the closing costs at settlement, meaning that the settlement service provider is paid by the lender in the first instance. The consumer then repays the lender for the advanced closing costs over the life of the loan, in the same manner as the consumer repays the yield spread premium. The only difference is that the closing costs are repaid through an increased principal while the yield spread premium is repaid through an inflated interest rate. In each instance, however, the consumer repays the creditor for amounts advanced on his or her behalf. It was the lender who structured how each of these costs were repaid, not the consumer.

Yield spread premiums can be quite large. For example in the case of Ms. D from Brooklyn, the lender contended that the broker fee and lender’s fees amounted to 7.956% of the loan amount. These fees, as calculated by the lender, amounted to $7,296, compared to an amount financed of $91,704. The broker also received a yield spread premium of $990, which was not figured into the lender’s HOEPA fees calculation. If it had been, the points and fees would have exceeded 9% of the loan amount. The loan included numerous features that would violate HOEPA, including a 24% default interest rate, a prepayment penalty, and a borrower whose income was less than the loan payment. See loan documents attached as Exhibit 5.

Since there is a lack of clarity, at least in the creditors’ minds on this issue, the Division should address this in the context of this review of HOEPA.

C. Per Diem Interest

Per diem interest charges are included in the points and fees trigger only by virtue of Commentary issued by the Federal Reserve Board.[27] While per diem interest is interest and is arguably excludable by virtue of 209 CMR § 32.32(b)(2)(A)-1, it is disclosed in the finance charge by virtue of its status as a prepaid finance charge and not because it is part of the interest earned over the life of the loan. Per diem interest, where collected at settlement or financed through the proceeds of the loan, is not that part of the interest or time-price differential that is earned over the life of the loan. It is only this latter type of interest that Congress meant to exclude from the points and fees trigger given how it worded § 1602(aa)(4)(A).[28]

VII. HOEPA NOTICE CAN BE MORE INFORMATIVE

The current mandated notice is fairly simple. The purpose of any additions to this notice should be carefully weighed with the goal of keeping the notice short and understandable. On the other hand, the notice plays a critical role in the HOEPA scheme of protecting homeowners against the worst abuses prevalent in the high cost lending market, a market in which many find themselves a captive audience due to perception, deceptive sales tactics, reverse redlining, lack of sophistication, and other factors. If homeowners can be warned off a bad loan, this preventive medicine goes a long way towards helping the market to regulate itself. That is, if fewer and fewer people borrow from the most expensive lenders, these lenders will have an incentive to lend at more reasonable rates in order to stay in business. NCLC supports limited and strategic additions to the notice as outlined below.

The notice should include some limited additional information that can assist homeowners in rejecting bad loans. For example, the “warning” section of the notice should include an introductory sentence as follows: WARNING—this is a high cost mortgage loan. The prepaid finance charges should be listed as an aggregate. The total of the closing costs (excluding the prepaid finance charge which would be separately disclosed) should also be included under this title. The total loan amount should be added. A sample notice would then look like the following (which includes the currently mandated information):

WARNING: This Is A High Cost Mortgage Loan.

If you obtain this loan, the lender will have a mortgage on your home. You could lose your home and any money you have put into it, if you do not meet your obligations under the loan.

You do not have to accept this loan just because you received these disclosures or have signed a loan application.

The APR (annual percentage rate) on your new loan will be:_______

Your monthly payment will be:_________________________

[Balloon disclosure: This is a balloon loan. Even if you make all your payments you will owe $ ______at the end of ___ years of repayment][29]

[Variable rate loans] Your monthly payment can go up to: [maximum based on rate cap]

Required charges you will finance to get this loan:

prepaid finance charges:_________________________
other closing costs: ____________________________

Total loan amount:___________________________________
These suggestions do not complicate the existing notice but give the homeowner a better shot at deciding if the loan terms and costs are too expensive. The Division suggests that an additional notice be sent at or prior to taking an application. NCLC supports such a notice but only if the other new substantive protections suggested in the proposed rule are included in the final rule. In other words, an additional notice alone will not protect consumers against the abusive nature of these loans.

VIII. PROHIBITED TERMS

A. Balloon Payments

The Division proposes to increase the term of the loan in which balloon payments are allowed to seven years. NCLC agrees that this is more helpful to consumers than the current standard.

However, NCLC recommends that the Division prohibit all balloon payments for a variety of reasons. Many borrowers do not know that the loan will contain a balloon payment until closing or thereafter. Worse yet, if a borrower inquires about the existence of a balloon payment before settlement, some lenders will lie.

For low-income homeowners who are sold a high rate home equity loan and who face no reasonable expectation of winning the lottery or inheriting a huge sum of money, balloon payments are simply an invitation to foreclosure. The current prohibition of balloons in loans under 60 months in term is inadequate.

Often, homeowners are kept ignorant about the existence of a balloon payment until closing. Some lenders engaged in a pattern and practice of lying to homeowners about the existence of a balloon even when the homeowners have the sophistication to inquire. Balloons are harmful to most homeowners for many reasons, not the least of which is that they are a way of requiring refinancing. This throws the homeowner back into the home equity scam market which results in the payment yet again of points, broker fees, closing costs, and higher interest rates.

B. Prepayment Penalties

The Division proposes to limit the use of prepayment penalties in a creative way. NCLC supports this action. While NCLC prefers that prepayment penalties be banned altogether in high cost loans, the Division's scheme goes a long way towards eliminating the use of these penalties in the high rate context.

As to the verification requirement, NCLC urges the Division to limit the countable income to that of resident obligors, i.e., those that actually live in the household. NCLC has reviewed many mortgage loan transactions in which lenders have stuck someone on the note and/or mortgage in order to pad the credit application and raise the “household” income to meet debt-to-income ratios. These additional obligors often are third parties who do not live in the household and contribute nothing to the mortgage payment.

IX. PROHIBITED ACTS AND PRACTICES

A. Ability to Repay

There is substantial evidence that large numbers of homeowners are losing homes to foreclosure as a result of subprime refinancing loans[30], and that loans are going into foreclosure very soon after origination.[31] This evidence suggests that there is a serious problem regarding the evaluation of ability to pay among subprime mortgage lenders. The absence of successful enforcement actions also indicates that the requirement to prove a pattern or practice has rendered HOEPA’s equity stripping prohibition ineffective. NCLC, therefore, strongly supports the Division’s proposal which removes this mandate from the equation.

On the other hand, there is widespread evidence of subprime mortgage loans being made that are virtually certain to go into default. For example, Ms. D in Brooklyn entered into a loan with Delta Funding with a monthly payment that exceeded her monthly income by $300, as a result of falsified income documents submitted by a broker. Loan documents are attached as Exhibit 5. Ms. Forrest of Berkeley California had social security income of $836 per month, and obtained a FAMCO mortgage requiring a monthly payment of $931 including tax and insurance. Her income was “grossed up” to $1,045, and her son’s “room and board” payments of $600 per month were added, to yield a paper debt ratio of 56%, on the strength of which she got her HOEPA loan, featuring a 16.9% origination fee. See loan documents attached as Exhibit 6.

Many lenders now offer “no-documentation” or “stated income” programs, which do not require any income verification.[32] These programs are an open invitation to broker fraud, and, by definition, constitute making loans without regard to the borrower’s repayment ability. Advocates report that no-doc subprime loans are often made with points and rates just below the HOEPA triggers.

It is not uncommon for subprime mortgage lenders to allow debt-to-income ratios of 55%, or even 60%[33]. These ratios contrast to the 41% back-end ratio typically used in conventional, VA or FHA mortgage underwriting. Perversely, borrowers with the poorest credit history are often allowed by subprime mortgage lenders to have the highest payments as a percentage of income.

A common practice in the subprime mortgage industry allows fixed Social Security income of elderly homeowners to be increased by a factor of 1.25 or more, a tactic called “grossing up.” The justification offered is that otherwise borrowers with taxable income are treated less favorably because debt-to-income ratios are applied to their pretax income, so they are allowed to borrow a larger
Taking residual income into account is most important for borrowers with low incomes, for whom the ratios do not adequately meet income ratio requirements, does not have adequate residual income, and therefore cannot afford such a large mortgage payment.

For example, a single parent with two children, earning a gross monthly income of $1,500, would qualify for a $600 monthly mortgage payment based on the 41% debt to income ceiling (assuming no other fixed monthly debt payments.) However, this borrower might not meet the residual income standard of the VA. To calculate residual income, all mandatory payroll deductions are subtracted. For example, this might mean the same hypothetical applicant has a net income of $1,200 per month. Shelter expense includes not only the mortgage, but also utilities. If this applicant needs $200 per month to pay utilities, and assumes a $600 monthly mortgage payment, the applicant will have $800 in monthly shelter expense. Subtracting $800 from the $1,200 monthly net income, the applicant has only $400 in residual income, to pay for food, transportation, child-care, clothing, medical care, and all other living expenses. The VA guideline is $788 in residual income for a family of 3. This applicant, who meets the income ratio requirements, does not have adequate residual income, and therefore cannot afford such a large mortgage payment.

Taking residual income into account is most important for borrowers with low incomes, for whom the ratios do not adequately measure repayment ability. Because subprime lenders have disproportionately high percentages of low-income borrowers residual income analysis is an essential component of determining repayment ability for subprime mortgages.

FHA and VA have also revised the required debt-to-income ratio from time to time, in light of their extensive experience with delinquency and foreclosure rates among the high-risk borrowers they serve.

NCLC urges the Division to consider use of the residual income standard as an alternative to the proposed median family income formula. The Division could then establish a safe harbor under the repayment ability provision. Any lender who applied FHA and VA repayment ability rules would be considered to have adequately determined repayment ability. Although lenders could still use higher ratios and/or lower (or no) residual income standards, a safe harbor rule for repayment ability would tend to discourage such reckless lending to low-income, high-risk borrowers, or at least require lenders to carefully research and document the validity of more lenient income guidelines.

In addition, lenders should not determine repayment ability on the strength of income of cosigners or additional borrowers who do not reside in the home and therefore cannot realistically be relied on to assist in making mortgage payments.

NCLC also recommends that the debt-to-income ratio comparison be made based upon the maximum monthly payment if the loan contains an adjustable rate feature. This suggestion ensures that this type of loan is affordable if the worst case scenario occurs. NCLC has reviewed many ARMs that are made to borrowers on fixed incomes. The monthly payments on these loans become affordable almost immediately.

Finally, NCLC strongly supports removing the pattern and practice requirement. The pattern and practice requirement places an unfair burden on the consumer. The creditor’s entire portfolio must be obtained and at least a statistically significant sample must be reviewed.

B. Financing of Points, Fees, and Charges

NCLC supports the Division’s proposal which prohibits lenders from financing more than 5% of the points and fees charged at closing as a significant improvement over the status quo. However, NCLC urges the Division to lower this percentage to 3% which comports with HR 4250 introduced into Congress by Representative LaFalce and Senator Sarbanes.

This protection is not rate regulation as it does not put a cap on the points or fees that can be charged for high rate loans. Presumably, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower -- the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower’s equity ownership in the home will be preserved. These loans will be structured exactly the same as the “no cost” mortgage loans provided to prime borrowers all the time.

There are indisputable advantages flowing from the prohibition against the financing of any points, fees, or credit insurance premiums or cap the amount that can be financed. The lower the cap, the greater the benefit:

No equity (or less equity depending on the cap) will be stripped from the home. The amount of money that the borrower directly receives, or is paid on the borrower's behalf will be the full loan amount, and nothing more. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will not rise when there is no cash out. The equity in the home will no longer be the source of financing the loan -- the loan can only be financed through the borrower's income.
The lender will have the incentive to make these loans affordable. Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the payments the lender has a clear incentive to make sure that the borrower can afford the payments.

The market will work to keep the interest rate on these loans competitive. So long as the borrower has not invested a significant amount of money in each loan -- as is done when thousands of dollars in points and fees are financed -- there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Consider the following high cost loan:

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<thead>
<tr>
<th>Borrower receives:</th>
<th>$70,000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower pays:</strong></td>
<td></td>
</tr>
<tr>
<td>6 Points:</td>
<td>$4,200 ($4,200 all profit to lender)</td>
</tr>
<tr>
<td>Closing Costs: [39]</td>
<td>$2,500 ($1,500 profit to lender)</td>
</tr>
<tr>
<td>Credit Insurance:</td>
<td>$2,200 ($1,000 commission to lender)</td>
</tr>
<tr>
<td><strong>Total Loan Amount:</strong></td>
<td>$78,900 ($6,700 - immediate profit to lender upon sale of loan)</td>
</tr>
<tr>
<td>Interest Rate:</td>
<td>12%</td>
</tr>
<tr>
<td>Term:</td>
<td>30 years</td>
</tr>
<tr>
<td>Monthly payment:</td>
<td>$811.58</td>
</tr>
<tr>
<td><strong>Consumer owes after 36 payments:</strong></td>
<td>$77,927.52</td>
</tr>
<tr>
<td><strong>Consumer owes after 60 payments:</strong></td>
<td>$77,056</td>
</tr>
</tbody>
</table>

So long as there is sufficient equity in the home (and there generally is plenty), the lender benefits if the borrower defaults. A default provides the lender with reason to make a new loan, lure the homeowner into refinancing, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Yet, the refinanced loan would be for an amount at least $6,000 more to cover the new closing costs, with the same interest rate of 12%, and the consumer will have that much less equity in the house.

However, if the lender could charge as high an interest rate as desired, but could not finance more than 3% in up-front costs and fees, the same loan might look like this:

<table>
<thead>
<tr>
<th>Borrower receives:</th>
<th>$70,000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower pays:</strong></td>
<td></td>
</tr>
<tr>
<td>Closing costs:</td>
<td>$2,100 ($1,100 immediate profit to lender)</td>
</tr>
<tr>
<td><strong>Total Loan Amount:</strong></td>
<td>$72,100</td>
</tr>
<tr>
<td>Interest Rate:</td>
<td>13.25%</td>
</tr>
<tr>
<td>Term:</td>
<td>30 years</td>
</tr>
<tr>
<td>Monthly payment:</td>
<td>$811.68</td>
</tr>
<tr>
<td><strong>Consumer owes after 36 payments:</strong></td>
<td>$71,415</td>
</tr>
<tr>
<td><strong>Consumer owes after 60 payments:</strong></td>
<td>$70,784</td>
</tr>
</tbody>
</table>

Lender makes up entire difference amount not permitted to be refinanced [$8,900 - $2,100 = $6,700] in 6 years in additional interest charges paid by the consumer.

This lender has much less incentive to flip this loan than the lender in the first example. Indeed, the lender's main concern will be to make sure that borrower can, in fact, repay the loan. The profit from the loan will only flow from the payments, not from upfront charges.

Finally, the Division should eliminate the exception for credit insurance products. As noted Section V above, the product is abusive and ought not to be financed under any circumstances. Creditors and insurers may still sell it but only on a monthly premium basis or simply may choose to make a lower cost loan and finance the premium. In addition, 209 CMR § 32.32(6)(1)(A) this provision appears to conflict with the prohibition on making a loan containing a single premium credit insurance product contained in
C. Frequent Refinancings

Regarding 209 CMR § 32.32(6)(b), NCLC recommends eliminating the time period of two years during which the prohibition applies. Lenders will simply wait for two years and one day to avoid the constraints of this provision. There should be no time limitation whatsoever. A refinancing to bleed equity and reap high profits is unacceptable if made by the same creditor or an affiliate.

The Division should also define those refinancing transactions that are abusive or not in the best interest of borrowers [40]. Evidence is accumulating that homeowners are unable to protect themselves in the unregulated subprime mortgage market from expensive, detrimental and pointless transactions, engineered by lenders and brokers concerned only about their fees and “gain-on-sale” income.

Consumer attorneys and advocates have also reported subprime mortgage lenders refinancing Habitat for Humanity mortgages (which bear no interest) and mortgages offered by government agencies and nonprofits that do not require repayment or include loan forgiveness features, and mortgages the payments of which are tied to the homeowner’s income (by definition affordable).

Some data from a study funded by the Ford Foundation being conducted in Philadelphia indicate that “upward rate refinancings” are occurring with regularity. Ira Goldstein of The Reinvestment Fund has found that, in a sample of Philadelphia homeowners who refinanced their mortgages, 48% refinanced a “prime” mortgage with another prime mortgage, 18% refinanced a prime mortgage with a subprime mortgage, 15% refinanced a subprime mortgage with another subprime mortgage, and only 7% refinanced a subprime mortgage with a prime mortgage [41].

While there are many refinancings that include a mix of debt being refinanced (low-interest conventional mortgage and high-interest credit card debts, for example), the upward rate refinancing scenario is simply too common. It often results from aggressive salesmanship or plain fraud by brokers motivated by large fees. NCLC is not aware of any legitimate case being made by the subprime mortgage industry for upward rate refinancings. The clearest examples of the “no-benefit” subprime mortgage loan are:

1. More than 50% of the prior debt refinanced bears a lower interest rate than the new loan;
2. The interest cost of the new loan will exceed the APR cost of paying out the debt being consolidated or refinanced;
3. Regardless of the interest rate before and after refinancing, the prepaid finance charges and closing costs are so great that the homeowner will never break even, i.e. never save enough in interest to recoup the transaction costs; and
4. Refinancing a special mortgage originated, subsidized or guaranteed by or through a state, tribal or local government, or nonprofit organization, which bears either a below-market interest rate, or has nonstandard payment terms beneficial to the borrower, such as payments that vary with income, are limited to a percentage of income, or where no payments are required under specified conditions, and where, as a result of the refinancing, the borrower will lose one or more of the benefits of the special mortgage.

C. Loan Packing

The Division is right to be concerned about loan packing. Its effects on the overall costs of the loan are significant. The premiums for various insurance or gap products are added to the principal, upon which points are calculated. Further, interest is charged on the premium, if financed, over the life of the loan. The most effective way to eliminate the practice is to forbid the financing of such products or to forbid the sale of them entirely.

Merely giving notice to the borrower and obtaining “informed” consent will do little to address the issue. Consumers now routinely “consent” to purchase credit insurance products. It is clear that few consumers understand that the loan includes insurance or they are told (despite the written disclosures) that they cannot obtain the loan without it.

NCLC, therefore, recommends the elimination of 209 CMR § 32.32(6)(1)(c). This section is particularly confusing since the sale of single premium credit insurance products is banned in (6)(1)(j).

D. Unconscionable Rates, Terms, and Charges

Laudably, the Division creates an outer limit on the price of mortgage loans in 209 CMR § 32.32(6)(1)(f) and (g). In addition, the Division places the burden of proof upon the creditor to show that the rates and terms are justified in § (6)(1)(f). Surprisingly, this provision regarding the burden of proof does NOT appear in the sister subsection, § (6)(1)(g). It should be added there as well or collapse both subsections should be collapsed into one section to which the burden of proof provision applies.

E. Mandatory Arbitration Clauses

Over the last few years, including mandatory arbitration clauses in consumer credit contracts has become standard operating procedure...more often than not. Creditors use arbitration clauses as a shield to prevent consumers from litigating their claims in a judicial forum, where a consumer friendly jury might be deciding the case. Arbitrators, who typically handle disputes between two businesses, are unfamiliar with consumer protection laws, and may be unsympathetic to consumers. Creditors also prefer arbitration because their exposure to punitive damage awards is dramatically reduced, jury trials are eliminated, and the threat of class actions is generally nullified.
Arbitration also limits discovery in most cases, which benefits the creditor, not the consumer, and the arbitration may cost the consumer far more than bringing an action in court. By comparison, indigents in many jurisdictions can file court actions in forma pauperis. And consumers lose their rights to appeal the decisionmaker's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent.

Of significance to TILA is the fact that mandatory arbitration conflicts with the public purpose of TILA and its private attorney general enforcement mechanism. TILA relies upon consumers acting as private attorneys general to police creditor compliance by providing individual and class remedies. The enforcement of TILA through damages provisions is made feasible by the Act’s fee-shifting provision, which mandates the award of costs and reasonable attorney fees to a prevailing consumer.

The class action remedy is an essential component to enforcing TILA’s protections and is a powerful deterrent to wrongful conduct. Indeed, class actions remain the only realistic way for consumers with small monetary claims to vindicate their rights under, and to promote compliance with, TILA. Without class relief and mandatory fee-shifting, TILA would be reduced to nothing more than a mere nuisance to creditors, thus diminishing the Act’s deterrent and remedial functions.

Arbitrators are not necessarily sworn to apply the Constitution and laws of the federal and state governments. For this reason, arbitrators may or may not award the mandatory damages or rescission available under TILA. Further, they may fail to assess fees against the losing creditor and may, even worse, assess fees against a losing consumer which is prohibited under TILA. Consumer rights are chilled and the purposes of TILA are completely frustrated under this scenario.

Consequently, mandatory arbitration clauses in the TILA context should be banned, unless and until the creditor assures that the arbitral context provides the consumer with the remedies and procedures that are available to it in the judicial forum. The National Consumer Dispute Advisory Committee guidelines do not accomplish this goal.

F. Counseling Disclosures

Counseling, while it has some potential to prevent predatory mortgage practices, is not a substitute for substantive protections, and effective regulation of unfair and deceptive mortgage practices. NCLC would not support regulations merely calling for written notification to HOEPA borrowers regarding counseling services. Effective counseling needs to be adequately funded, the counselors must have sufficient training, and there must be a mechanism to insure that consumers who are the most vulnerable and most in need of counseling make use of it. NCLC supports the North Carolina statute, which makes counseling mandatory, and in the absence of which a covered high-cost loan is not valid or enforceable.

NCLC is concerned that a mere notification requirement will only add to the deluge of documents received by prospective mortgage borrowers, and will give the appearance of reform without having any meaningful impact on predatory practices or unsuitable mortgage refinancings.

X. THE DIVISION MUST ADDRESS THE REMEDIES AVAILABLE FOR VIOLATING ANY REGULATORY PROHIBITIONS IT MIGHT ESTABLISH

The present enforcement scheme for violations of TILA is the following:

A) Statutory damages of up to $2,000 for the failure “to comply with any requirement under this part” which is Subpart B of TILA, including § 1639.[42]

B) Any failure to comply with the any requirement under § 1639 triggers enhanced HOEPA damages in the amount of all the finance charges and fees paid by the consumer.[43]

C) Rescission for the failure to provide the HOEPA advance notice or the inclusion of a prohibited loan term.[44]

Since the Division the authority to prohibit acts and practices which the Division finds to be unfair, deceptive, or designed to evade the provisions of HOEPA, a violation of such prohibitions as the Division may identify in Regulation Z arguably triggers statutory and enhanced damages. It is less clear whether creditor non-compliance would trigger rescission. Rescission should be available when any mortgage “contains a provision prohibited by this section,” according to § 1639(j). Thus, the Division should take care to make clear in 209 CMR § 32.32 that certain unfair and deceptive acts are “provisions,” listed in Regulation Z § 226.32(d), and, therefore, trigger rescission under 209 CMR § 32.23.

XI. TYING HOEPA VIOLATIONS TO MORTGAGE LENDER AND BROKER LICENSING LAWS

It is an excellent idea to prohibit mortgage broker and lender licensees from violating the provisions of 209 CMR §32.32. This enhances the potential penalties that wayward brokers and lenders will face when violating any provisions of the HOEPA regulation.

XII. APPLICABILITY OF HIGH RATE LOAN PROTECTIONS TO ALL LENDERS

NCLC commends the Division for taking the important step of extending the applicability of these high rate mortgage regulations to all lenders doing business in Massachusetts. This creates a level playing field in the Commonwealth so that no lender maintains a
competitive advantage over another.

[1] The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with hundreds of legal services, government and private attorneys around the country and in Massachusetts, representing low-income and elderly individuals, who request our assistance with the analysis of credit transactions to determine appropriate claims and defenses their clients might have. As a result of our daily contact with these practicing attorneys we have seen examples of predatory lending to low-income people in almost every state in the union. It is from this vantage point—many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities—that we supply this testimony today. Cost of Credit (NCLC 2d ed. 2000), Truth in Lending (NCLC 2d ed. 2000) and Unfair and Deceptive Acts and Practices (NCLC 1997), are three of twelve practice treatises that NCLC publishes and annually supplements. These books as well as our newsletter, NCLC Reports Consumer Credit & Usury Ed., describe the law currently applicable to all types of consumer loan transactions.


[10] Id. at App. 1, Table 1. It should be noted that the HOEPA trigger is based on APR, which is generally higher than the interest rate. On the other hand, a significant difference between the APR and the interest rate on a long-term mortgage loan results from very high prepaid finance charges (points), which is another strong indicator of potential predatory practices.

[11] For example, Banc One reported in a March, 1999 prospectus supplement that its net losses as a percentage of the average amount outstanding on all serviced mortgage loans was .78% on 3/31/99. Banc One Financial Services Home Equity Loan Trust 1999-2, Prospectus Supplement at S-20. All prospectuses and supplements hereafter cited may be obtained through the SEC’s EDGAR database, at www.sec.gov/edgarhp.htm.


[14] Other cost items besides credit losses going into the interest rate, such as servicing fees and the cost of funds, are generally the same regardless of the loan’s credit grade, at least for loans that are pooled and securitized, since these costs are distributed uniformly to the whole loan pool.


[16] Commonwealth v. First Alliance Mortgage Co., Civil Action No. 98-5534-A (Suffolk County Superior Court, Nov. 27, 1998)(court preliminarily enjoined FAMCO from making mortgage loans in Massachusetts in which they charged more than five points)(affidavit of Professor Dwight Golann).

[17] Federal Reserve Bulletin (August 2000), Table 1.53.


See HUD, Unequal Burden: Income and Racial Disparities in Subprime Lending in America (April 2000) in which HUD discusses the results of studies conducted in Atlanta, New York, Baltimore, Los Angeles, and Chicago. Key findings of the Department of Housing and Urban Development analysis show that: 1) From 1993 to 1998, the number of subprime refinancing loans increased ten-fold; 2) Subprime loans are three times more likely in low income neighborhoods than in high-income neighborhoods; 3) Subprime loans are five times more likely in black neighborhoods than in white neighborhoods; 4) Homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. See also Stripping the Wealth: An Analysis of Predatory Lending in Boston, Acorn (2000).

HUD unequivocally agrees that the borrower pays the yield spread premium. HUD Policy Statement 1999-1, 64 Fed. Reg. 10080, 10081 (March 1, 1999).

OSC § 226.32(b)(1)(i)-1; 62 Fed. Reg. 10198 (March 6, 1997).

“For purposes of paragraph (1)(B), points and fees shall include—

(A) all items included in the finance charge, except interest or the time-price differential…” 15 U.S.C. § 1602(aa)(4)(A).

For some inexplicable reason, the Divisions suggested notice does not include the balloon disclosure currently required by the Federal Reserve Board. See OSC § 226.32(c)(3)-2. This is essential information about which the homeowner needs to be forewarned.

Mansfield and White report that for 14 lenders servicing less than one-half of all subprime mortgages at the end of 1998, 72,000 homeowners are over 90 days delinquent, or in foreclosure or bankruptcy. This represents 4.65% of loans serviced, nearly double the rate for FHA and VA mortgages. Testimony of Cathy Lesser Mansfield, supra note 8.

A single pool of 5,600 loans originated by WMC Mortgage Company in 1998 had reached a point after less than two years where a full 24.75% of the loans in the pool were in 90+ delinquency, foreclosure, bankruptcy, or already foreclosed. Testimony of Cathy Lesser Mansfield, supra note 8.

United Companies Lending filed 1400 mortgages in the City of Philadelphia in the 1990’s, and filed more than 400 foreclosures. Joseph DiStefano, Foreclosures follow Flood of High-Cost Loans, Philadelphia Inquirer, August 2, 2000 at A1. See also, Treasury/HUD Task Force Report, at 25 (mean time between loan origination and foreclosure for subprime mortgages was 1.8 years, compared to 3.2 for conventional mortgages.)


The current maximum total fixed debt to income ratio for FHA and VA mortgages is 41%. 38 C.F.R. §36.4337, HUD Handbook 4155.1 at 2-29 to 2-30 (available at [http://www.hudclips.org/sub_nonhud/cgi/hudclips.cgi](http://www.hudclips.org/sub_nonhud/cgi/hudclips.cgi)).


In over 50% of mortgages loans, closing costs includes a broker's fee. In the interests of simplicity of this example, we have not identified and included either broker's fee.


Preliminary results communicated by e-mail from Mr. Goldstein, complete results of the study to be published by the end of the year 2000.


§ 1640(a)(4).

§ 1639(j); Regulation Z § 226.23(a)(3), n.48.