COMMENTS
of the
National Consumer Law Center, and
Consumer Action, Consumer Federation of America, Consumers Union
Leadership Conference on Civil Rights, National Association of Consumer Advocates, National Fair Housing Alliance, and the Empire Justice Center
to the Board of Governors
of the Federal Reserve System
[Docket No. R-1305]
Regarding
Proposed Regulations
Relating to Unfair Trade
Practices In Connection with Mortgage Lending

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National Consumer Law Center,[1] and
Consumer Action,[2] Consumer Federation of America,[3] Consumers Union[4]
Leadership Conference on Civil Rights,[5] National Association of Consumer Advocates,[6] National Fair Housing Alliance,[7] and the Empire Justice Center[8]
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[1] **The National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments are filed on behalf of NCLC's low-income clients and were written by Alys Cohen, Elizabeth Renuart, Margot Saunders, and Diane Thompson.

[2] **Consumer Action** (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action (CA) serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. CA offers many free services to consumers and communities. Consumer Action develops free consumer education modules and multi-lingual materials for its network of more than 10,000 community based organizations. The modules include brochures in Chinese, English, Korean, Spanish and Vietnamese.

[3] **Consumer Federation of America** (CFA) is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education. Among the reports issued by CFA concerning the current mortgage crisis are the following: *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Products for Consumers and Lender;* and, *Subprime Locations: Patterns of Geographic Disparity in Subprime Lending.*

[4] **Consumers Union** is a non-profit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. To maintain our independence and impartiality, Consumers Union accepts no outside advertising, no free test samples, and has no agenda other than the interests of consumers. Consumers Union supports itself through the sale of our information products and services, individual contributions, and a few noncommercial grants. Consumer Reports, Consumer Reports Online, and our health and financial newsletters, with more than 7.4 million paid subscribers, regularly carry articles on health, product safety, financial services, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union joins in these comments to strongly endorse these regulatory and policy recommendations. The facts and examples described in these comments are provided by other commentors.

[5] The **Leadership Conference on Civil Rights** (LCCR) is the nation's oldest, largest, and most diverse coalition of civil rights organizations. Founded in 1950 by Arnold Aronson, A. Philip Randolph, and Roy

Wilkins, the Leadership Conference seeks to further the goal of equality under law through legislative advocacy and public education. LCCR consists of approximately 200 national organizations representing persons of color, women, children, organized labor, people with disabilities, the elderly, gays and lesbians, and major religious groups.

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

[7] Founded in 1988 and headquartered in Washington, DC, the **National Fair Housing Alliance** is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Through comprehensive education, advocacy and enforcement programs, NFHA protects and promotes residential integration and equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

[8] **Empire Justice** is a statewide, multi-issue, multi-strategy non-profit law firm focused on changing the "systems" within which poor and low-income families live. We represent and advocate on behalf of individuals in a number of areas including Consumer Housing and Community Development (CHCD). The CHCD unit has been representing victims of predatory lending since 2000 and analyzing Home Mortgage data since 1994. Empire Justice has represented hundreds of victims of predatory lending practices and supports the changes proposed by NCLC. Additional details are included in EJC's comment letter.

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I. Introduction

The Federal Reserve Board is the only federal agency with authority to pass comprehensive and enforceable regulations that can stop the reprehensible abuses in the mortgage market. These are the abuses which are directly responsible for the current escalation of foreclosures across the nation and the unraveling of the broader housing market and economy. Yet, while the Summary of the Proposed Regulations thoroughly articulates the complex reasons for the current mortgage meltdown, nevertheless enactment of the Proposed Regulations will not prevent a recurrence. Despite the Board's understanding of the difficulties faced by borrowers when dealing with the mortgage lenders and the unequivocal need for strong regulation, the Proposed Regulations continue to be most protective of the flawed concept that access to credit should be the guiding principle for credit regulation. These regulations need to be significantly strengthened in order for consumers to be adequately protected.

The stakes are high. At the end of 2007, about 40 percent of all foreclosures were homeowners with prime or subprime loans who couldn't make their payments before any reset.[9] Another 23 percent are borrowers who received some form of loan modification, typically a freezing or a reduction of their rate, and then default.[10] 20 percent of new foreclosures were prime adjustable-rate mortgages, which accounted for 15 percent of all home loans.[11]

The guiding principle of the Proposed Regulations issued under the Board's mandate to stop unfair, deceptive or evasive mortgages should be only *protecting homeowners from overreaching lenders.* As the Board said:

> …[C]onsumers in the subprime market face serious constraints on their ability to protect themselves from abusive or unaffordable loans, even with the best disclosures; originators themselves may at times lack sufficient market incentives to ensure loans they sell are affordable; and regulators face limits on their ability to oversee a fragmented subprime origination market. These circumstances appear to

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[9] Kathleen M. Howley, *U.S. Mortgage Foreclosures Rise as Owners `Give Up'* , Bloomberg.com (Mar. 6, 2008)(discussing interview with author of Mortgage Bankers Association delinquency survey; while the author attributed many of these delinquencies to overreaching borrowers buying houses they never could afford, the number of refinancings, especially in the subprime market, makes it clear that it is the loans—and the originators—at fault, not simply a run on greedy borrowers), *available at* http://www.bloomberg.com/apps/news?pid'20601087&refer'home&sid'aPb48hRS1h.

[10] *Id.*

[11] *Id.*

> warrant imposing a new national legal standard on subprime lenders to help ensure that consumers receive mortgage loans they can afford to repay, and help prevent the equity stripping abuses that unaffordable loans facilitate.[12]

The last time Congress passed a law addressing the mortgage crisis was in 1994 when it passed the Home Ownership Equity Protection Act.[13] Congress recognized at the time that it was not addressing all of the potential abuses that could arise in the mortgage market. Congress recognized that the best way for consumers to be protected from dangerous mortgage practices was for the – more nimble and faster acting – Federal Reserve Board to address the new practices as they evolve.[14] Congress provided the Board with a powerful and efficient implement with which the Board is *required* to act to protect consumers.[15] The language is not permissive – the Board is not simply *allowed* to act. Congress has specifically instructed the Board to look for, find and prohibit practices which are "associated with abusive lending practices, or that are otherwise not in the interest of the borrower."[16] Once identified – as the Board has now identified abusive practices – those practices *must* be prohibited.

The tempering measurement that the Board continually employs in all of its analyses of new protections for consumers is whether access to credit may be affected. While this focus is understandable – it has historically been the yardstick by which consumer credit regulation has been evaluated for the past two decades – it is nevertheless unnecessary in these circumstances for it to constrict the scope of the provisions in question. First, the language of the Congressional mandate in 1639(l) does not authorize this balancing test – the mandate is simply to protect consumers from overreaching creditors. Secondly, even the balancing tests employed in implementing the FTC Act's prohibition against unfairness only uses this kind of balancing test as one part of the analysis.

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

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

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

[12] 73 Federal Register 1672, January 9, 2008 at 1677.

[13] 15 U.S.C. 1639. As added by act of Sept. 23, 1994 (108 Stat.2191).

[14] H.R. Conf.Rep. No. 652, 103d Cong.2d Sess. 147, 161 (1994): 1994 U.S.C.C.A.N. 1987 (accompanying H.R. 3474).

[15] 15 U.S.C. 1639(l)(2).

[16] 15 U.S.C. 1639(l)(2)(B).

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

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

We appreciate the distance the Board has come in proposing these Regulations. While the Board clearly recognizes the horrific problems facing homeowners, these Proposed Regulations will simply not stop these problems from occurring in the future. The Regulations should:

- Cover all owner-occupied mortgage loans, including prime loans and HELOCs;
- Require an ability to repay analysis for each loan;
- Require a thorough and genuine income analysis that includes subordinate liens;
- Ban prepayment penalties;
- Require escrowing with a later and more substantial opt-out;
- Establish a fiduciary duty for all brokers and allow yield spread premiums only where the rate includes all closing costs; yield spread premiums also should be included in the HOEPA points and fees trigger.
- Address lender and originator incentives for appraisal fraud;
- Set significant requirements for mortgage servicers including a right to reasonable loss mitigation prior to foreclosure;
- Provide early, binding mortgage disclosures for all loans;
- Promote the APR in advertisements to promote shopping based on this factor;
- Provide effective remedies, including: an actual damages standard that can be satisfied; rescission for failure to provide early disclosures; and clarification that assignee liability applies to substantive violations in the rule where violations were apparent on the face of the loan file documents.

II. *The Entire Owner-Occupied Primary Residence Mortgage Marketplace Should Be Regulated*

A. *Background*

We appreciate the Board's recognition of the need to regulate a larger slice of the mortgage market in light of the abuses in the origination and servicing of mortgage loans revealed most agonizingly by the shocking rise in loans seriously delinquent.[17] In the prime market, this percentage for both fixed and adjustable rate loans more than doubled from .77% in the first quarter of 2006 to 1.67% in the fourth quarter of 2007. In the subprime market, this percentage also more than doubled from 6.22% to 14.44%, between the same quarters of 2006 and 2007. When the data on adjustable rate mortgages is separated out, the numbers are even more alarming for both parts of the market, as is evident in the chart below.[18]

YEAR	SERIOUSLY DELINQUENT ARMS: PRIME	SERIOUSLY DELINQUENT ARMS: SUBPRIME
2006	Q1: .82 Q2: .92 Q3: 1.14 Q4: 1.45	Q1: 6.28 Q2: 6.52 Q3: 7.72 Q4: 9.16
2007	Q1: 1.66 Q2: 2.02 Q3: 3.12 Q4: 4.22	Q1: 10.13 Q2: 12.40 Q3: 15.63 Q4: 20.43

Instead of applying new regulation to the entire residential market, the Board distinguishes between subprime ("higher-priced") consumer loans secured by the consumer's principal residence and consumer loans secured by the consumer's principal residence without regard to price. Regarding the former group, the Board proposed to address shoddy underwriting and verification practices, prepayment penalties, and the failure to escrow for property taxes and insurance. As for the larger subset of loans, the Board proposes to address certain lender payments to brokers, appraisal fraud, and some servicing practices.

We urge the Board to extend its consumer protection rules to the entire owner-occupied primary residence mortgage marketplace, including home equity lines of credit

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[17] The Mortgage Banker's Association reports the percentage of loans seriously delinquent each quarter in its Delinquency Survey. Seriously delinquent includes the loans that are at least 90 days delinquent plus the loans in foreclosure inventory.

[18] This chart contains data from the Mortgage Banker's Association Delinquency Survey for each of the quarters listed.

(HELOCs), for the reasons we articulate below.[19] We believe this position is consistent with the objective of these rules, as articulated by the Board.[20]

B. Abuses Migrate to the Least Regulated Portions of the Market

Experience has shown that regulating smaller slices of the market does not prevent the abuses from migrating to the less regulated segments. Case in point: HOEPA loans. The Home Ownership and Equity Protection Act (HOEPA) effectively shut down the making of most of these very high-priced, abusive loans in the thirteen years since its effective date on October 1, 1995. The 2006 HMDA data shows that the reporting lenders made only 14,730 HOEPA loans secured by owner-occupied residences.[21] This is down from 2004, when the HMDA data first collected HOEPA information.[22] Contrast this with one industry-commissioned study reporting that 12.4% of first-lien loans and 49.6% of second-lien loans made by nine large lenders between July 1, 1995 and June 30, 2000 were HOEPA loans.[23]

Concurrent with the passage of HOEPA, the subprime market took off for a variety of reasons, one of the most important being the lenders' ability to obtain capital from investors by pooling, packaging, and securitizing their loans. Subprime securitization volume rose from $17.771 billion in 1994 to $448.598 billion in 2006.[24] Abuses in the subprime market became apparent over the years due to consumer complaints, lawsuits, investigations by public agencies, and testimony presented to the Board at hearings in 2000, 2006, and 2007.[25] It is evident that abuses migrated to the

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[19] At the outset, we agree with the Board that whatever slice of the market it decides to regulate, it ought not to include investment properties, business loans, or loans secured by second homes.

[20] These guidelines are discussed at 73 Fed. Reg. at 1681.

[21] This number includes both one-to-four family dwellings and manufactured homes. Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, *The 2006 HMDA Data*, Table 4, Fed. Res. Bull. (Dec. 2007). We believe these numbers do not include all HOEPA loans made in 2006 because the data covers about 80% of all home lending nationwide. *Id.* at A73. In addition, we believe that many HELOCs are truly closed-end transactions masquerading as open-end and should be covered by HOEPA, which presently exempts HELOCs from its protections. Nevertheless, relative to the market as a whole, the numbers are small.

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

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

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

[25] *See* 73 Fed. Reg. at 1677-78 (summarizing testimony presented to the Board at the 2006 and 2007 hearings). Some of the public investigations of subprime lenders include the largest companies, *e.g.,* Household Finance Corp. (2002) and Ameriquest Mortgage Co. (2006). Journalists reported on practices of other large subprime lenders, *e.g.,* Citifinancial (Michael Hudson, *Banking on Misery: Citigroup, Wall Street, and the Fleecing of the South*, Southern Exposure 31.2 (Summer 2003), http://www.southernstudies.org/reports/bankingonmisery.pdf); and Countrywide (Gretchen Morgenson &

subprime market at the same time that lenders began to face the liability risk from making abusive HOEPA loans. In other words, they made loans below the HOEPA triggers to avoid stringent regulation and the risk of significant liability.[26]

The prime market is not exempt from abuses. Lenders have paid brokers yield spread premiums without transparency and consent by borrowers in the prime market for years.[27] Lenders in that market also made no documentation loans. For example, Chevy Chase Bank instructed loan brokers to "black out" any income information on social security letters and on IRS Schedule B forms in its Stated Income Loan Origination Guidelines--Wholesale Lending Division. **See Appendix A.** Indymac Bank instructions state: "Competed typed 1003 Application with no reference to income or assets. The file must not contain any documents that reference income or assets." **See Appendix B.**

When lenders in any part of the market shrug off prudent banking practices, such as verification and assessment of ability to repay, grave consequences occur. The examples highlighted below constitute compelling evidence of practices that would not be covered by the suggested higher-priced loan rules that violate prudent underwriting standards. These loans represent prime products. Two of the three homeowners gave permission to provide their identities and that of their lenders. They are from two very different parts of the United States: the Atlanta, GA area and Brooklyn, NY.

C. Prime Loans Raise Significant Verification and Ability to Repay Concerns

Example 1:[28] Ms. Avonia Carson is a 66-year-old African American woman. She has lived in her home in southeast Atlanta since 1971. Her adult son has lived with her since 2001 after an accident that rendered him blind and in need of 24-hour care. Ms. Carson also has custody of her three-year-old great-granddaughter, for whom she has been caring since birth. Ms. Carson is on a fixed

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Geraldine Fabrikan, *Countrywide's Chief Salesman and Defender*, N.Y. Times, Nov. 11, 2007, at 1 (Sunday Business)(origination issues); Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. Times, Sept. 2, 2007, at 1 (Sunday Business)(servicing issues); Gretchen Morgenson & Jonathon D. Glater, *The Foreclosure Machine: An Industry Thrives on Housing Woes*, N.Y. Times, Mar. 30, 2008, at 1 (Sunday Business)(servicing issues).

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

[27] The Department of Housing and Urban Development has been struggling with this type of compensation since at least 1992. See Supplementary Information , Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080, 10,080 (Mar. 1, 1999)(reporting that it conducted rulemakings on three occasions in the previous seven years; promulgating a policy statement that applied to the entire mortgage lending market; discussing why these payments were ":particularly troublesome" for consumers and industry).

[28] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

monthly income of $1,160.00 from Social Security. In 2006, Wachovia Bank made her a mortgage loan she could not possibly afford. Five months later, JPMorgan Chase Bank made her a second mortgage she had no way of paying. The specific loan details are shown in attached **Appendix C.**

The loans themselves are decently priced and did not contain high points or closing costs. However, both Wachovia and Chase made mortgage loans without regard to Ms. Carson's ability to pay. At the time of each closing, Ms. Carson's monthly income was about $1,135. The debt-to-income ratio in the first mortgage is 78%. When the first and second mortgage payments are combined ($1,265.49), the debt-to-income ratio is 112%.

Wachovia's loan file contains no loan application and no documentation of Ms. Carson's income. JPMorgan Chase Bank's loan file also contains no loan application and no documentation of her income. Wachovia extended the first mortgage based on the value of the home, not on Ms. Carson's ability to pay. An appraisal report in Wachovia's file states the property was valued at $167,000. Neither Wachovia nor Chase included an escrow for taxes and insurance.

Neither loan would be prohibited under the proposed rules. The APRs for both the first and second mortgages fall below the trigger for "higher priced loans."

Example 2:[29] Ms. Josephine Reese is a 55-year-old African American woman. She bought her home in southwest Atlanta in 1982 and has lived there for the past 26 years. Ms. Reese is both mentally and physically disabled. She and her 15-year-old son struggle financially, as their only support is her fixed monthly income of $1,384 from Social Security disability and a pension. On October 13, 2006, Wachovia Bank made her two mortgage loans she could never afford. The specific loan details are shown in attached **Appendix D.**

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

[29] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

account there for years. Indeed, Wachovia documented her income for its loan file with a printout of Ms. Reese's checking account history for the previous six weeks.

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

Neither loan would be prohibited under the proposed rules. The APR of the first mortgage falls below the trigger for "higher priced loans." The second mortgage would be excluded as it is a home equity line of credit.

Example 3:[30] Ms. W is a 73-year-old woman who lives in Brooklyn with her 17-year-old grandson. She has owned her home since 1959. She never finished high school and is financially unsophisticated. Before retiring, she held a variety of jobs, including salesperson, laundry hand presser, and babysitter.

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

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

Ms. W's loan would not violate the proposed rules because the APR falls below the trigger for "higher priced loans."

D. The Higher-Priced Loan Rules Focus on Prudent Underwriting Standards and Should Apply to the Prime Market

[30] This loan example is provided by Jessica Attie, co-director, Foreclosure Prevention Project, South Brooklyn Legal Services.

The higher-priced loan rules that the Board recommends address basic prudent underwriting practices, *e.g.*, verification of income, repayment ability, and escrows for property, taxes, and insurance. We comment below on the substance of these rules and offer suggestions for improvement in some areas. However, all lenders who offer consumer credit secured by owner-occupied primary residences should operate under the same set of sensible rules.[31]

The Board identifies two principal reasons why it suggests excluding the prime market from these rules.[32] First, it argues that there is limited evidence that underwriting problems have been significant in the prime market. However, the data shows that the seriously delinquent rates for prime ARMs increased fourfold between the first quarter of 2006 and the fourth quarter of 2007 (see chart above). In addition, we present evidence with these comments that major prime lenders ignored prudent underwriting standards to make prime loans that were doomed to fail due to extraordinarily high debt-to-income rations.

Second, the Board claims that any undue risks to consumers can be adequately addressed through the federal agencies that supervise a large part of the prime market, citing to guidances issued by these agencies over the last few years. Unfortunately, these guidances are not enforceable by anyone other than these agencies. Consumers have no right to enforce them under federal law. Relevant guidances have been issued since 1997.[33] Neither the guidances nor the examination process prevented the abuses in any part of the market, prime or subprime.

E. HELOCs Should Be Covered

The Board justifies the exclusion of HELOCs from coverage of both Regulation Z 226.35(higher-priced loans) and § 226.36 (general market) protections on three grounds.

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[31] The Board also proposed to ban prepayment penalties unless the lenders and the penalty provision meet several criteria. Applying this rule to the prime market would not be burdensome since only about 2% of loans in this market carry these penalties. Eric Stein, Quantifying the Cost of Predatory Lending, at 8, Center for Responsible Lending (July 25, 2001), available at http://www.responsiblelending.org/pdfs/Quant10-01.pdf. *See also* Roberto G. Quercia, Michael A. Stegman, & Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, Kenan Institute for Private Enterprise, University of North Carolina (Jan. 25, 2005)(finding that the existence of prepayment penalties leads to a significant increase in foreclosure risk, after controlling for other factors), available at http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

[32] 73 Fed. Reg. at 1683.

[33] Examples of guidances predating 2006 include: FIL-44-97: Risks Associated with Subprime Lending (May 2, 1997); FIL-94-99: Interagency Guidance on High Loan-to-Value Residential Real Estate Lending (October 12, 1999); FIL-9-2001: Federal Banking Regulatory Agencies Jointly Issue Expanded Examination Guidance for Subprime Lending Programs (January 31, 2001); FIL-57-2002: Unfair or Deceptive Acts or Practices: Applicability of the Federal Trade Commission Act (May 30, 2002); FIL-15-2003: Interagency Advisory on Mortgage Banking Activities (February 25, 2003); FIL-26-2004: Unfair or Deceptive Acts or Practices Under Section 5 of the Federal Trade Commission Act (March 11, 2004); Credit Risk Management Guidance for Home Equity Lending (May 16, 2005)..

First, the Board states that most originators of HELOCs hold them in portfolio which aligns the originators' interests more closely with those of the borrowers.[34] Our review of limited public information shows this assertion to be faulty. Non-agency MBS production for HELOCs for the years 2005 and 2006 were $24.62 billion and $23.48 billion, respectively.[35] Internet research resulted in the HELOC Loan Pool Data--selected pools, attached as **Appendix F.** This Chart provides example of some HELOC loan pools that were securitized in 2006 and 2007, representing $5.72 billion in principal and 80,014 loan. This information is by no means comprehensive. Nevertheless, the information we present shows that a significant volume of HELOCs were and, in the future, likely would be, sold and securitized.[36]

Second, the Board argues that TILA provides borrowers special protections for HELOCs. Presumably, this statement means that consumers need no additional protections beyond what already exists in the Act. However, these "protections" boil down to disclosures tailored to open-end credit secured by the home,[37] with the exception of a handful of substantive protections, none of which overlap with the Board's proposed rules.[38]

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

Below, we provide two examples of borrowers who were sold HELOCs that were completely unaffordable.

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[34] 73 Fed. Reg. at 1682.

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

[36] Given the Board's vast resources and access to data unavailable to the public, its staff certainly could collect more complete data on this point.

[37] Regulation Z §§ 226.5b, 226.6.

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

Example 1:[39] Ms. Josephine Reese's situation was described above in the coverage section. The specific loan details are shown in attached **Appendix D**.

Example 2:[40] Ms. Nessia Jones is a 55-year old African American who has lived in her home in Decatur, Georgia for 27 years. Ms. Jones has received Social Security widow's benefits since 1988. Her mental and physical health is poor and requires an extensive medication regime. Ms. Jones's adult daughter who lives with her has been disabled since an infant, is profoundly mentally retarded, and suffers from seizures. In 2006, GreenPoint Mortgage Funding made her two mortgage loans that should never have been made. The specific loan details are shown in attached **Appendix G.**

Ms. Jones's monthly income at closing was $633 in Social Security. The combined monthly mortgage payments ($1,266.59) were 200% of her monthly income. The loan application stated Ms. Jones was not employed, received Social Security disability benefits, and that her income was $3,950 in employment income. The information on the loan application was obviously inconsistent and falsified. No one receives Social Security benefits in that amount. (The average monthly Social Security benefit for disabled workers in 2006 was $947. The maximum retirement benefit was only $2,053.) The lender's loan files did not include any documentation of her income. GreenPoint apparently made these mortgages based on the value of the home ($150,900 per GreenPoint's appraisal), not her ability to pay.

The second mortgage would not be covered by the proposed rules because it was a HELOC. The first mortgage would be considered a "higher priced loan."

Finally, NCLC has provided numerous examples to the Board over the last decade of abusive HELOCs that should have been covered by HOEPA. All of this evidence supports our belief that excluding HELOCs from the proposed rules simply provides an incentive for lenders to make them to avoid added regulation. For this reason, we urge the Board to include HELOCs in the new rules and to use its UDAP authority under § 1639 to cover them under HOEPA as well. As a result, lenders would apply the same prudent lending principles to this product as they would to its competition--fixed terms mortgage loans---throughout the entire market.

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[39] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

[40] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

F. If the Board Retains the Higher-Priced Triggers, the Spreads Should Be Small and the Board Should Include a Points and Fees Trigger

1. The APR Margins Should be Small

We agree with the Board that the APR margin added to the comparable constant maturities should be no higher than 3% for first lien loans and 5% for subordinate loans. If these margins are too high to cover the Alt A market, then they should be lower. By definition, the Alt A market includes borrowers with less than prime eligible credit scores.[41] A large percentage of the exotic (or toxic) mortgage loans were made to borrowers in this category. In addition, the "higher-priced" category should cover the entire subprime market. Over-inclusion is better than under-inclusion.

2. The Board Should Include a Points and Fees Trigger

Congress wisely created two triggers when designing the high-cost loan coverage in 1994: one that measured the APR and one that measured the points and fees added to the loan. The reason is clear: Congress understood that many high cost loans would not be captured if only one or the other of the triggers were used. We face exactly the same situation today, if the Board uses only the APR to define higher-cost loans.

Those closing costs that are prepaid finance charges affect the APR to a lesser degree if the loan term is longer than they do if the term is shorter. The mortgage loan context provides the best example of the former situation. Lenders can pad the loan principal with excessive fees and stay under an APR trigger, given the length of these loans. Since forty year loans are sold more frequently these days, this problem becomes more exacerbated.

The Chart below lists the APRs for a $200,000 loan with a fixed rate of 6%, using two different loan terms, 30 and 40 years, and assuming varying amounts of prepaid finance charges. The APR trigger for a higher-cost loan under the proposed regulation as of the first business day of 2008 using a 10-year treasury security (3.91%) and adding the 3% margin is **6.91%.**

Fixed Rate Example

Prepaid Finance Charges	APR for 30-yr. terms	APR for 40-yr. term	Exceeds 6.91% Benchmark
$10,000	6.49%	6.41%	N
$15,000	6.74%	6.63%	N
$20,000	7.01%	6.86%	Y: 30-yr.
$25,000		7.10%	Y: 40-yr.

[41] The 2007 Mortgage Market Statistical Annual, Vol. I (definitions), Inside Mortgage Finance Publications (2007).

This chart demonstrates that the lender can keep its APR below the trigger until it charges almost **10%** of the loan principle as prepaid finance charges in a 30 year loan and almost **12.5%** in a 40 year loan. Given that the definition of a "finance charge" under TILA excludes many closing costs,[42] the actual price to close these loans could be much higher. These percentages well exceed the 8% HOEPA points and fees trigger and make for very expensive loans.

Another way that lenders keep the APR under the proposed higher-priced triggers is to sell ARMs with teaser rates, a very common practice. In this case, the APR is a composite number based upon the teaser rate for the length of time it is in effect and the fully-indexed rate for the remainder of the term. The Chart below compares two ARM loans with initial teaser rates of 4% that are fixed for two years. We assumed that the fully indexed rate at closing is 6%. The higher-cost APR trigger is the same as used in the fixed rate example above.

2/28 ARM Example

Prepaid Finance Charges	**APR for 30-yr. terms**	**APR for 40-yr. term**	**Exceeds 6.91% Benchmark**
$10,000	6.124%	6.076%	N
$15,000	6.371%	6.283%	N
$20,000	6.627%	6.499%	N
$25,000	6.895%	6.742%	N
$30,000	7.176%	6.962%	Y

This Chart shows that the APRs for ARMs with teaser rates will be lower than their fixed rate counterparts and permit the lender to charge more prepaid finance charges before triggering the higher-cost protections.

By omitting a points and fees trigger, lenders will be encouraged to gouge consumers, not through the interest rate, but through fees. This is a pernicious dynamic, one that Congress foresaw when crafting HOEPA.

For these reasons, we urge the Board to add a points and fees trigger. We suggest the trigger percent be lower than HOEPA and be set at 5% to capture loans below the HOEPA trigger.[43] Otherwise, for consistency, we believe the Board should adopt the same definition of points and fees as exists in HOEPA.[44]

[42] *See* Elizabeth Renuart & Diane Thompson, The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending, ____Yale J. on Reg. ____(2008)(forthcoming), available at http://ssrn.com.

[43] Several states use a 5% points and fees trigger in their mini-HOEPA laws.

[44] Elsewhere in our comments, we discuss why the Board should clarify that yield spread premiums are included in points and fees.

III. Ability to Repay Should Be Analyzed For All Home Mortgages: A Pattern and Practice Requirement Will Reduce Incentives to Comply and Bar Homeowner Remedies

A. An Ability to Repay Analysis is Central to the Board's HOEPA Rule

We support the Board's inclusion of an ability to repay requirement in the proposed rule. The central thread connecting abusive mortgage loan originations over the past decade is the unaffordability of those loans.[45] A requirement that loan originators evaluate the borrower's ability to repay that loan is essential to a functioning, fair and transparent market. Only when the interests of loan originators, servicers and investors are aligned with those of the borrower—when all have an interest in performing loans—will the market be able to deliver loans that sustain homeownership and that provide growth without the dangerous externalities that brought the market to today's crisis. We encourage the Board to clarify, as proposed, that current and expected income must be reasonably anticipated. In addition to the examples provided by the Board, this analysis also will help highlight that borrowers with a fixed income, including those on disability and those who are retired, do not have any reasonable expectation of a significant increase in their income.

Unaffordable loans are loans that are designed to fail, either from the outset,[46] or as soon as the fixed rate period ends and the payment begins to adjust upward. These loans are made because the individuals and entities involved in the lending process make enough money from the loans so that it does not matter whether the borrower ultimately is forced to refinance or face foreclosure. The extent to which making unaffordable loans has come to dominate mortgage lending is shown most tellingly by subprime lenders' own words: "[M]ost subprime borrowers cannot afford the fully indexed rate, and . . . it will hurt liquidity for lenders and effectively force products out of the marketplace."[47]

Such lending cannot be preserved in the name of access to credit. Borrowers need access to affordable, constructive credit; not just *any* credit.

Legal services and other consumer attorneys are (and have been) flooded with clients seeking protection from unaffordable loans that never should have been made. Following are three examples (two from Atlanta and one from Brooklyn).

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

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

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

Example 1:[48] Ms. Nessia Jones's situation was described above in the HELOC section, including the fact that the combined payments on her two loans were 200% of her income. The specific loan details are shown in attached **Appendix G**.

Example 2:[49] Ms. Avonia Carson's situation was described above in the coverage section, including the fact that the combined payments of her two loans were 99% of her income. The specific loan details are shown in attached **Appendix C**.

Example 3:[50] Mary Overton is an elderly African-American widow who has owned her Brooklyn home since 1983. Although she suffers from serious health ailments that limit her mobility and practically confine her to the ground floor of her home, she manages to care for her teenage grandson, who lives with her. Ms. Overton did not finish high school and has difficulty understanding numbers.

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

In order to make it appear that she could afford the loan, Ameriquest employees created a fake set of financial documents to include in her loan file, including fake tax returns, a fake 401(k), a fake employment statement showing that she sold makeup for Avon, and a fake lease agreement. The fake documents (with the social security numbers redacted) are attached as part of **Appendix H.**

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

[48] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

[49] This loan example is provided by Karen E. Brown, an attorney at Atlanta Legal Aid Society.

[50] This loan example is provided by Jessice Attie, co-director, Foreclosure Prevention Project, South Brooklyn Legal Services.

B. *Specificity in the Presumption Will Ensure Better Compliance and More Uniform Lending; PMI Also Should Be Included*

The Board's proposal incorporates the existing presumption of § 226.34(a)(4) that a violation has occurred where there is a pattern or practice of failing to verify and document repayment ability. It further has included an additional rebuttable presumption of a violation that incorporates considerations of ability to repay based on a specified interest rate, the ability to make fully-indexed, fully-amortizing payments including PITI for seven years, and the borrower's debt-to-income ratio (DTI) and residual income (without providing specific numbers). The seven year requirement is substantial, as it will allow homeowners a significant period of predictability and a genuine opportunity to acquire some equity. **The Board should clarify that all factors in the presumption need to be met.** The Board also notes that a creditor could violate this requirement even without violating these specific presumptions.

It is essential that any ability to repay analysis examine fully amortizing payments including taxes and insurance. In particular, PMI must be included in the rebuttable presumption analysis. The advent of credit scoring in PMI pricing has resulted in many borrowers showing up at closing, only to find that the PMI obligation increases the monthly payment by several hundred dollars.[51] We therefore strongly support the Board's proposed requirement in § 226.34(a)(4)(i)(C) that lenders consider consumers' ability to make loan payments based on a fully amortizing payment that includes "premiums for any guarantee or insurance protecting the creditor against consumers' default or other credit loss; and premiums for other mortgage related insurance." However, we ask that the Board revise this language, or add language to the Commentary, that specifically mentions PMI, so that there is no question that the PMI premium must be considered.

We applaud the Board's inclusion of residual income along with DTI in the presumption. Residual income is an essential component of an affordability analysis, especially among lower-income families.[52] After making housing related monthly payments, and all other regularly scheduled debt payments due as of the date the home loan is made, sufficient residual income must be available to cover basic living necessities, including but not limited to food, utilities, clothing, transportation and known health care expenses.

The Board's failure to specify acceptable levels of DTI and residual income undermines the utility of its endorsement of safe and sound underwriting criteria. Specificity will result in higher compliance rates and more performing loans. The Board's assertion that specific numbers will limit credit is unconvincing, and fails to recognize that the enormous market pressure to originate unaffordable loans that led to the current mortgage crisis. If other factors may offset the risk of high DTI, those factors can be enumerated in a specific regulation. The credit market has not, left to itself, developed safe and sound underwriting guidelines. Many subprime lenders already

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

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

purport to consider residual income and to set DTI limits. Nonetheless, in many cases the loans originated were obviously not affordable by any realistic assessment of residual income. We have seen cases where lenders approved loans of DTI of 52%, looking only at the borrowers' mortgage payment and excluding car payments, taxes and insurance, student loans, and other fixed debt. Seldom, if ever have we seen a lender at origination look carefully at the necessary components of residual income—utilities, food, clothing, repairs.[53] By itself, the credit market may "consider" residual income much as it does now—based on partial assessments of debt and unrealistically low (few hundred dollar) requirements for residual income.

The Board should recognize the relationship between DTI and residual income. Obviously, higher income borrowers can generally afford to carry a higher DTI than can lower income borrowers without putting themselves and their families at imminent risk of foreclosure. As residual income increases, borrowers can generally safely tolerate a higher DTI. Conversely, as residual income decreases, permissible DTI should also decrease. Adopting a tiered or teeter-totter approach allows the Board to ensure that all loans are made with an eye to long term affordability while permitting higher income individuals unfettered access to debt.

The Board need not reinvent the wheel in mandating specific DTI and residual income guidelines. The Department of Veterans Affairs (VA) has long used a specific set of guidelines that are widely recognized as useful and appropriate. Significantly, to our knowledge, the VA guidelines have not resulted in widespread denial of credit to veterans nor the unavailability of VA guaranteed loans. We recommend that the Board mandate that creditors use the approach to residual income and DTI that is found in the VA's guidelines at 38 CFR § 36.4840. Failing that, the Board should develop its own specific guidelines that reflect meaningful standards of residual income, well delimited DTI ratios, and a holistic evaluation of the borrower's ability to repay.

The VA guidelines combine specificity and flexibility. They allow loans to be approved without special supervisory approval if the veteran has a DTI of 41% or less *and* meets a residual income test. The DTI takes into account the monthly PITI of the loan being sought, homeowners' and other assessments such as condo fees, and any other long-term obligations. The residual income test is used to determine whether the veteran's monthly income, after subtracting monthly shelter expenses and other monthly obligations, will be sufficient to meet living expenses. The VA has fine-tuned the residual income standards to reflect family size, regional differences, and loan amount.

A critical feature of the VA guidelines is the flexibility they provide to make exceptions based on documented facts, and the manner in which DTI and residual income relate to each other. If the veteran meets the DTI standard but not the residual income standard, or if the DTI is greater than 41%, the underwriter must justify the loan in accord

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

with detailed guidelines, and the underwriter's supervisor must approve the loan.[54] If, however, the veteran has residual income substantially in excess of the guidelines, the loan can be approved without special justification.[55] This rule recognizes that the importance of DTI recedes if the borrower has larger residual income.[56] The VA guidelines demonstrate that adopting specific DTI and residual income standards does not mean, as the Board has suggested in its discussion of the proposed rule, that creditors would be forced to focus woodenly on just one or two underwriting factors.

The VA guidelines include the veteran's credit record and downpayment as factors to consider in approving a loan that does not meet the DTI or residual income standards. These factors work in the context of the VA guidelines, with specific guideposts for residual income and expansive requirements of debt. The Board's offer to creditors to ignore residual income guidelines and DTI ratios wholesale in the face of a high credit score and downpayment is more problematic. A good credit history and equity in the property have no bearing on whether the borrower actually has the money to pay the mortgage each month. Credit scores and downpayments tell us about past behavior and about incentive to make the payments, not ability to repay. If the money is coming from income, only a DTI and residual income analysis can answer the forward looking ability to repay. Indeed, reliance on a high down payment to waive residual income or DTI requirements could be seen as an invitation to asset based lending, a per se predatory practice, or fraudulent downpayment schemes that give the appearance of homeowner equity in the property without the actuality. Without specific requirements, bank examiners—and for that matter, assignees—have no guideposts against which to measure compliance or safety and soundness.

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

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

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[54] 38 C.F.R. § 36.4840(c)(4), (5).

[55] 38 C.F.R. § 36.4840(c)(3) (special justification unnecessary if residual income exceeds guidelines by at least 20%).

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

C. The Fully-Indexed Rate Analysis Is Never Charged and Will Shortchange Homeowners During a Steep Yield Curve

There are several problems with the "fully indexed rate" standard. First, the fully indexed rate is a rate which in most loans will *never* actually be the rate that is charged to the borrower. It is a fictional rate which is based on the application of the index at or shortly prior to origination plus the margin that will apply at the end of the first (two or three year) period of fixed rates. If, as is almost certain to be the case, the index rate changes during the fixed-rate period, the rate that will apply at the end of the fixed rate period will be different from the "fully indexed rate" that was calculated when the loan was originated. Assessing the affordability of a loan based on a rate that will never actually be applied to it makes little sense.[57]

Second, and even more importantly, assessing affordability based solely on the fully indexed rate does not protect homeowners from the risk of increasing payments when the underlying index, for example the LIBOR rate, increases.

Almost all 2/28 and 3/27 loans include terms by which the interest rate that applies for the initial fixed period of the loan is the *lowest* rate that can ever be charged. In other words, the interest rate can climb, but even if the index upon which the interest rate is based drops, the interest rate charged the borrower can never go down.

The interest rates and thus the payments do rise on these loans. Almost all of the subprime loans that we see are based on the six month LIBOR index. In recent years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).[58] The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

If interest rate increases on adjustable rate loans are not considered in underwriting, borrowers will continue to feel pressured to return to the closing table for a refinancing, where their equity may be used for closing costs, and where their wealth will continue to dwindle. Others will be unable to refinance, and will lose their homes.[59]

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

[58] HSH Associates Financial Publishers, http://www.hsh.com/indices/fnmalibor-2007.html

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

D. The Pattern and Practice Requirement Undermines the Strength of the Rule and Creates Insurmountable Burdens for Individual Homeowners

The Board's proposal falls short by requiring a showing of "pattern and practice" in order to obtain relief. This requirement undermines the strength of the ability to repay requirement and will result in many homeowners with unaffordable loans facing foreclosure because they can not avail themselves of the rule.

In its Supplementary Information, the Board acknowledges the complexity of the market, including "limitations on price and product transparency" and the need for regulation beyond disclosure. The Board spends several pages describing misaligned incentives and the limited role that shopping has played, particularly in the subprime market. Yet, in the same document, the Board fails to provide any protection to an individual facing foreclosure who has received a loan that was unaffordable.

Moreover, the Board itself has described the limitations to a pattern and practice requirement. In the 1998 Joint Report to Congress by the Board and HUD, the Board (and HUD) described the challenges of the HOEPA pattern and practice requirement to the rights of individual consumers:

> As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a "pattern or practice" of making loans without regard to homeowners' income and repayment ability. Thus, the Congress should consider eliminating HOEPA's "pattern or practice" standard, so that individual consumers will have a remedy based solely on their own loans. If the "pattern or practice" requirement is eliminated, creditors should be allowed to accommodate consumers in special circumstances provided that appropriate documentation verifying the circumstances is obtained.[60]

The Board has clarified in the existing comment to § 226.34(a)(4) that the pattern and practice requirement does not require statistical evidence but rather should be judged by the totality of the circumstances and that isolated, random or accidental acts do not satisfy this test. This clarification, while helpful at the margins, does not remove the insurmountable barriers faced by individual homeowners seeking to remedy their abusive home loans. The Board contends that perpetuating this rule is intended to reduce the risk that the rule "inadvertently causes an unwarranted reduction in the availability of mortgage credit." This assumes that a pattern and practice requirement, applied, as it is here, only to higher-cost loans,[61] will have a significant effect on the market. To the extent that the presumptions in the requirement are general, this claim is even harder to support because compliance will be varied and ensuring such compliance will be difficult

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[60] Federal Reserve Board and U.S. Deparment of Housing and Urban Development, *Joint Report to Congress* (July 17, 1998), at 63, *available at https://www.federalreserve.gov/boarddocs/press/general/1998/19980717/default.htm.*

[61] As we stated above, we believe this narrow approach misses the mark.

for regulators, enforcement agencies and homeowners. Even if the requirements were more specific, regulation has not proved to be a sufficient means of eliminating abuses, as is evident by the history of Guidance on predatory mortgage lending in the last decade and the simultaneous expansion of overreaching origination practices. Moreover, a substantial number of non-depository institutions must be reigned in by the rule and no examination process will apply to them. While the Federal Trade Commission and the state Attorneys General have taken on some substantial cases, their resources are sorely limited. Thus, while enhanced regulatory involvement is necessary, and application of new guidelines is welcome, wholesale reliance on the regulatory process will not result in widespread market change.

Moreover, the requirement's burden on individual homeowners will be, for most, insurmountable. Discovery about loans other than the one a plaintiff is challenging is hard to obtain, even where the statute requires it. Where such discovery is granted, attorneys representing such clients are flooded with so many documents that it impedes their ability to take on other cases.

> **Example:**[62] In October 2005, Mary Overton, described above and in attached **Appendix H,** (represented by South Brooklyn Legal Services (SBLS)) sued Ameriquest in federal court. To prove that Ameriquest engaged in a pattern and practice of extending unaffordable loans to borrowers, SBLS asked Ameriquest to produce loan files for borrowers around New York. Ameriquest initially refused to turn over the documents. After a lengthy court battle, Ameriquest was ordered to produce about 50,000 pages of documents. The documents proved to be an enormous drain of resources on SBLS's office: two attorneys expended hundreds of hours reviewing the documents, and, as a result, were forced to turn away other low-income homeowners in need of legal assistance. Moreover, SBLS is unable to share the documents with other attorneys or use them in any future cases because they are subject to a protective order.

Accordingly, the Board should retain the ability to repay requirement but eliminate the pattern and practice requirement. Further, in order to secure compliance with this requirement, we urge the Board to clarify the actual damages standard under Truth in Lending, as we discuss below in Section XI.

IV. Income Should Be Verified for All Home Mortgages – No Safe Harbor Is Appropriate.

The Proposed Regulations require that income and assets must be verified for higher cost mortgages; however, the lender is relieved of this requirement if it turns out

[62] This case example was provided by Jessica Attie, co-director, Foreclosure Prevention Project, of South Brooklyn Legal Services.

later that the amount of income and assets relied upon by the lender in making the loan are not "materially greater" than the borrower's actual income and assets.[63]

The Board's recitation of all the significant risks to consumers and the inappropriate incentives to originators fully covers the multitude of reasons why allowing stated income loans is 1) a practice which causes substantial injury to borrowers, 2) which is not outweighed by benefits to consumers or competition, 3) which cannot be avoided by many consumers in the marketplace.

In sum, as the Board has recognized, the failure to verify income harms consumers because the practice:

- Presents the opportunity for originators to mislead consumers who could easily document their incomes into paying a premium for a stated income loan – making the loan unnecessarily expensive.
- Provides originators with incentives as well as opportunities to inflate the applicant's income, by rewarding the originator for providing a stated income loan with a higher premium.
- Allows originators to hide the inflated income in the rush and confusion of the loan application and closing process.
- Results in loans to consumers with payments that are unaffordable leading to default, foreclosure, loss of the home and home equity,
- Causes increases in foreclosures which in turn harms neighborhoods, communities and cities.[64]

The Board articulates several potential benefits from stated income lending, including speeding access to credit by several days for emergency situations; saving some consumers from expending "significant effort to document their income;" and providing access to credit for some consumers who would otherwise not have access because they cannot document their income.[65] However, the Board notes that "where risks to consumers are already elevated, the potential benefits to consumers of stated income/stated asset lending *may be* outweighed by the potential injury to consumers and competition."[66]

A. The Safe Harbor Should Be Eliminated

After this promising introduction, the Proposed Regulations do not go nearly far enough to protect consumers from the recognized risks from stated income loans. Lenders would be required to verify income from third party sources for income actually relied upon to make the loan, *unless* the lender wanted to run the gamble that if later

[63] Proposed Regulation 226.35(b)(2).

[64] 73 Federal Register 1672, January 9, 2008 at 1691.

[65] *Id.*

[66] *Id.*

challenged, the lender could show that the consumer's stated income was not materially greater than the actual income.[67]

The problem is that this still permits lending without verification of income. Lenders will be able to ignore the rule in many cases without significant repercussions. Many borrowers will not be able to enforce their rights after-the-fact and bank examiners will not be able to examine the income that was not properly documented in order to verify that indeed it was significantly different from the income relied upon when the loan was made..

When a loan is challenged, the safe harbor will result in significant litigation of an issue that should be eliminate by a clear prohibition. In the cases in which a challenge is brought, *and* the consumer can show that their actual income was materially less than that used by the lender in the underwriting process, the focus in the litigation inevitably will shift to the consumer's supposed complicity in the misstatement of income. The case likely will become a "he said/she said" issue that will be resolvable only by a full scale jury trial. The party with the greatest resources invariably wins in this situation. The party with ongoing, reliable, well paid access to legal services, the party with the deepest pocket, and the least to lose in the litigation will have the ability to win these contests regardless of the truth or the equities of the situation. That party is the creditor.

While the consumer is struggling to make unaffordable payments on a mortgage and suffering the stress, embarrassment and emotional torture of the prospect of losing the family's home, that consumer will have to find an attorney with sufficient knowledge and expertise to handle a complex case such as this. The attorney must be willing to take on – for free (as the consumer's income will be used to meet the mortgage payments and deal with daily expenses) -- an affirmative case to litigate the issue of whose fault it was that the application signed by the consumer states the wrong amount of income. Moreover, while most Truth in Lending cases can be resolved without access to oral testimony by the parties, and are thus dealt with through the documents in the pleading or summary judgment stage of litigation, because of the availability of the safe harbor defense to lenders, every one of these cases will end up in a full trial. The lender will have the right to prove the factual question of what the real income was at the time of the loan – as that is the safe harbor defense to the claim.

But what will the remedy be for this difficult to win and stressful case? Only $2,000 and attorneys fees. Although the Board states that actual damages are also available, unless there is a clarification by the Board that actual damages are recoverable without proof of reliance,[68] in the real world, there are no actual damages available in most Truth in Lending cases. The threat of an occasional $2,000 statutory penalty levied against the lender is not a sufficient counter-weight to the incentives outlined by the Board for making these dangerous stated income loans.

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[67] Proposed Regulation 226.35(b)(2).

[68] This issue is discussed in detail in the remedies portion of our Comments in Section XI.

To stop the recognized harms from stated income loans, lenders should be required to verify income using the *best available evidence of such income.* There should be no safe harbor at all. Lending secured by a home should be required to be based only upon legitimate verification of the ability to repay that loan. Falsification of income verification documents is not uncommon. For example, Appendix H recounts the situation of Mary Overton. In order to make it appear that she could afford the loan, Ameriquest employees created a fake set of financial documents to include in her loan file, including fake tax returns, a fake 401(k), a fake employment statement showing that she sold makeup for Avon, and a fake lease agreement. The fake documents (with the social security numbers redacted) are attached.

All consumers who seek to borrow money must have some income and some assets, or else there is no reasonable way for them to repay the loan. That income should be verifiable from some reasonable source unless the income is from an illegal source. Whether the source is a W-2 form, deposits into a bank account, a letter from an employer, or a federal tax return, *something* must be available. In this age of electronic banking, almost all consumers have access to an electronic print out of their bank account balances. Going to the bank and requesting a print out of the past 12 months' account history is neither onerous, time consuming, nor is it an inappropriate requirement upon which to base a loan the non-payment of which will lead to the loss of a family home. The deposits into that bank account over the past year might be sufficient proof of income to show the ability to repay the mortgage loan. The key is that the requirement to verify income is not meaningful unless it is clear, applicable to all mortgages, and does not invite litigation as the current safe harbor does.

B. Subordinate Lien Loans Should Be Fully Covered

The Board's current proposal requiring income verification would cover all subordinate lien loans, and comments are requested on the question of whether subordinate lien loans should be exempted from the requirement in some situations.

Subordinate lien loans should be fully covered by the requirement to verify income.

The Board must establish an across-the-board, baseline regulation for all loans secured by a consumer's home that reasonable third party verification of income is an essential part of all such lending. Consumers do not understand the risks of changing interest rates, different margins, increasing balances, changes from teaser rates to base line rates, in their mortgage agreements. Consumers cannot be expected to underwrite themselves for their mortgage lending. Indeed, leaving to consumers the essential analysis of whether they can afford a mortgage loan is part of what has created the mortgage disaster facing the nation currently.

Just as the non-payment of a first mortgage loan can lead to a foreclosure and the loss of the home, so can the non-payment of a subordinate lien loan. Generally, there is no justification to treat subordinate lien loans differently from first mortgages.

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

V. Prepayment Penalties Should Be Banned

Over 70% of subprime loans include prepayment penalties.[69] Payment of the yield spread premium is often conditioned on the borrower's acceptance of a prepayment penalty.[70] Thus, brokers have an incentive not only to put borrowers into a high cost loan in order to receive a YSP, but also to make sure the borrower is locked into the high cost loan.[71]

Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest. In addition, prepayment penalties are disproportionately imposed on borrowers in minority neighborhoods.[72] Data is accumulating that borrowers in brokered loans receive no interest rate reduction from the imposition of a prepayment penalty: for most borrowers, it is a lose-lose proposition.[73]

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[69] David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS,* Presentation at the National Housing Forum, Office of Thrift Supervision (Dec. 11, 2006), *available at* http://www.ots.treas.gov/docs/4/48978.pdf. *See also* Doug Duncan, *Sources and Implications of the Subprime Meltdown*, Manufactured Housing Institute (July 13, 2007), *available at* http://tondahall.com/tlhdocuments/lagunapresentation.pdf.

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

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

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

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

Prepayment penalties harm consumers. They are associated with an elevated risk of foreclosure.[74] By keeping the consumer in an unaffordable product, the *quid pro quo* between lender and broker thus contributes to the foreclosure crisis. These harms are not outweighed by benefits to consumers or to competition. Indeed, prepayment penalties reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders. Finally, borrowers cannot reasonably avoid prepayment penalties. A prepayment penalty is a complex and contingent contract term that would be relatively immune to the comparison shopping even if the disclosure regime were drastically improved.

The rule proposed by the Board—extending and amending the HOEPA prepayment penalty rule—will not stop borrowers from being locked into abusive loans by prepayment penalties. A low-income borrower with a 48% DTI, may still have very limited residual income and therefore a loan that is very difficult to afford and could be locked into a loan for up to five years. Moreover, the Board's inquiry regarding the advisability of disclosures regarding prepayment penalties moves in the wrong direction. As the Board has noted, the mortgage market is complex and often not transparent. No amount of disclosure about prepayment penalties will be able to adequately convey the relationship between that loan term and the rest of the loan terms, or the long-term effect of the penalty on the borrower, including limitations on refinancing options. If prepayment penalties were worthwhile, the prime market—where many borrowers try to shop and do refinance due to interest rate changes—would use them readily. The absence of prepayment penalties in a market where borrowers refinance of their own volition combined with the widespread use of them in a market where refinancings are originator-driven makes it clear that a tepid rule on prepayment penalties is misplaced.

The Board should adopt a rule that bans prepayment penalties. If the Board declines to do so, it should prohibit prepayment penalties in the same loan as any rate-rising term, including a YSP. At a minimum, the Board should provide a six-month cushion before reset; 60 days is not a sufficient amount of time for a borrower to address any credit issues and secure a new loan. The 60-day rule gives the illusion of a cushion without actually providing one.

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

VI. Escrowing Should Be Required and the Opt-In Period Should Only Apply After a Borrower Has Developed a Paid-as-Agreed Payment History and Sufficient Equity

Paradoxically, it is often the least sophisticated borrowers who are most often sold loans without escrows. This is because omitting the tax and insurance payment can fool either a first time homebuyer or an existing homeowner refinancing into thinking that the loan is affordable. Omitting the tax and insurance payment is a favorite trick of brokers and loan officers who promise lower monthly payments.

The failure to require escrow leads to unaffordable loans and inflated foreclosure rates. We have over the years seen many clients who, a year or two into their loans, are faced with losing their homes as a result of unplanned-for tax bills. Additionally, lenders who fail to escrow tax and insurance payments often force-place expensive insurance. Force-placed insurance is not only more expensive than normal insurance; it typically provides less coverage for the homeowner. The failure to escrow permits and encourages the use of expensive and unfair force-placed insurance. There is no reason to permit lenders to create a profit center from force-placed insurance.

By and large, lenders whose primary concern is loan performance require escrows. Lenders whose primary concern is maintaining loan volume for securitization pools typically do not require escrows. Lenders should not be permitted to understate the cost of homeownership by failing to escrow payments.

While the Board's rule rightly requires escrowing, the opt-out after one year is too early and easily can be used to manipulate borrowers into giving up the escrow. The advantage for the servicer in obtaining opt-outs—among others—is a potential opportunity to force-place insurance. First, any opt-out should be genuinely requested by the homeowner, not simply engineered by the servicer through a form mechanism. In addition, in order for a homeowner to opt-out, the homeowner should be in a current paid-as-agreed status, with no more than 2 missed payments over the previous five years, and no missed payments in the previous 12 months. Finally, like the PMI rule, a homeowner should have reached a certain equity level before opting out, so that any delinquent taxes could be redressed through a refinance. The 80% rule, as used with PMI, would be appropriate.

VII. Yield Spread Premiums Should Be Banned or Heavily Regulated; Disclosure Will Not Result in Transparency

A. Lender-Paid Compensation to Brokers Is Confusing to Borrowers

The Board, in its proposed rule, recognizes that lender paid compensation to brokers is "not transparent to consumers and [is] potentially unfair to them."[75] Indeed, lender-paid broker compensation has undoubtedly contributed to the overpricing of many

[75] 73 Fed. Reg. 1672, 1698 (Jan. 9, 2008).

loans and the placement of thousands of borrowers with prime credit into subprime loans.[76]

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

The costs of these tradeoffs can never adequately be disclosed to borrowers. The Most consumers are unaware of these incentives and believe that the broker is acting in their best interests.[77]

Most borrowers are confused whenever lender-paid broker compensation is explained to them. Survey respondents often respond to a disclosure of the amount paid by the lender with the question, "Do I have to pay that, too?"[78] Often, when disclosure forms explain broker compensation, borrowers actually do worse at picking the cheaper loan.[79]

The studies of mortgage broker compensation disclosure understate the problems real life consumers are likely to have in the real world. First, of course, the studies happen in quiet rooms, away from the pressures many homeowners experience when entering into a mortgage transaction. More importantly, the studies look only at what happens when borrowers are asked to compare two loans identically priced except for

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

[77] 73 Fed. Reg. 1672, 1698 (Jan. 9, 2008).

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

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

how the broker is paid. The other fees, monthly payment, and the interest rate are held constant. But yield spread premiums involve a tradeoff.[80] If the lender-paid broker compensation drops, the interest rate increases. At this point, borrowers are no longer comparing apples-to-apples, but apples-to-oranges. The tradeoff between financed fees, fees paid out of pocket, and interest rate over time is at best a complicated calculus, and most borrowers cannot do it to any degree of precision.[81]

While the details of the present value of lender-paid broker compensation are intricate, if all the fees and costs are pressed into the rate, borrowers should be able to choose the roughly right loan for their circumstances. In theory, an informed borrower could rely on a generic preference in making the decision on how to pay the broker. The borrower who expected to hold the loan for a relatively short period of time should choose, in most cases, to have the broker paid by the lender in exchange for a rate increase. A borrower who expected to hold the loan for a longer term would generally be better off financing the broker fees or paying them out of pocket. This simple analysis seldom plays out, however. A consumer is seldom offered a straight choice between all in or all out. In many cases, the broker compensation will be neither all in nor all out of the interest rate and there will be other fees and costs besides the broker's compensation to take into account. Given most consumers' limited ability to manipulate percentages and interest rates, such a task is clearly beyond all but the most financially sophisticated consumers.[82]

Most borrowers cannot compare the cost of two loans when interest and fees are disaggregated. Most consumers cannot calculate interest;[83] even fewer could begin to

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

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

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

[83] Only 22% of the adult U.S. population in 1992 could even describe how to calculate interest, given a stream of payments, an amount borrowed, and a total loan amount, according to the 1992 National Assessment of Adult Literacy. The question and results are available at http://nces.ed.gov/NAAL/SampleQuestion.asp?NextItem'0&AutoR'2. Macro International, Inc., Design

puzzle out the relative merits of financing a broker fee or paying for it with a yield spread premium. When borrowers are forced to compare loans with disaggregated fees, even when the interest rate is the same, more than a third cannot identify the cheaper loan.[84] Only at the point when all the fees are pushed into the interest rate can most consumers intelligently evaluate the costs of trading fees for interest.

Even if consumers could calculate the tradeoff between the financed fees and higher interest rate, however, consumers are not given the baseline information they need to evaluate the true costs of that tradeoff. Borrowers are not told ever—and the Board is not proposing that they be told—what interest rate they actually qualify for.[85] Nor are they given in dollar amounts the actual increase in interest they will pay in exchange for having the lender pay their broker. Borrowers are instead presented with a done deal from their broker, a broker whom they assume is acting in their best interests, since they are, after all, paying the broker.

Sophisticated borrowers may negotiate a tradeoff between lender-paid broker compensation and borrower paid broker compensation and push the entire broker compensation into the interest rate. However, in many cases, brokers receive compensation from both borrowers and lenders, increasing their total compensation from lender payments as the brokers upsell the borrowers.[86] Lender-paid broker compensation,

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and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (borrowers have difficulty calculating interest); Danna Moore, Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes and Experiences 27 (Technical Report 03-09, Soc. & Econ. Sci. Research Ctr., Wash. State Univ., 2003), *available at* http://www.dfi.wa.gov/news/finlitsurvey.pdf (same); Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, J. MONETARY ECON. (forthcoming) (manuscript at 34), *available at* http://www.dartmouth.edu/~alusardi/Papers/BabyBoomers.pdf. (same); Annamaria Lusardi & Olivia S. Mitchell, Financial Literacy and Planning: Implications for Retirement Wellbeing 5, 8 (Oct. 2006), http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf (same).

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

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

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

when combined with borrower-paid broker compensation, is pure gravy for most brokers, a lucrative source of extra cash, and a strong incentive to brokers to operate in the lender's interests, not the borrower's. The financial tradeoffs are complicated, hard to disclose adequately, and difficult to calculate even when transparently disclosed.

B. Lender Paid Compensation to Brokers Results in Racially Disparate Pricing

Disparities in the pricing of home mortgage loans between whites and African Americans and Latinos exist at every income and credit level.[87] The disparities increase as the income and credit levels of the borrowers' increase. In other words, the wealthiest and most credit worthy African Americans and Latinos are, compared to their white counterparts, the most likely to end up with a subprime loan. One stark example: African Americans with a credit score above 680 and a loan to value ratio between 80% and 90% are nearly three times as likely as similarly situated whites to receive a subprime loan.[88] As Board researchers have concluded, the origination channel—whether or not a loan is brokered—accounts for most of the difference in pricing.[89]

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

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

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

Lender-paid broker compensation creates the incentives that drive much of the racially disparate pricing.[90] By encouraging brokers to overprice loans where and when they can, lenders implicitly encourage brokers to target the vulnerable and gullible and those perceived as vulnerable and gullible. Most borrowers naively believe that their lenders will give them the loan they qualify for, and are insufficiently on their guard in dealing with brokers. African Americans and Latinos are particularly likely to believe that lenders are required to give them the best rate for which they qualify. [91]

The mechanics and extent of lender-paid broker compensation reach beyond simply overcharging African-American and Latino borrowers. Lenders use broker compensation to lock African-Americans and Latinos into downwardly mobile borrowing and destructive products. For example, lender payments to brokers are often conditioned on the borrower's acceptance of a prepayment penalty.[92] Thus, brokers have an incentive not only to put borrowers into a high cost loan in order to receive additional compensation from the lender, but to make sure the borrower is locked into the high cost loan. Prepayment penalties in these circumstances are seldom chosen by the borrower or in the borrowers' interest.[93]

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

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

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

[93] Loans with prepayment penalties attached have higher rates of foreclosure, and in brokered loans, borrowers generally receive no interest rate reduction in exchange for the imposition of the prepayment penalty. *See, e.g.*, Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 45 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (prepayment penalties and balloon notes combined on a fixed rate refinance subprime loan increase the rate of foreclosure 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 21 (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages* 15 (Sept. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for "borrower income, property value, loan amount, whether the loan was originated by a broker, and type of interest rate," in which case the difference shrank); s*ee also* Debbie Gruenstein Bocian, Keith S. Ernst &

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

C. The Board's Proposal Will Not Reduce Fraud and Abuse or Create Transparency

The Board proposes to address these systemic inequalities by requiring an agreement, signed by the borrower and the broker, disclosing 1) the total cost of the broker's compensation prior to acceptance of the borrower's application by the broker and 2) that the broker may be influenced by a lender payment. The broker's total compensation would be capped at whatever the broker disclosed in that initial contract. No other duties or requirements are imposed on the broker. The loan sought and offered need not be fairly priced, nor need the loan or its terms be in the consumer's interests.

The rule relies on lenders for enforcement. Lenders would be in violation of the rule if there was not in the file a signed, dated piece of paper reflecting the total broker compensation as reported on the HUD-1. Obviously, lenders, to varying degrees, have been complicit in the extraction of yield spread premiums from borrowers. Even when lenders are not complicit, they are unlikely to verify the validity of an agreement between the broker and borrower. We have seen brokers forge agreements, require signatures on blank agreements, and present backdated agreements at closing to be signed. Nothing in the proposed rule would reduce the incidence of these practices. Lenders are not made liable for failing to look beyond the piece of paper presented to them with all the other documents accompanying the loan.

The creation of this rule, without more, would encourage brokers to add another piece of paper to the already overwhelming stack faced by borrowers. It would not make brokers any more attentive to ensuring that borrowers received affordable loans or that brokers performed services for their work. It would not in any meaningful improve the ability of consumers to shop for the best loan.

1. By itself, a contract capping the broker's compensation is unlikely to reduce any of the abuses in the marketplace.

If the contracts between brokers and borrowers were negotiated at arms' length, with full transparency and rational pricing, using these contracts to cap lender-paid broker compensation might do some good. However, the contracts are none of these things. By itself, a contract that merely lists the broker's total compensation is unlikely to be effective in reducing the pernicious effects of lender-paid broker commissions.

Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).

Borrowers do not generally negotiate broker compensation. Borrowers, when they contact a broker, are looking for a loan. The broker's costs are incidental to the main cost, and are easily bundled into the main cost and so not ultimately noticed.[94] Merely requiring disclosure of the broker's compensation up front will not overcome the fact that for most borrowers the entire loan, from broker to closing, is one transaction. Most consumers, whether they finance the broker fees or have the lender pay them or both, pay for the broker out of the loan proceeds, at the closing table.

Brokers prepare and fill out the contracts. Often, borrowers are handed the broker contracts to sign along with a loan application and numerous disclosures designed to exculpate the lender and broker from any wrongdoing. In preparing the contract for the borrower's signature, the broker will set the total compensation at an amount to include both what the borrower will pay and what the broker thinks the lender will likely pay out. The broker's guess as to the lender's payment is at worst an educated guess and more likely a near certainty, given the easy availability of rate sheets to brokers. At the time when borrowers complete their loan applications (the time by which a contract must be signed under the Board's proposal), brokers have in hand rate sheets from a variety of lenders that allow them to estimate, with a high degree of precision, how much they can recoup from any given lender on any given loan. This is information borrowers do not have, that is not disclosed to borrowers, and that the Board is not proposing borrowers be given. (Even if more complete disclosures are given, the information about trade-offs and costs would be very complex and virtually impossible for most consumers to navigate without careful on-the-spot coaching). Brokers may even choose to pad the total disclosed compensation to allow for an extra generous lender payment. And should the broker underestimate how much is available from a lender, there is nothing in the proposed rule to restrain a broker's impulse to backdate a contract.

The Board's proposal presumes that mortgage broker compensation is a fixed target or perhaps that the existence of a contract between the borrower and the broker will make it so. There is no evidence to support this view. Indeed, most of the evidence on lender-paid broker compensation suggests that when brokers receive lender payments, their overall compensation increases.[95]

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[94] *See* Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures at vii (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (consumers do not notice cumulative effect of paying small amounts of fees every month); Richard H. Thaler, *Mental Accounting Matters,* 12 J. BEHAVIORAL DECISION MAKING 183, 194 (1999) (small disaggregated fees ignored); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice,* 211 SCI. 453, 457 (1981) (observing that "[m]any readers will recognize the temporary devaluation of money which facilitates extra spending and reduces the significance of small discounts in the context of a large expenditure, such as buying a house or a car."); James M. Lacko & Janis K. Pappalardo, Fed'l Trade Comm'n, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms 32 (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf ("This Tax Related Service Fee didn't make any sense to me. It was $75 so I overlooked it for the convenience of signing papers there."); *see also* Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. CHI. L.REV**.** 33 (2006) (discussing the general phenomenon of bundling in consumer contracts)**.**

[95] *See, e.g.*, Howell Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums at 8 (Jan. 2002)*, available at*

Many states already require broker agreements that fix or disclose the total compensation.[96] Nothing suggests that overpricing by brokers is less common in those states. Indeed, some courts have relied on these agreements to find that brokers have no fiduciary duty to borrowers and that otherwise usurious loans are not usurious.[97] That is, these form disclosures are more effective for helping brokers evade liability for abusive practices than for restricting such abusive practices. Brokers are free and will remain free to set their total compensation package as high as the (lender) market will bear.

The Board proposes to reign in the tyranny of yield spread premiums and other lender-paid broker compensation by capping total broker compensation at the amount contained in the consumer's contract. Experience under similar state laws suggests that this rule will do nothing more than provide an additional piece of paper in the loan file and another method for the broker to disavow responsibility for abusive conduct. Under the Board's proposal, brokers are left free to conceal from borrowers the magnitude of their upselling and to choose, albeit at the beginning rather than the end of the process, how much to get paid.

2. The proposed disclosure language in the contract does not create transparency in lender-paid broker compensation.

The proposed disclosure language will not work. It is inadequate to advise consumers of the actual cost of the tradeoff. It does not require, for example, that the borrower be told what interest rate they are eligible for, how much the interest rate will increase if the lender pays the broker money, what the dollar amount of the increased interest will be, or what are the components of the total compensation and how each will be paid. Moreover, there is substantial evidence that discussions of broker compensation substantially similar to those proposed by the Board actually confuse borrowers, leading borrowers to misjudge the relative cost of two identically priced loans.[98] Significantly,

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http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (in a survey of mortgage transactions, when yield spread premiums are not paid, brokers received on average no more than 1.5% of the loan amount); *cf.* Jack Guttentag, *Another View of Predatory Lending* 7-12 (Wharton Financial Institutions Center Working Paper No. 01-23-B, Aug. 21, 2000) (reporting on a survey of mortgage brokers showing no correlation between effort as measured by time expended and payment; brokers largely compensated based on size of loan).

[96] *See, e.g.*, Ala.Code 1975 § 5-25-12 (disclosure of relationship and method of compensation before any fee is paid); 5 Del.C. § 2113 (written agreement disclosing total broker compensation required before broker performs any services); MD Code, Commercial Law, § 12-805 (brokers can only receive finder's fees or loan origination points pursuant to a written agreement, signed before any work performed); Minn. Stat. Ann. § 58.15 subdiv. 2.

[97] *See, e.g.,* Nunn v. IMC Mortgage Co., 308 B.R. 150 (W.D. N.Y. 2004); Hanning v. Homecomings Fin. Networks, Inc., 436 F. Supp. 2d 865, 872 (W.D. Mich. 2006).

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

none of the studies of disclosure of broker compensation required borrowers to compare loans with different interest rates or loan features or lengths of the loan. The math gets much more complicated in the real world when the payment of a yield spread premium likely changes more than just the out-of-pocket settlement costs.

Receipt of an additional piece of paper from the broker, in those cases where states do not already require agreements and brokers do not provide them as cheap insurance against later litigation, is unlikely to lift consumers' awareness of or understanding of the complicated tradeoffs involved with lender-paid broker compensation.

D. Solutions

1. The Board Should Impose a Fiduciary Duty on Brokers

The Board in its proposed rule does not impose any duty on either brokers or lenders. Brokers may charge whatever they wish for any loan, no matter how terrible, so long as they tell borrowers the total amount they are getting and that the loan might not be in borrower's best interests. Lenders may pay brokers whatever they wish for any loan, no matter how terrible, so long as a form contract exists that is dated prior to the application date and that the total compensation reported on the HUD-1 is no more than on the form contract.

Oddly, the Board proposes a higher standard for comparable state laws. For brokers to be exempted under state law, the state law must both require an agreement and "impose[] a duty on mortgage brokers, under which a mortgage broker may not offer to consumers loan products or terms that are not in the consumers' interest or are less favorable than consumers could otherwise obtain."[99] The Board should set the same standard for itself. Lenders should not be permitted to pay any broker compensation in the absence of a fiduciary relationship between the broker and the borrower.

Broker agreements with borrowers will not, in and of themselves, do anything to limit broker overreaching and abusive pricing. Indeed, broker agreements have been used and would continue to be used by brokers to evade any responsibility whatsoever to borrowers.

As the Board itself recognizes in determining which state laws provide a safe harbor, in order for a broker-borrower agreement to be meaningful, it must be coupled with a fiduciary duty flowing from the broker to the borrower. A fiduciary duty would align the broker's interests with the borrower's. The Board should push lenders and brokers to conform the legal realities of the situation to the borrower's understanding, based on the common representations of both brokers and lenders.

[99] 73 Fed. Reg. 1672, 1726 (Jan. 9, 2008).

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

We have argued elsewhere at length the importance of pushing all costs into the finance charge and APR.[100] The problem is not that brokers are paid out of the interest rate: the problem is that brokers are paid both out of the interest rate and out of pocket. Most consumers simply cannot aggregate interest and fees to be able to compare the cost of credit of two loans. The problem only gets worse when the settlement statement is cluttered with a myriad of fees, some to the broker, some to the lender, some to a settlement agent. The current proposal requires consumers to continue to shop in an inefficient, piecemeal way for a large, bundled transaction. It ignores the economic realities of the situation: a loan is for most consumers a single transaction. It also ignores the realities of consumer financial literacy: most consumers cannot shop effectively on multiple fees and attributes. If all of the fees are included in the interest rate, then consumers can shop in a meaningful way on the total cost of the loan.

The Board should prohibit the practice of paying the broker a yield spread premium, which increases the interest rate, at the same time as the borrower is being charged other up-front fees that purport to reduce the rate. Yield spread premiums should be prohibited unless all other fees (other than escrow fees imposed in accordance with RESPA, actual government fees, and title insurance and title examination fees, if paid to an unrelated party and if bona fide and reasonable) are folded into the interest rate and no discount points are charged. Additionally, no other lender-paid broker compensation should be permitted if the borrower is making any direct payments to the broker.[101]

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

In the proposed Regulation Z §226.36(a)(2)(ii) and accompanying Commentary the Board proposes to exempt lender-paid broker compensation from disclosure if it is not determined by the interest rate. Lender-paid broker compensation, whether or not it is covered in the interest rate, misaligns the broker's incentives. Lender-paid broker compensation in exchange for loans with a prepayment penalty, a shorter fixed rate term, or a balloon note, to give a few common examples, is no more benign and considerably less transparent than pure interest rate based compensation. There is no reason to exempt even volume based lender-paid broker compensation from the requirements of fairness and transparency. Even volume based payments to the brokers by lenders will ultimately be paid by the consumer through the consumer's interest rate. Borrowers should always

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[100] *See, e.g.,* Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth in Lending,* ___Yale J. on Reg.___ (2008)(forthcoming).

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

be told what the compensation arrangements are; lenders should require brokers to act as the borrower's fiduciary in arranging the loan; all costs should be bundled into the rate to facilitate shopping; and all broker fees must be treated as both higher-priced and HOEPA points and fees. To do otherwise will simply squeeze the gluttony of lender-paid broker compensation from interest to other, less transparent and potentially more harmful, *quid pro quos*.

4. The Board Should Clarify that Yield Spread Premiums Are Broker Compensation, Included in the HOEPA Points and Fees Trigger.

The general rule for the points and fees test is that all broker compensation should be included in the points and fees trigger.[102] Logically, yield spread premiums should be included. They are paid to the broker, ultimately payable by the consumer, through an increased interest rate (indeed, the dollar amount of a yield spread premium is often calculated based on the lender's present value calculation of the excess interest paid by the consumer), and paid in a lump sum to the broker usually contemporaneously with the closing. We discuss why the current HOEPA rules include these payments in the points and fees trigger and address industry counter-arguments in National Consumer Law Center, *Truth In Lending* § 9.2.6.3.4 (6th ed. 2007) and incorporate that discussion here in full.

Including the yield spread premium in the points and fees trigger will create downward pressure on it and other points and fees. Particularly in the subprime market, the benefits of lender-paid broker compensation are dubious at best. It seems reasonable to discourage them in this market.

VIII. Appraisal Standards Should Address Lender and Originator Incentives

As the Board has recognized, inflated appraisals across the nation have caused substantial harm to homeowners, their families and their communities. Inflated appraisals are rampant.[103] Lenders – both brokers and the originating lenders – have incentives to make loans, even if the collateral securing the loan is not sufficient to protect the investor from loss. These incentives have led to wide spread abuses, which not only place substantial risk on the investors, but create devastating traps for consumers.

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[102] 12 CFR §226.32(b)(1)(ii); 60 Fed. Reg. 15,463, 15,466 (Mar. 24, 1995); 61 Fed.Reg. 49237, 49238-39 (Sept. 19, 1996).

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

The investigation and legal proceeding recently initiated by the New York Attorney General's office against a large appraisal company for conspiring with a large, nationwide lender provides vivid illustrations of how these incentives play out in the relationship between the originating lender and the appraiser.[104] As is evident from the emails quoted in the pleadings, the large, national, federally regulated savings bank-lender repeatedly and regularly demanded certain appraised values in exchange for its continued business.[105]

When a loan is made based on an appraisal which is inflated, the borrower is essentially a captive customer to that bad loan. As the house is worth less than the loan, the homeowner cannot sell to escape the onerous terms without finding the cash to pay off the difference. Neither can the homeowner refinance – there is not adequate security to provide a legitimate lender with the means to extend sufficient credit to cover the bad loan. The lender who has made this bad loan has the borrower completely at its mercy – the payments must be made, at all costs, to preserve the family homestead. Even leaving and turning the house over the lender often leaves the homeowner subject to a potential deficiency judgment for the balance of the loan (now inflated by foreclosure and sale costs) over the value of the home (now deflated by the forced sale in a foreclosure proceeding).

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

Standard underwriting practices in place for several years require the lender to independently evaluate the appraisal. This evaluation is supposed to be conducted by a part of the lender's business which is separate from the origination arm – an attempt to require some independent judgment to be applied to the process.[106]

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[104] http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html.

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

[106] *See, e.g.,* Fannie Mae Selling and Servicing Guide, XI, 102: Ongoing Review of Appraisals (11/01/05): "A lender must continually evaluate the quality of the appraiser's work through the normal underwriting review of all appraisal reports, as well as through the spot-check field review of appraisals as part of its quality assurance system." *Also see,* "The underwriter's role is to review the appraisal report to ensure that it is of professional quality and is prepared in a way that is consistent with our appraisal standards, to analyze the property based on the appraisal, and to judge the property's acceptability as security for the mortgage requested in view of its value and marketability." Fannie Mae Selling and Servicing Guide, XI, Introduction (06/30/02).

The Proposed Regulation will not solve the problem with the widespread use of inflated appraisals because the potential punishment that will result from a violation of the regulation is simply not sufficient to counter the huge financial incentive that will continue to exist to facilitate inflated appraisals. Consider --

- First of all, violation of the specific requirements will be virtually impossible for a homeowner – or the homeowner's attorney – to prove.
- Secondly, evidence of the violation of these prohibitions will not be available in the homeowner's loan file, or even in those of the broker, title attorney, original lender, or the investor.
- As a result, only those lenders who are most brazen in their continued and serious violation of the regulation *might* have administrative enforcement against them.

Even if an individual homeowner were to somehow stumble upon the proof of collusion, conspiracy, bribery and fraud, that would essentially be necessary to prove a violation of these Proposed Regulations, the only penalty would be a TILA statutory penalty of $2,000. This is clearly not sufficient to enforce such an important prohibition as these regulations seek to maintain.

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

The regulations should flatly state that when a loan is made which is based on an inflated appraisal, the lender is responsible for that conduct. The remedy should be a rewrite of the loan to be at the same percentage to the *real* appraised value as the original loan was to the inflated appraised value. The real appraised value of the home at the time the loan was written can be determined based on a retrospective appraisal.[107]

For example, assume the original loan in January, 2006, was based on an 80% LTV ratio, and the original appraisal showed the house had a value of $120,000, and the loan was for $96,000. Two years later, after complaints or concerns about an original inflated appraisal, a retrospective appraisal is completed which shows that as of January, 2006, the real value of the home was $85,000. The loan should now be rewritten to be 80% of $85,000, or reduced to a loan amount of $68,000. All payments made on the loan should be applied to the loan as if had been a $68,000 loan all along.[108]

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

[108] Just to continue the illustration: if the original loan had an interest rate of 7.5% and a term of 30 years, the payments would have been $671.25. If the payments had been made on time, through the current month - - March, 2008, presumably 25 payments of $671.25 would have been made. When the loan is rewritten in March, 2008 retroactively to be for 80% of the retrospective appraised amount of $68,000, the current amount due on the mortgage would be $61,071. The remaining payments could be kept what should have

Inflated appraisals are creating serious problems across the nation, and have fueled, to a significant extent, the current foreclosure problems. If the appraisals had been honest to begin with, many of the loans currently defaulting would not have been made.

IX. The Board's Rule Should Address Serious Servicing Abuses

We commend the Board for recognizing the extent of serious servicing problems in mortgage loans, as well as for initiating the process to deal with these problems. In order for any servicing rule under TILA to have effect, the regulation should make clear that "no creditor or assignee, through its servicer, shall...[insert rule]" Servicers are the agents of the creditors when the loans are held in portfolio, or are agents of the holder or trustee when they are sold. Those entities are primarily responsible for the acts of their servicers. They should be held liable for their failure to comply with the proposed rule. If liability attached to them, they would police these entities carefully to ensure compliance, a desirable goal. These duties should be included in or deemed a part of the loan contract. Without this language, consumers will have no right to enforce these important duties. Proposed Regulation Z § 226.36(d) places duties upon servicers to curb servicing abuses. However, sections 1640(a) and 1641 do not attach civil liability to servicers, only to creditors and assignees.

With regard to the substantive regulation of servicing, the Board clearly describes the regulatory vacuum. As the Board articulates, "Consumers do not have the ability to change servicers . . . ."[109] The Board also notes, in a somewhat understated fashion, "there may not be sufficient market pressure on servicers to ensure competitive practices."[110] Otherwise put: there are no real restraints on home mortgage servicing abuses. This is exactly the kind of situation that Congress intended the Board to address when it provided the authority in 15 U.S.C. 1639 (l)(2)(A).

The Board has been supplied with substantial anecdotal evidence about the problems in the mortgage industry, much of which is cited in the Commentary prefacing the proposed regulations. More importantly, the Board has recognized the need to place restraints on mortgage servicers. Yet, the proposed regulations do not strike at the core abuses in the mortgage servicing industry.

First, one essential point must be clarified by the Board. Some might interpret the language in the Board's proposed Rule to establish new rules for the assessment of fees, which abrogate the terms of the note and the mortgage already establishing basic rights of

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been the original amount – sufficient to pay off a mortgage of $68,000 in 30 years , which would mean that the loan would actually be paid off more quickly, because of the higher payments made before the inflated appraisal was found and corrected, or the payments could be reduced even further to allow the balance due to be paid off in the remaining months of the original 360 month term.

[109] 73 Federal Register 1672, 1702 (Jan. 9, 2008).

[110] *Id.*

the parties. The servicer is only permitted to assess any fees if all of the following three criteria are met:

- The fee is authorized by the governing state and federal law.
- The fee is authorized by the Note.
- The circumstances justify the imposition of the fee.

The Board needs to clarify the effect of the new regulation on servicer imposed fees to ensure that it does not lend support for any argument that compliance with this Regulation relieves the servicer from complying with the requirements of other applicable law and the contract.

The proposal regarding prompt crediting of payments requirement[111] is excellent, if it is interpreted to require that servicers are prohibited from placing moneys received from homeowners in suspense accounts and credit the payments immediately to the loan.

As the Board has recognized, the failure to credit payments to the loan is one of the most common problems that borrowers are reported to have with servicers. Having failed to properly credit the borrower's payment to principal and interest, servicers frequently compound this problem by improperly imposing late fees and erroneously reporting the homeowner late to the credit rating agencies.[112] In many cases, borrowers attempting to correct errors in their accounts are met with the servicer's callous indifference, compounding the effect of the problem.[113] Moreover, even the improper application of a single payment, can have a snowball effect that leaves the homeowner fighting foreclosure and struggling to repair their credit for months, or even years.

The proposed response to this problem – to require that payments be credited promptly – is exactly what is needed. However, the question asked by the Board is an indication that there may be some misunderstanding about just what this requirement actually means. The Board asks how partial payments are to be dealt with in the context of this requirement. One issue is *what is considered a partial payment?* Another issue is *why should a partial payment be treated any differently?*

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[111] Proposed 226.36(d)(1).

[112] *See, e.g., Islam v. Option One Mortg. Corp*., 432 F. Supp. 2d 181 (D. Mass. 2006)(servicer continued to report borrower delinquent even after receiving the full payoff amount for the loan).

[113] *See, e.g., Hukic v. Aurora Loan Servicing, et al,* 2006 WL 1457787 (N.D. Ill. May 22, 2006)(servicer's clerical error in recording amount of payment left homeowner battling with subsequent servicers and fending off foreclosure for nearly five years); *Rawlings v. Dovenmuehle Mortgage, Inc., 64 F. Supp. 2d 1156* (M.D. Ala. 1999)(servicer failed for over 7 months to correct account error despite borrowers' twice sending copies of canceled checks evidencing payments); *Choi v. Chase Manhattan Mortg. Co.*, 63 F. Supp. 2d 874 (N.D. Ill. 1999)(home lost to tax foreclosure after servicer failed to make tax payment from borrowers escrow account and then failed to take corrective action to redeem the property); *Monahan v. GMAC Mortg. Co.*, 893 A.2d 298 (Vt. 2005)(affirming $43,380 jury award based on servicer's failure to renew flood insurance policy and subsequent uninsured property damage).

If the goal of the loan servicing is to maintain the loan as a performing loan, as well as to maintain the homeowner's interest in staying in the home, every effort should be made to facilitate the continued payments on the loan. This is the dynamic that this Board regulation can most dramatically affect. A strong regulation on this point can change the incentive for the servicer, from one that encourages the imposition of fees, to one that discourages default.

Currently, servicers often will put payments into a suspense account because the payments do not include a) extra fees the servicers have assessed, b) late fees from previous payments that did not include the extra fees charged by the servicers, c) additional amounts charged by the servicer (often for forced placed insurance). Because these payments do not include these extra fees the payments are deemed to be "partial" payments. Yet, under the terms of almost all outstanding mortgage contracts entered into since 2001, the Application of Payments section of the Note requires that each payment be applied first to interest, second to principal, third to amounts due for taxes and insurance, and fourth to late fees.[114]

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

Some servicers may argue that there will be great confusion about how to deal with the application of partial payments. This concern is unfounded. The mathematical application of partial payments to a loan amortization – whether interest accrues based on when the payments are actually made, or based on when the payments are scheduled to be made – is simpler than the confusing fiction of a suspense account.[115]

The key clarification that must be issued with this proposal is that all payments must be applied to the loan as they are made, regardless of whether there is some

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[114] 2. Application of Payments or Proceeds. Except as otherwise described in this Section 2,

all payments accepted and applied by Lender shall be applied in the following order of priority:

(a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3. Such payments shall be applied to each Periodic Payment in the order in which it became due.

Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then to reduce the principal balance of the Note. If Lender receives a payment from Borrower for a delinquent Periodic Payment which includes a sufficient amount to pay any late charge due, the payment may be applied to the delinquent payment and the late charge.

Fannie Mae/Freddie Mac Uniform Note, Paragraph 2 (widely used in the mortgage industry from 2001 and after).

[115] We will be happy to demonstrate this with a spreadsheet to the Board, or its staff.

contention that more money may be due at the time the payment is made. This rule is integral to ensuring that servicers treat loans as a means to maintain homeownership, and not simply as a means to milk more fees from the captive homeowners.

The Board also proposes to restate the existing, applicable rule, from the FTC's Credit Practices Rule, prohibiting the charging of a late fee for failing to pay a previously due late fee. This proposal neither limits nor extends existing protections for homeowners.

The required disclosure of the schedule of servicing fees over which the consumer has no control and no way to avoid (except by refinancing) will provide little value to the homeowner. As the Board recognizes, there are currently no marketplace incentives to curb servicer abuses. The point of these regulations – presumably – is to provide at least one such incentive.

Servicers make substantial parts of their income from ancillary fees, consisting of late fees and other Aservice@ fees. The imposition of these fees is a critical part of a servicers' income. For example, one servicer's CEO reportedly stated that extra fees, such as late fees, appeared to be paying for all of the operating costs of the company's entire servicing department, leaving the conventional servicing fee almost completely profit.[116] Consequently, servicers have incentives to charge borrowers as much in fees, both legitimate and illegitimate, as they can. For example, just one improper late fee of $15 on each loan in one average size loan pool (3500 loans) would generate an additional $52,500 in income for the servicer.

Given that the only incentives on servicers now are to charge fees, and very few, if any, market forces limit these charges, it is incumbent on the Board to change that dynamic and protect homeowners from these problems.

Instead of a fee disclosure with little or no effect on servicer practices, the Board's regulation on fees should prohibit servicers from imposing any fees, charges or assessments unless the fee is authorized by governing state and federal law; agreed to in the Note; and actually incurred and reasonable in amount.

Additionally, mandating an Accurate Payoff Notice is a good idea, although not particularly new. There are already many state laws which impose just this requirement on servicers.[117]

Even in these terrible times of exploding numbers of foreclosures, servicers are not cooperating. They seem to be simply proceeding with foreclosures as usual. Servicers

[116] Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers, Housing Policy Debate* 15(3): 753 (Fannie Mae Foundation 2004)(AThe way a loan is serviced often has a greater effect on the borrower than the way it was originated.@) at 758.

[117] National Consumer Law Center, *Foreclosures,* Appendix E (2d ed. 2007).

need to be *required* to engage in searches for alternatives to foreclosures – especially those that will not only preserve the home, but also will save money for investors.

Accordingly, the Board should require that reasonable loss mitigation efforts must be pursued before a foreclosure can be initiated on a home mortgage. By doing so, servicers would be required to evaluate affordable and reasonable alternatives to foreclosures and save money for their investors while preserving homeownership. *We specifically request that the Board make it an unfair practice for a lender to proceed to foreclosure on a home mortgage unless reasonable loss mitigation alternatives have been attempted.*

There are significant losses when a home is sold through a foreclosure. The homeowner loses the equity built up in the home,[118] which for many families is their chief form of wealth-building. The family suffers a disruptive move away from its support systems. Children may face academic difficulties because of changing schools. The neighborhood and the community deteriorate.[119] "Every new home foreclosure can cost stakeholders up to $80,000, when you add up the costs to homeowners, loan servicers, lenders, neighbors, and local governments."[120]

As a result there should be every effort to avoid the foreclosure. Loss mitigation offers all parties the opportunity to reduce these financial losses, save homes, and maintain neighborhoods. So long as the cost of the loss mitigation effort is less than the cost of the foreclosure for the investor, the effort is sensible and cost effective.

Reasonable loss mitigation activities generally include a range of alternatives:[121]

1. A *delay of the foreclosure sale* to allow time to work out a foreclosure avoidance agreement;

[118] According to the Center for Responsible Lending, By the end of 2006, "2.2 million households in the subprime market either have lost their homes to foreclosure or hold subprime mortgages that will fail over the next several years. These foreclosures will cost homeowners as much as $164 billion, primarily in lost home equity." Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, Center for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* December, 2006 at 2.

[119] A foreclosure is quite damaging to the neighborhood in which it occurs. Some examples of this include the drop in property values in low- and moderate-income neighborhoods in Chicago and Minneapolis directly resulting from home foreclosures. Crime rates increase as well when homes are abandoned. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosures: The Impact of Single-Family, Mortgage Foreclosures on Property Values*. Hosing Policy Debate (Dec. 30, 2005).

[120] Joint Economic Committee, U.S. Senate, *Sheltering Neighborhoods from the Subprime Foreclosure Storm* at Summary (Apr. 11, 2007).

[121] H.R. 5679, recently introduced in the U.S. House of Representatives by Maxine Waters discusses loss mitigation alternatives and places them in two tiers in order to prioritize home-saving options.

2. A *repayment plan* to cure a default by allowing the homeowner to make scheduled monthly payments as they are due, together with partial monthly payment on the arrears;

3. A *forbearance plan* to provide a more formal agreement to repay the arrears over a period of time while making regular monthly payments;

4. A *temporary interest rate reduction* for homeowners who have financial problems which appear to be temporary in nature, but which preclude full payment of the mortgage for a foreseeable period of time;

5. *Deferral of missed payments* by which missed payments are no longer treated as missed but are instead added to the end of the loan obligation;

6. A full *modification of the loan* which can include one or more of a combination of interest rate reduction, extension of the loan terms, reamortization, and cancellation of principle. Loan modification will generally be the necessary response to the multitude of subprime, adjustable rate loans, which are currently adjusting to unaffordable payments.[122]

Indeed the FHA,[123] as well as Fannie Mae[124] and Freddie Mac,[125] recognize the financial loss to their investors, as well as the devastation to homeowners, from foreclosure, and specifically require loss mitigation before foreclosure should be pursued when a homeowner is in default. Most Pooling and Servicing Agreements ("PSAs"), governing the trusts in which most home mortgages are held, permit loss modification.[126] The federal banking agencies have also issued encouragement for loss mitigation.[127]

However, for all of the mention of loss mitigation by these housing agencies, the permission included in the PSAs, or even the recommendations by the banking regulators, nothing *requires* that loss mitigation be pursued before foreclosure. None of

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[122] *See* National Consumer Law Center, *Foreclosures – Defenses, Workouts, and Mortgage Servicing*, Chapter 2 (1st Ed. 2005) and 2006 Supplement.

[123] U.S. Dep't of Hous. & Urban Dev., Loss Mitigation Program-Comprehensive Clarification of Policy and Notice of Procedural Changes, Mortgagee Letter 00-05, at 1 (Jan. 19, 2000). *See also* Wells Fargo Home Mortg., Inc. v. Neal, 2007 WL 1310141 (Md. May 7, 2007).

[124] Fannie Mae Single Family Selling and Servicing Guide, Part VII, Chapter 3.

[125] Freddie Mac Single Family Servicing Guidelines 65.1.

[126] American Securitization Forum, Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007; Kenneth Harney, Mortgage Mod Squad, Washington Post, April 14, 2007, at F01.

[127] The federal banking regulators have encouraged financial institutions to work with "financially stressed" borrowers. FFIEC, "Statement on Working with Mortgage Borrowers," April, 2007. This seems intended to specifically permit and facilitate loss mitigation techniques to avoid foreclosures. This is good in so far as it goes, yet there no *requirements* on these financial institutions to avoid foreclosures through loss mitigation. Further, many home mortgages are not serviced by federally regulated financial institutions.

these entities *enforce* any requirement to consider alternatives before initiating the process that will cost a family their home. Homeowners can only occasionally raise them as a defense to a foreclosure, and the investors have no institutional mechanisms to police loss mitigation efforts. It is telling that in the policy arena servicers are seeking immunity from investor lawsuits challenging loan modifications but not foreclosure actions.[128]

Moreover, there are no specific loss mitigation requirements – other than those vaguely included in some PSAs – applicable to the millions of subprime loans which are not subject to FHA, Fannie Mae or Freddie Mac rules. Yet these are often mortgages that need most intervention.

Now it is up to the Board. Loss mitigation should be a required endeavor before foreclosure is permitted on a home mortgage.

X. Early Mortgage Loan Disclosures

We commend the Board for extending the right to early disclosures to non-purchase money mortgages. Consumers who contemplate taking out a home refinance loan should surely have the same ability to compare loan terms as those who borrow money to purchase a home. We also appreciate the Board's plan to engage in consumer testing of the disclosures to make sure that the key credit pricing information is clearly conveyed to consumers.

We are concerned, however, that the proposed regulation lacks teeth. As the regulation stands, consumers have little redress when confronted with a lender who fails to make the early disclosures or who makes the early disclosures so inaccurately as to vitiate their effectiveness for shopping. As a result, the regulation will not be self-enforcing and the market efficiencies promised by improved disclosure will not be realized.

We urge the Board to further exercise its rulemaking authority under both Section 105(a) and Section 129(*l*) of the Act to ensure that the early disclosures are actually made, timely and accurately, in both the purchase and non-purchase money mortgage markets.

A. Effective Disclosure Promotes Consumer Shopping and Provides a Cheap Form of Market Regulation

As the Board has recognized, disclosures cannot cure all the ills of subprime lending.[129] Disclosures did not and could not have prevented the current crisis. Substantive regulation remains essential. Nonetheless, as the Board has also recognized, disclosure, when well-done, is not without value. We share the Board's interest in

[128] H.R. 5579, the Emergency Loan Modification Act of 2008, provides such immunity in certain circumstances.

[129] 73 Fed. Reg. 1672, 1676 (Jan. 9, 2008).

"help[ing] consumers make informed use of credit and shop among available credit alternatives."[130]

Disclosures promote shopping by reducing the opportunity cost of shopping.[131] Uniform, standard disclosures permit potential borrowers to compare, quickly and cheaply, the most salient points of loans under consideration.[132] Shopping by consumers is essential if markets are to police themselves to any extent.

As Senator Paul Douglas so fondly hoped at TILA's genesis, disclosure can move markets and weed out inefficiencies.[133] It is a relatively cheap form of regulation.[134] When done right, disclosure reduces information asymmetries and permits consumers to make their own decisions, based on their own circumstances. Substantial evidence shows that even the current TIL disclosures are widely used by consumers.[135] In markets with rigorous regulatory oversight and enforcement mechanisms, TIL disclosures are given regularly and accurately and the cost of consumer credit drops.[136]

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[130] 73 Fed. Reg. 1672, 1715 (Jan. 9, 2008).

[131] *Cf.* Y.Regina Chang & Sherman Hanna, *Consumer Credit Search Behavior*, 16 J. Consumer Studies and Home Economics 207 (1992) (consumers seek to minimize the cost of searching).

[132] *See, e.g., Improving Financial Literacy in the United States: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 9-10 (2006) (statement of Ben S. Bernake, Chairman, Board of Governors, Federal Reserve System); Kleimann Communication Group, Testing HUD's New Mortgage Disclosure Forms with American Homebuyers 17, 21 (2007), *available at http://www.huduser.org/intercept.asp?loc'/Publications/PDF/Round_6.pdf* (by standardizing the RESPA required good faith estimates and providing subtotals of settlement costs, survey participants were able roughly 90% of the time to identify which loan had lower settlement costs).

[133]*Consumer Credit Protection Act: Hearings Before the Subcomm. on Consumer Affairs of the H. Comm. on Banking & Currency on H.R. 11601*, 90th Cong. 142, 173 (1967).

[134] *Cf.* Gregory Elliehausen & Barbara R. Lowery, The Cost of Implementing Consumer Financial Regulations: An Analysis of Experience with the Truth in Savings Act (Bd. of Governors, Fed. Reserve Sys. Staff Study No. 170, Dec. 1997), http://federalreserve.gov/pubs/staffstudies/1990-99/ss170.pdf (discussing costs of implementing Truth in Savings Act disclosures; costs were approximately $29,390 per bank).

[135] *See, e.g.,* Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much and What Else?,* 9 FIN. SERVICES REV. 277, 286 (2000) (78% of refinancing homeowners report using TIL disclosures, including the APR, when shopping for a refinance mortgage); *see* Macro International, Inc., Design And Testing Of Effective Truth In Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (consumers look for the standardized open end TIL disclosure form known as the "Schumer box" and indicate that it is the most important part of a credit offer).

[136] *See* Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3-4 (Sept. 5, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id'928956 (in markets where TILA disclosures made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures not made reliably, same consumers pay 200-400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree).

In order for disclosures to be effective for shopping, they need to be received at a time when the consumer can still shop. As the Board has recognized, this means in advance of closing.[137] Many consumers are practically committed to a loan by closing: they may have a contractor ready to start work or they may have paid fees that are difficult to have refunded. Other consumers are psychologically committed to a loan by closing: they have shopped and asked around and now believe that this loan is the best they can get. For most consumers, there is certainly hassle involved in canceling a loan at the closing table, even if they are able to see and understand the disclosure amid the mass of other documents presented at closing.[138] The disclosures must also reflect the actual terms of the loan the borrower will receive. Disclosures that reflect some hypothetical loan or that significantly understate the cost of credit increase consumers' search costs and result in confused consumers and inefficient markets.

In extending the early disclosure requirement to non-purchase money mortgages, the Board has taken an important step towards addressing the first requirement of effective disclosure, timing. The Board has not, however, addressed the question of accuracy. Nor has the Board ensured that any disclosures, accurate or not, will in fact be given. Unless the disclosures are given before the consumer is committed to the loan and are given accurately, none of the beneficial results of disclosure will ensue. Consumers cannot shop based upon nonexistent or inaccurate disclosures. In the worst case scenario, when the disclosures given are fraudulent, the ability of consumers to shop is not only thwarted but perverted. Thus, the Board must ensure that the disclosures both are given in a timely manner and are given accurately. If the Board does not impose consequences for failing to make the disclosures in a timely and accurate manner, the Board's laudable desire to promote consumer shopping will be nothing more than empty words.

B. As the Proposed Regulation Stands, Lenders May Choose Not to Give the Early Disclosures, Thus Rendering the Requirement of Early Disclosure Meaningless.

Without further action by the Board, lenders may not give the early disclosures at all. Failure to give the early disclosures is not listed as a material violation for purposes of rescission in Regulation Z. Moreover, some courts have been hostile to providing any statutory relief for late disclosures, even ones delivered *after* closing.[139] The Sixth Circuit has opined that the redisclosure provision in the statute suggests that Congress does not

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[137] 73 Fed. Reg. 1672, 1715-1716 (Jan. 9, 2008).

[138] *See* Kleimann Communication Group, Testing HUD's New Mortgage Disclosure Forms with American Homebuyers 16 (2007), *available at http://www.huduser.org/intercept.asp?loc'/Publications/PDF/Round_6.pdf* (survey respondents had trouble extracting information from more than two documents and appear to become confused when a third document is introduced); *Cf.* Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RESEARCH 432, 435 (1984) (when confronted with too much information, consumers may miss a key piece of information); Sprague v. Household Intern., 473 F. Supp.2d 966 (W.D.Mo. 2005) (describing closings of real estate loans of less than ten minutes at fast food restaurants and delis).

[139] *See, e.g.*, Baker v. Sunny Chevrolet, Inc., 349 F.3d 862 (6th Cir. 2003).

think that timing matters.[140] Without strong language from the Board, some lenders—particularly those who would be disadvantaged by early disclosure of the terms of credit—will gamble, perhaps correctly, that there will be no penalty for failing to provide the early disclosures.

Without credible enforcement mechanisms and penalties for noncompliance, lenders do not reliably give required disclosures. One example is the Federal Reserve's booklet explaining adjustable rate mortgages, the CHARM booklet. The CHARM booklet should be given to a consumer any time the consumer applies for an adjustable rate mortgage product.[141] Nonetheless, in our collective experience of working with hundreds of homeowners entitled to receive the CHARM booklet, we have only seen a handful of instances where the consumers received the CHARM booklet or a comparable booklet produced by the lender. By contrast, in our experience, a notice of the right to cancel is given to consumers most of the time (even if it is not given correctly). Why are lenders and their agents more careful to make sure consumers receive the notice of the right to cancel than the CHARM booklet? Perhaps because failure to give the notice of the right to cancel unquestionably gives rise to a three year extended right to rescind while failure to give the CHARM booklet may not give rise to the right to rescind nor to statutory damages.[142] Simply put, relying on regulatory oversight is not enough to ensure lender compliance absent meaningful consumer redress.

Regulatory enforcement is particularly ill suited to ensure consumers receive the early disclosures. Examinations will not catch files where early disclosures were not given, provided the lender prior to the exam puts a disclosure in the file, whether or not it was timely provided to the borrower. Moreover, many high-cost lenders are not subject to regular examinations, whether because they are operating subsidiaries or otherwise. Unless consumers can clearly rescind and collect statutory damages for the failure to deliver early disclosures, most high cost lenders will not timely and accurately disclose the cost of credit.

Lenders who comply with the regulation may be at a competitive disadvantage with those who do not. Certainly, high-cost and abusive lenders will have the least incentive to comply with the expanded early disclosure requirements. Why disclose that your loan is costly if there is no penalty for failing to do so? Borrowers are least likely to

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[140] *Id.*at 869 n. 12.

[141] Reg. Z § 226.19(b).

[142] *See, e.g.,* Oscar v. Bank One, N.A. , 2006 WL 401853 (E.D. Pa. Feb. 17, 2006) (failure to give variable rate disclosures not a material violation for purposes of rescission); Pulphus v. Sullivan, 2003 WL 1964333 (N.D. Ill. Apr. 28, 2003) (same); Resolution Trust Corp. v. Martinez, 1994 WL 1631035 (S.D. Ohio Aug. 24, 1994) (same); Ralph J. Rohner & Fred H. Miller, Truth in Lending, ¶ 12.04[2][a]n.140 (2000) (arguing that statutory damages not available for violations of the ARM disclosure requirements); *but see* National Consumer Law Center, Truth in Lending, § 8.6.5.8 (arguing that failure to provide the variable rate disclosures should give rise to both statutory damages & rescission). The Board could easily address this by clarifying that the CHARM booklet and other variable rate disclosures are material for purposes of rescission, in Reg. Z §§ 226.15 n.38 (open end), 226.23 n. 48 (closed end).

get disclosures when they need them the most: when they are entering into a comparatively expensive loan.

C. By Failing to Require that the Early Disclosures Meet a Standard of Accuracy, the Proposed Regulations Encourage the Use of Disclosure to Mislead Consumers

If lenders do give the early disclosures, there is no requirement that the early disclosures be accurate, honest, or otherwise provide borrowers with actual information about their loan terms. Lenders may give inaccurate disclosures with impunity. If the disclosures are inaccurate, the lender need only provide a corrected version at closing.[143] Closing, as the Board acknowledges, is simply too late.[144]

As the Board is aware, both purchase money and non-purchase money mortgages have in recent years been sold in large numbers based on fraud. Early disclosures can play a critical role in either facilitating or preventing that fraud. When timely and accurate disclosures are given, consumers are able to protect themselves from fraud to some extent. When the disclosures given are misleading, the disclosures themselves facilitate fraud. The failure to require that the early disclosure be accurate invites predatory lenders to use the early disclosures as instruments of fraud. We have seen many instances where lenders have provided early TIL disclosures that understated the APR significantly. Whether done in good or bad faith, the result is the same: the borrower's ability to shop is thwarted. For purposes of legalistic compliance with TILA, the issuance of a correct disclosure at closing "cures" the initial flaw. For purposes of compliance with TILA's intent, the issuance of a correct disclosure at closing cannot cure the initial flaw.

Unless the Board mandates accuracy in the early disclosure regime, lenders and brokers remain free to use the early disclosures as instruments of fraud rather than as tools to promote informed consumer choice in the credit marketplace.

D. Solutions: How the Board Could Ensure that the Early Disclosures Are Made and Made Correctly.

1. The Board Should Provide that Failure to Make the Early Disclosures Is a Prohibited Practice and a Material Violation for Rescission.

Failure to make the early disclosures in accordance with the Board's regulations should be listed as a prohibited practice under 15 U.S.C. §1639(*l*), applying to the entire market, incorporated perhaps into the proposed Regulation Z §226.36. This would make clear that failure to provide the disclosures should give rise to statutory damages under 15 U.S.C. §1640(a).

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[143] Reg. Z § 226.19(a)(2).

[144] 73 Fed. Reg. 1672, 1715-1716 (Jan. 9, 2008).

The Board should define the early disclosure as a "material disclosure" for purposes of rescission in non-purchase mortgage loans by amending Regulation Z § 226.23 n. 48. This would provide a powerful incentive for lenders to ensure that the disclosures are made. As discussed above and as recognized by the Board, receipt of the early disclosures is material to furthering the purposes of TILA.

2. The Board Should Require Accurate Disclosures Before Closing

The Board should require that, when estimated disclosures become inaccurate in home-secured transactions, corrected disclosures must be given before closing as well as at closing. We recommend that a new § 226.19(a)(3) be added to Regulation Z as follows: "If there are material changes in the terms disclosed in the early disclosures, the creditor shall disclose all the changed terms no later than seven days before consummation or settlement."[145] Seven days is sufficiently in advance of the closing that consumers could still use the TIL disclosure to shop or perhaps even to withdraw from the transaction altogether. This new requirement for accurate disclosures before closing would apply to both purchase and non purchase money mortgages.

In order to ensure accuracy, the Official Staff Commentary should be amended to make clear what would constitute a material change. The Commentary should define "material change" from the early disclosures as any of the following:

- any change in the annual percentage rate that exceeds 1/8 of 1 percentage point in a regular transaction or ¼ of 1 percentage point in an irregular transaction;
- any change from a fixed rate to a variable rate or from a variable rate to a fixed rate;
- the addition of a prepayment penalty;
- any change greater than 1% or $100, whichever is smaller, in the amount of the monthly payment, or any other change in the payment schedule;
- any change in the amount financed that exceeds 1% or $100, whichever is smaller;
- any change in the variable rate terms of a loan, such as changes in the margin (even if this would not translate into a change in the APR beyond the tolerance);
- a change from one type of ARM to another;
- any addition or elimination of a payment option or negative amortization feature;
- any change in the loan term.

Requiring redisclosure in the event of inaccuracy permits consumers to rely on the early disclosures for shopping purposes and is within the Board's authority under Section 105(a) of the Act. Section 105(a) allows the Board to promulgate regulations that implement Congressional mandates or fill in gaps where Congress was silent. While the statute provides for an early disclosure,[146] nothing in the statute prevents the Board from

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[145] A corresponding revision would need to be made to Reg. Z § 226.17(f) and footnote 39.

[146] 15. U.S.C. §1638(b)(2).

requiring additional disclosures or for ensuring that the disclosures mandated by Congress are made in a meaningful way.

3. The Board Should Provide that Failure to Make the Early Disclosures Accurately Is a Prohibited Practice

Again, using its rulemaking authority under 15 U.S.C. §1639(*l*) and defining the failure to make the early disclosures as required as a prohibited practice would allow the Board to make the accuracy of the early disclosures enforceable in the purchase mortgage context as well as the non-purchase money mortgage context.

XI. Remedies and Assignee Liability Are Essential to the Success of the Proposed Rules

We are particularly pleased that the Board discussed remedies and assignee liability in the Supplementary Information accompanying the proposed rules.[147] Congress envisioned consumers playing a pivotal role in the success of TILA by complementing public enforcement efforts through a private right of action. The ability of consumers to obtain redress for violations of the Act and to fulfill their central role depends upon the strength and clarity of these remedies. The success of these new rules, measured by the reduction or elimination of fraudulent and shoddy lender, broker, and servicer practices, cannot occur without energetic private and public oversight. It is the very practices which the Board seeks to restrain that have brought the mortgage market to its knees and spread insecurity throughout the rest of the national economy.

In the Supplementary Information, the Board listed the remedies it believes are available under section 1640 for a violation of the substantive rules in proposed Reg. Z §§ 226.35 and 226.36:

- actual damages under section 1640(a)(1);
- statutory damages of up to $2,000 under section 1640(a)(2), capped in a class action;
- special statutory damages for a section 1639 violation of all the sum of all finance charges and fees paid by the consumer; <u>and</u>
- attorney fees and costs.

Rescission is noticeably absent from this list. However, the Board stated it will revise footnote 48 in Reg. Z § 226.23 to clarify that a violation of one of the new rules that apply to "higher-priced" mortgage loans, the prohibition related to prepayment penalties, can trigger the three-year right of rescission.

Finally, the Board noted that assignees will be liable for violations triggering damages only when the disclosure violations are apparent on the face of the disclosure

[147] 73 Fed. Reg. at 1716-17.

statement required by TILA.[148] The Board stated that TILA does not authorize private civil actions against parties other than creditors and assignees. Examples of these parties include a mortgage broker who is not the creditor and loan servicers who have not owned the mortgage for purposed beyond administrative convenience.[149]

We urge the Board to expand its discussion of these issues in the final rule to address several concerns.

A. The standard that consumers must meet to obtain actual damages.

B. The standard that consumers must meet to hold assignees liable when seeking damages for violations of substantive rules.

C. Rescission for failure to provide the early TIL disclosures.

D. Rescission for violations of the prepayment penalty rule.

A. The Board Should Clarify the Standard Consumers Must Meet to Obtain Actual Damages

1. The Background

Actual damages are an important remedy for consumers. TILA's caps on statutory damages for individual and class claims mean that, in mortgage loan cases, statutory damages will not provide anywhere near full compensation for the consumer's losses. For example, if the consumer pays an illegal prepayment penalty of $10,000, the consumer's statutory damage remedy will be capped at only $2,000.[150] Given this disparity between the penalty if caught and the actual profit to the lender, lender incentives to flout the law can be significant, unless consumers can obtain actual damages.

Another problem with statutory damages is that they are only available for some TIL violations, while actual damages are available for all violations except credit advertising and oral disclosure requirements.[151] For some violations for which statutory damages are unavailable, including disclosure of late charges and prepayment charges, actual damages can be a significant sum.

In addition, statutory damages are further limited in a class action or a series of class actions involving the same violations by the same creditor. There, the award cannot exceed more than $500,000 or 1% of the creditor's net worth, whichever is smaller,

[148] 15 U.S.C. § 1641(e).

[149] 15 U.S.C. § 1641(f)

[150] 15 U.S.C. § 1640(a)(2)(A)(iii).

[151] 15 U.S.C. § 1640(a). The Board recognized that damages have not to date been available for violations of the advertising rules. 73 Fed. Reg. at 1717.

regardless of the number of class members.152 The consumer is entitled to only one statutory award even where there are multiple disclosure violations.153 Multiple obligors can only recover statutory damages once.154

The rescission remedy, available to consumers only in non-purchase money mortgage loans, can come with a significant price tag for the offending lender. When a loan is rescinded, the lender must subtract from the principal all closing costs incurred and all payments made by the consumer up to the date of a judgment.155 Nevertheless, the finance charge tolerances temper the potential for liability, except where the consumer is defending against a foreclosure.[156] Moreover, the three-year right to cancel is triggered only when the lender violates one of only a handful of the most important of the Act's requirements.157 Two appellate courts have held that rescission is not available in a class action, further limiting potential liability.158

For these reasons, the consumer's ability to recover the cost of the harm is critical given the limitations placed on the award of statutory damages and the fact that only the proposed prepayment penalty rule may trigger rescission.[159]

Prior to 1974, actual damages were not included in the civil liability provisions of the Truth in Lending Act. The only explicit private remedy was statutory damages of twice the finance charge (not less than $100 or more than $1,000), plus costs and attorney fees. This provision applied to both individual and class actions.

In 1974, Congress amended the Act's civil liability section, retaining substantial class action civil penalties with the clear intent to promote, within limits, a meaningful deterrent against creditor noncompliance and an incentive for voluntary compliance.[160]

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[152]15 U.S.C. § 1640(a)(2)(B).

[153]15 U.S.C. § 1640(g).

[154]15 U.S.C. § 1640(d).

[155]15 U.S.C. § 1635(b); 12 C.F.R. §§ 226.15(d)(2), 226.23(d)(2); Official Staff Commentary §§ 226.15(d)(2), 226.23(d)(2).

[156] 15 U.S.C. §§ 1605(f); 1635(i)(2).

[157]For fixed-term mortgage loans, only the failure to accurately disclose the APR, finance charge, amount financed, the total of payments, the payment schedule, to comply with certain provisions of the Home Ownership and Equity Protection Act, and the failure to properly provide the notice of right to cancel trigger the extended right to rescind. 12 C.F.R. § 226.23 (a)(3) n. 48. There is a slightly different list for open-end real estate secured loans. 12 C.F.R. § 226.15(a)(3) n. 36.

[158]McKenna v. First Horizon Home Loan Corp., 475 F.3d 418 (1st Cir. 2007); James v. Home Construction Co. of Mobile, Inc., 621 F.2d 727 (5th Cir. 1980)

[159] For a discussion of the many ways in which Congress built protections for lenders from excessive liability into TILA, see Elizabeth Renuart & Diane Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending,* ____Yale J. on Reg. ____(2008)(forthcoming), *available at* http://ssrn.com.

[160] Pub. L. No. 93-495 § 408 (enacted and effective Oct. 28, 1974); S. Rep. No. 750, 92d Cong., 2d Sess. (1972), p.12; 118 Cong. Rec. S6912 (Apr. 27, 1972) (remarks of Senator Proxmire); S. Rep. No. 278, 93d

To protect creditors from potentially devastating judgments, the amendment capped class action awards of statutory damages at the lesser of $100,000 (now raised to $500,000)[161] or one percent of the creditor's net worth. Congress also added liability for actual damages, without a cap, in both class and individual actions.[162]

Beyond making clear that proof of actual damages is not a prerequisite to the recovery of the statutory award in either an individual or class action,[163] the legislative history sheds little light on how actual damages are to be determined.

In recent years, four circuits have borrowed a common law fraud standard and held that the consumer must show detrimental reliance on an inaccurate disclosure in order to obtain actual damages.[164] These courts adopted a standard that requires the consumer to show the following elements (more or less, depending on the court) to recover actual damages: (1) the consumer read the disclosures, understood the charges; (2) would have sought a lower price had the disclosure been accurate; and (3) would have obtained a lower price or would have foregone the transaction altogether if the disclosure had been accurate.[165]

Proving entitlement to actual damages is difficult, if not impossible under the judicial standards that have evolved for disclosure violations. In fact, there have been few or no actual damage awards in TIL cases since courts formulated these restrictive standards. And, these standards do not work at all for substantive violations, as disclosure and reliance are not germane to substantive violations.

If, as a practical matter, actual damages are unavailable to compensate harmed consumers for violations of the proposed substantive rules, enforcement will remain with the supervising banking agencies. Examinations by these agencies have resulted in very small amounts of restitution over the years. For example, between 2003 and 2006,

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Cong., 1st Sess. 15, 43 (1973) (supplemental remarks of Senators Tower, Bennett, and Brock); 119 Cong. Rec. S14424 (July 23, 1973) (remarks of Senator Hart); and 120 Cong. Rec. H10270 (Oct. 9, 1974) (remarks of Rep. Sullivan). *See also* the FRB's fourth Annual Truth in Lending Report To Congress, at 119 Cong. Rec. S2813 (Feb. 20, 1973).

[161] The $100,000 limit was increased to $500,000 in 1976 by Pub. L. No. 94-240.

[162] *See In re* Russell, 72 B.R. 855 (Bankr. E.D. Pa. 1987).

[163] *See* S. Rep. No. 750, 92d Cong., 2d Sess. 12 (1972); S. Rep. No. 278, 93d Cong., 1st Sess. 15 (1973); 119 Cong. Rec. S14420 (July 23, 1973) (remarks of Senator Bennett).

[164] Smith v. Gold Country Lenders, 289 F.3d 1155 (9th Cir. 2002); Turner v. Beneficial Corp., 242 F.3d 1023 (11th Cir. 2001); Perrone v. General Motors Acceptance Corp., 232 F.3d 433 (5th Cir. 2000); Peters v. Jim Lupient Oldsmobile Co., 220 F.3d 915 (8th Cir. 2000). *See also* Stout v. J.D. Byrider, 228 F.3d 709 (6th Cir. 2000) (trial court did not abuse its discretion in refusing to certify class on ground that reliance would have to be shown on individual basis).

[165] The Eleventh Circuit defined detrimental reliance less strictly, as "a causal link between the financing institutions's noncompliance and [the plaintiff's]damages." Turner v. Beneficial Corp., 242 F.3d 1023, 1028 (11th Cir. 2001), *proceedings upon remand,* 2001 WL 34145276 (M.D. Ala. July 6, 2001) (applying the detrimental reliance standard set forth in the earlier *Turner* decision and granting summary judgment for creditor defendants).

inclusive, three federal agencies ordered $3.8 million in restitution, or only slightly more than one-millionth of the consumer credit outstanding in 2006.[166]

2. Solution

We urge the Board to comment on this issue in the Supplementary Information and indicate that a fraud detrimental reliance standard is inappropriate for both disclosure and substantive rule violations. The Board could state the following:

> The Board considers all TIL requirements to be a part of the consumer credit contract. For disclosure violations, the standard that exists in § 1640(b) (correction of error defense) applies: the consumer should not pay an amount in excess of the charge actually disclosed, or the dollar equivalent of the annual percentage rate actually disclosed, whichever is lower. For substantive violations, the actual damage is the amount of the harm caused by the creditor's violation, for example, the difference between the cost to the consumer of a loan the consumer could repay and the cost to the consumer of the loan the consumer received.

The suggested standard for disclosure violations is derived from the restitution formula set by Congress when creditors self-correct errors.[167] The suggested standard for substantive violations borrows from general contract law principles. It treats the disclosed terms as part of the binding contract between the creditor and the consumer, and allows the consumer to enforce them like any other contract term. It treats substantive requirements as part of the contract as well, and allows the consumer to recover the standard measure of contract damages if the creditor violates that contract term.

The Board has never promulgated regulations or commentary under section 1640. We are not asking the Board to issue a regulation on this subject. Nevertheless, the Board has authority to address *all* statutory provisions through regulation "to carry out the purposes of this subchapter."[168] TILA is a consumer protection statute and is designed to protect borrowers who are not on equal footing with creditors either in bargaining power or with respect to knowledge of credit terms.[169] An additional goal is "to deter generally illegalities which are only rarely uncovered and punished."[170] The

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[166] 2006 Bd. of Governors of Fed. Reserve Sys. Ann. Rpt. 106; 2005 Bd. of Governors of Fed. Reserve Sys. Ann. Rpt. 101-102; 2004 Bd. of Governors of Fed. Reserve Sys. Ann. Rpt. 71; 2003 Bd. of Governors of Fed. Reserve Sys. Ann. Rpt. 69-70, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/default.htm. (reporting numbers for the Board and the FDIC for 2003-2006, OTS for 2003 only).

[167] 15 U.S.C. § 1640(b).

[168] 15 U.S.C. § 1604(a).

[169] *See, e.g.,* Thomka v. A.Z. Chevrolet, Inc., 619 F.2d 246 (3d Cir. 1980).

[170] Fairley v. Turan-Foley Imports, Inc., 65 F.3d 475, 480 (5th Cir. 1995)(*quoting* Williams v. Public Fin. Corp., 598 F.2d 349, 356 (5th Cir. 1976).

Act is remedial and must be liberally construed in favor of borrowers.[171] If obtaining actual damages for the harms of creditor conduct is virtually impossible, one goal of the Act, to deter unlawful conduct, is completely undermined.

There is precedent for the action we urge the Board to take. First, the Board itself has interpreted the remedy provisions of section 1635(b) related to rescission in both Regulation Z and the Commentary, expanding upon and clarifying what Congress included in that subsection.[172] Second, looking to other agencies, the Federal Trade Commission issued a regulation that requires certain sellers to include a contract provision that creates assignee liability for any purchaser of the contract despite the fact that the FTC Act never mentioned assignee liability.[173]

B. The Standard Consumers Must Meet to Hold Assignees Liable When Seeking Damages for Violations of Substantive Rules.

1. The Background

Most mortgage lenders sell their loans to companies that purchase them in the secondary market or to third parties that transfer them to a trust and sell certificates "secured" by the mortgages into the investment market (the process known as "securitization").

In most credit transactions, it is critical to hold the entity (usually an assignee) which holds the loan note or credit contract responsible for its behavior and/or that of the original lender for several reasons. Usually, the consumer must make payments to the assignee during any litigation or risk foreclosure and adverse information reported to the credit bureau. Raising claims and defenses to the obligation itself can provide the consumer with a defense to a foreclosure and significant practical relief from an overbearing debt. In addition, the original lender who was directly responsible for the illegal behavior may be judgment-proof, may have filed bankruptcy, or may have disappeared. The assignee may be the only entity in a position to provide some relief to a harmed consumer.

The incentives created by assignee liability are beneficial for the market as a whole. Investors in the mortgage market must be more careful about the loans they purchase. As Congress put it when adding HOEPA assignee liability in 1994:

> [Assignee liability] ensures that the market polices itself to eliminate abuses. Similar liability has been previously extended by the FTC to

[171] Dozens of courts have adopted this view. *See* cases compiled in National Consumer Law Center, Truth In Lending § 1.4.2.3.1 n. 106 (6th ed. 2007).

[172] Reb. Z 21 21 226.15 and 226.23 and accompanying Commentary.

[173] 16 C.F.R. § 433.

> consumer installment paper, including automobile loans, without a significant impact on credit availability.[174]

Purchasers of mortgage loans are not "creditors" under TILA and generally have faced no liability for any creditor violations of TILA under section 1640. However, special provisions in section 1641 transfer liability to the assignees in certain circumstances.

If the loan is not a high cost loan covered by section 1602(aa) and the consumer is seeking damages for the TIL violations, the assignee is liable only when the violation is apparent on the face of the disclosure statement when comparing the disclosure statement, any itemization of the amount financed, the note, or any other disclosure of disbursement.[175]

Section 1641(e) contains a difficult standard to meet, particularly when the creditor violates the current HOEPA and subprime proposed substantive rules. For example, an assignee cannot determine that the lender had a pattern or practice of making loans without adequately assessing the consumer's ability to repay when comparing the specified documents. Similarly, an assignee cannot not detect if appropriate verification of debts and income by the creditor occurred.

As a result, some of the most important provisions of TILA, its substantive protections, may be unenforceable through a damage award.[176] The incentives to comply are reduced or eliminated and TILA's goals unravel.

2. Solution

We urge the Board to state in the Supplementary Information that "apparent on the face of the disclosure" in the context of the substantive protections in Regulation Z §§ 226.32, 226.34, 226.35, 226.36 means the entire loan file. Only by an examination of the entire lender (and servicer file regarding servicer obligations under new Regulation Z § 226.36) can the purchaser determine compliance with the TILA's rules addressing prohibited provisions and acts and practices. Perverse results can occur absent this file review. For example, the assignee would not be liable even when it has actual knowledge from a loan file of violations simply because the violations are evident from documents other than the disclosure statement, any itemization of the amount financed, the note, or any other disclosure of disbursement.

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[174] H.R. Conf. Rep. No. 652, 103rd Cong. 2d Sess. 147, 163 (1994); 1994 U.S.C.C.A.N. 1987 (accompanying H.R. 3474).

[175] 15 U.S.C. § 1641(e).

[176] Rescission is only available to consumers for disclosures deemed "material" in footnote 48 of Reg. Z § 226.23 and for the inclusion of prohibited loan terms in high cost mortgage loans but not for acts and practices prohibited under § 1639. *See* 15 U.S.C. § 1639(j) and the Board's comments at 73 Fed. Reg. at 1717.

In the alternative, the assignee need evaluate only those documents necessary for the assignee to determine that a violation had *not* occurred. This permits to the assignee to determine compliance by evaluating a smaller number of documents than the entire file. For example, an assignee would need to examine a smaller subset of information, such as the loan application and verifications, to determine if the lender adequately verified income and the consumer's ability to repay. Assignees and lenders would likely create simple and efficient forms to assist each other in this process. I don't quite understand this par. and how it fits in with the preceding paragraph.

C. Rescission should be available for failure to provide the early TIL disclosure.

1. The Background

The TIL rescission remedy currently is triggered for the creditor's failure to give an accurate *final* TIL disclosure. The proposed rules do not extend rescission to the failure to give the new *early* TIL disclosure for non-purchase home equity loans.[177] We discussed the merits of the Board's early disclosure proposal elsewhere in these comments.

We emphasize here that creditors will have little motivation to comply with the proposed early TIL disclosure rule if damages alone are available, given the current state of actual damages law, as discussed above. We highlighted earlier the widespread creditor non-compliance with the current mandate to provide the CHARM booklet due to the absence of meaningful sanctions and the difficulty of proving a violation during agency examinations. In an analogous context, the Real Estate Settlement Procedures Act provides no private right of action against lenders who fail to provide good faith estimates of closing costs in a timely way.[178] In our experience and in that of consumer attorneys around the United States, consumers rarely receive this disclosure until the loan closing, if at all, in the subprime market.

2. Solution

Amend Regulation Z § 226.23 n. 48 to define the early disclosure as a "material disclosure" for purposes of rescission in non-purchase mortgage loans.

D. Rescission Remedy for Violations of the Prepayment Penalty Provision in Reg. Z § 226.35(b)(3)

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[177] The violations of the early disclosure currently required for purchase money mortgage loans do not trigger rescission because the rescission remedy does not apply to purchase money mortgage loans for *any* TIL violations. 15 U.S.C. §§ 1635(e)(1)(exempting "residential mortgage transactions defined in § 1602(w) to be loans which finance the acquisition or initial construction of the dwelling). Our proposal does not disturb this exemption. It simply extends the right to rescind to violations of the early disclosure rules in the same manner as it applies to violations of the final TIL disclosure requirements.

[178] The duty to provide a good faith estimate not later than three business after an application is received or prepared exists in 12 U.S.C. § 2604(c) and 24 C.F.R. § 3500.7(a).

We strongly support the Board's statement that it plans to revise to footnote 48 of Regulation Z § 226.23 which incorporates a violation of the prepayment penalty prohibition as a rescission trigger.[179] The Board's legal analysis of its authority to do so is completely supported by the Act[180] and parallels the remedy for a violation of the prepayment penalty provision in section. In fact, to do otherwise would violate the will of Congress expressed in section 1639(j).

However, we did not find the actual change in the proposed rules to Regulation Z § 226.23, likely just an oversight. We hope the Board will rectify that error in the final rules.

XII. The Board Should Highlight the APR in Advertisements to Promote Its Importance to Consumers When Shopping for Credit

TILA requires two key disclosures of the cost of credit: the APR and the finance charge.181 The critical role of the finance charge and the APR is highlighted by the fact that the Act requires these two disclosures to be more conspicuously displayed than the other mandatory disclosures. The exact terms "finance charge" and "annual percentage rate" must be used.[182] "Without accurate disclosure of the APR, the borrower is unable to compare credit terms offered by other lenders, and a central purpose of TILA is defeated."[183]

The APR is calculated based on the finance charge. The APR converts the finance charge into a percentage rate.184 The APR, by transforming a dollar amount into a rate, scales the finance charge to the size of the loan and its term. Where separate fees constituting "finance charges" are imposed, the APR both bundles the fees with the interest rate and standardizes the rate over an annual term. Thus, a shopper can tell whether a two-week loan is cheaper than a six-month loan, just by looking at one number. The APR provides a unitary shopping instrument.

The drafters of TILA understood that without uniform disclosure interest calculations are forbiddingly complex.[185] The APR is meant to be a simplifying

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[179] 73 Fed. Reg. at 1717.

[180] 15 U.S.C. § 1639(j), § 1639(l)(2).

[181] 15 U.S.C. §§ 1605, 1606.

[182] 15 U.S.C. §§ 1632(a); Edwards, *supra* note 8, at 214.

[183] First Nat'l Bank of Council Bluff, Iowa v. OCC, 956 F.2d 1456, 1462 (8th Cir. 1992)(quoting the Comptroller of the Currency).

[184] 15 U.S.C. § 1606(a).

[185]*See Consumer Credit Protection Act: Hearings Before the Subcomm. on Consumer Affairs of the H. Comm. on Banking & Currency on H.R. 11601,* 90th Cong. 142 (1967) at 76 (statement of Joseph W. Barr, Treasury Undersecretary) ("Even a financial expert" could not be relied on to compare how much interest was being charged by competing lenders.). This has not changed, unfortunately. *See* Jinkook Lee & Jeanne M. Hogarth, *Returns to Information Search: Consumer Credit Card Shopping Decisions,* 10 Fin.

"heuristic" that allows borrowers to employ a rule of thumb to decide between options that are otherwise overwhelmingly complex.186 Many consumers stumble even when confronted with basic computational problems. Only a small minority of consumers can consistently aggregate fees.[187] Almost none can then bundle those fees with the interest rate to figure out the actual cost of credit.[188]

Lenders can compound those missteps by marketing to distract consumers from the salient points. Marketing to the interest rate instead of to the fee-inclusive price is one method used to distract consumers from the true price of credit.

Consumers are capable of making credit decisions, provided they are given information in a form that plays to their cognitive framework, highlights the key factors, and simplifies the detail. An inclusive unitary pricing system, such as the APR, is critical given the level of complexity inherent in modern credit transactions, Americans' low quantitative literacy level, and common patterns of consumer decision making.[189]

Counseling & Planning 23, 33 (1999) (researchers have trouble determining payoff from shopping for credit cards, given complexity of pricing structure); William C. Apgar & Christopher E. Herbert, U.S. Dep't of Housing and Urban Dev., Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis at x (2006) ("[G]iven the . . . complexity of . . . the cost of [mortgages], even the most sophisticated borrower will find it difficult to evaluate mortgage options.").

[186] A heuristic is a shorthand method for making a decision without necessarily understanding or reviewing all the details and nuances. Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 Sci**.** 1124, 1124 (1974).

[187] *See, e.g.,* Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 12, 15, 19, 41 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (borrowers have difficulty aggregating fees); Mark Kutner, Elizabeth Greenberg & Justin Baer, **U**.S. Department of Education, A First Look at the Literacy of America's Adults in the 21st Century 1 (2005), *available at* http://nces.ed.gov/NAAL/PDF/2006470.PDF (only 13% of the U.S. population can compare costs if some intermediate calculation has to be performed).

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

[189] These issues and the supporting academic literature is described in Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth In Lending*, ____YALE J. REG. ____(2008)(forthcoming), *available at* http://ssrn.com.

TILA disclosures have been remarkably effective in educating consumers to pay attention to the APR as a key measure of the cost of credit.190 Most consumers report looking for and using TILA's standardized disclosures when shopping.[191] In credit markets where APRs are disclosed, more competition and lower credit prices result.[192]

For these reasons, we urge the Board to follow these canons when finalizing the advertising rules:

- The APR should always be more conspicuous (meaning in larger type print) than any other numerical disclosure and should be in bold print; AND
- In closed-end transactions where the actual APR will differ from the annual interest rate, the APR alone must be disclosed.

Congress has not explicitly permitted the note rate to be disclosed with the APR.[193] The contract interest rate is listed in the loan note, for consumers who want to find this information. The Board should eliminate current and proposed language in Regulation Z § 226.24 that permits the advertisement of simple annual rates of interest in transactions where the actual APR will differ from the annual interest rate. To disclose the two together is inherently misleading and undermines the APR.

To our knowledge, the Board did not engage in this testing prior to promulgating section 226.24. Since the Board is overhauling this section as part of this proposal, the Board should ensure disclosing interest rate with an APR does not undermine the statutory mandate to clearly and conspicuously disclose the APR. Fundamentally, as long as credit pricing is split between the interest rate and the fee, conspicuous disclosure of the interest rate may mislead consumers to underestimate the effective cost of the interest rate. This is particularly true in advertising, where creditors will be motivated to present the credit as cheaper than it actually is.

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[190]S. Rep. No. 96-368, at 16 (1979), reprinted in 1980 U.S.C.C.A.N. 236, 252 (citing Federal Reserve Board statistics showing an increase in awareness of the APR in the closed end context from 15% before the enactment of TILA to 55% in 1977); Thomas A. Durkin, Consumers and Credit Disclosures: Credit Cards and Credit Insurance**,** Fed. Res. Bull. 203, 206 (April 2002)(awareness of the APR in the credit card context rose from 27% before enactment of TILA to 91% by 2000; 76% of credit card holders surveyed in 2001 indicated that the APR was a very important credit term and another 19% responded that the APR was somewhat important).

[191]See, e.g., Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures 9, 26 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (consumers look for the standardized open end TIL disclosure form known as the “Schumer box” and indicate that it is the most important part of a credit offer).

[192]See Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3-4 (Sept. 5, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id’928956 (in markets where TILA disclosures made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures not made reliably, same consumers pay 200-400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree).

[193] 15 U.S.C. § 1664.

Consumer testing should be helpful to make certain that a joint disclosure is not misleading to consumers, does not undercut the disclosure of the APR, and that consumers are still able to choose the cheaper loan when presented with both an APR and an interest rate. Should both numbers be disclosed, given the widespread confusion between the APR and the interest rate,[194] the Board should conduct consumer testing to determine how most effectively to describe the difference between the two numbers.[195]

XIII. Conclusion

We commend the Board on proposing rules under its authority pursuant to § 129(l) and appreciate the opportunity to comment. We urge the Board to reconsider the places where it placed significant barriers to effective consumer protections and to market change, in the interest of not inhibiting access to credit. Well-crafted rules targeting abuses will not restrain credit; they simply will allow affordable, fair credit to flourish, rather than being crowded out by the race to the bottom.

An examination of the FTC's Holder Rule is instructive because it applies liability for all claims and defenses that could be brought against the seller to assignees of loans used to purchase goods and services. The rule reallocates the cost of seller misconduct from the consumer to the creditor, so that a consumer who has been harmed may obtain a remedy by abrogating the Holder in Due Course doctrine. At the time the rule was proposed, the automobile dealers and other sellers of goods, argued that, if the rule passed, the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether. The finance companies and the banks argued that they did not want the responsibility of policing sellers, sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and the rule would interfere with free competition. These nightmare scenarios did not materialize. There was no reduction in available consumer credit; there were no indications that sellers were hurt in any way; there was no discernable increase in defaults.

The primary argument addressed by the FTC was that the proposed rule would increase the cost of credit or make it very difficult to obtain.[196] Following is a chart showing the level of credit in the United States from 1970 through 1980.

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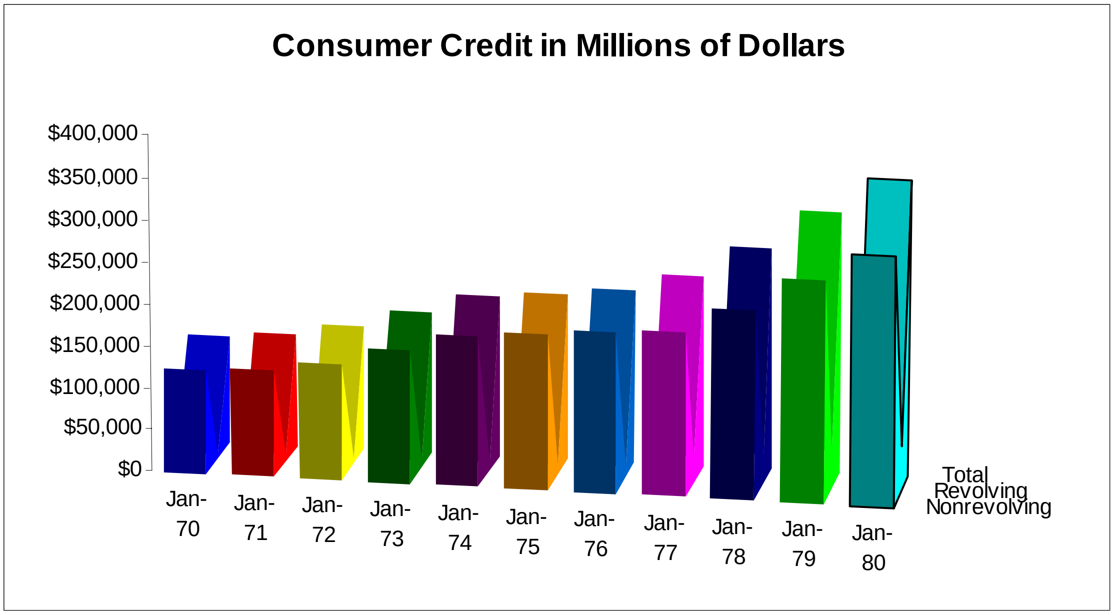
[194] See, e.g., Macro International, Inc. Design And Testing of Effective Truth In Lending Disclosures 47 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf.

[195] Cf. Macro International, Inc Design and Testing of Effective Truth in Lending Disclosures 47 (2007), http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf (relabeling the periodic statement APR the "Fee-Inclusive APR" increased both understanding of the periodic statement APR and appreciation of its utility).

[196] *Id*



The level of "non-revolving credit" is indicated in the last column and includes auto loans, loans for mobile homes, education, boats, trailers and vacations but excludes all credit card loans. In 1970, total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s, with not even a blip in 1975 and 1976 when the FTC rule was announced. By December 1980, total non-revolving credit in the United States was approximately $297 billion. In the space of ten years, consumer credit – notwithstanding the announcement and final promulgation of the holder rule halfway through that decade – had more than doubled.[197] The amount of outstanding consumer credit has continued to climb unabated since then: the outstanding amount of non-revolving debt increased over 500% during the seventeen years from January 1980 to December 2007.[198] In the area of auto loans, this FTC rule has not interfered with the securitization of auto credit.[199] Auto ABS volume for 2005 for prime and subprime loans combined exceeded $75 billion.[200]

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

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

[199] Letter from Vernon H.C. Wright, Chairman, American Securitization Forum, to Financial Accounting Standards Board (May 10, 2004), available at http://www.americansecuritization.com/uploadedFiles/FAS_140_Setoff_Isolation_letter_51004.pdf. The letter in part describes the FTC Holder Rule and its importance and describes the assessment used in the regular course of business to incorporate such liability into deals. It also states that buyers are willing to assume such risks and purchase such assets.

> For decades, a rule of the Federal Trade Commission2 (the "FTC Rule") has required every consumer credit contract (for instance, retail automobile installment loans) to include a legend to the effect that any purchaser of the contract is subject to all claims and defenses which the debtor could assert

Today's foreclosure crisis is cause for bold action. To date, measures to prevent future predatory lending have been tabled so that current loans and market weaknesses can be addressed and consumer protections have not been a core part of proposed solutions to the present crisis. The Board can play a significant role in steering the market toward a future where lender and investor interests are aligned with those of consumers. We urge you to take up that challenge.

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against the seller of the goods financed under the contract. This is to assure that consumers are not deprived of important defenses relating to payments owed on defective goods merely because their initial creditor sells the contract.

The Uniform Commercial Code3 (the "UCC") provides that a buyer of many common types of receivables (for instance, credit card receivables, short term trade receivables and lease receivables) may be subject to all defenses or claims of the debtor against the seller… .

Notwithstanding these risks, buyers are willing to purchase these types of assets. For instance, most retail auto installment paper is originated by auto dealers, who assign the paper to a finance company or bank. The finance company or bank may in turn transfer the paper into a securitization. The FTC and UCC rules about setoff are the same for both the initial purchase from the auto dealer and any subsequent transfer into a securitization.
Banks and finance companies that buy this paper analyze potential setoff risks as analogous to other ordinary course seller risks that a buyer of any asset takes.

[200] ASF 2006 Retail Auto ABS Sector Review, *available at*

http://www.americansecuritization.com/uploadedFiles/Retail%20Auto%20Loan%20ABS%20Sector%20Panel%204pm.ppt#646,1,ASF 2006 Retail Auto ABS Sector Review.

Appendix A

"Stated Income" Conforming Fixed Rate

Investor Code: 004
Loan Types: 151 (30 Year); 152 (15 Year)

PROPERTY REQUIREMENTS:

- Eligible properties:
  - Single Family Residence
  - Townhouse
  - 2-4 Unit
  - Condominium
  - PUD
- Manufactured housing, condohotels, time-share units, apartment conversions and cooperatives are not acceptable.
- Leasehold properties are acceptable per Fannie Mae guidelines.
- Properties located in the following states are not eligible:
  - Colorado
  - Minnesota
  - Nevada
  - Ohio

UNDERWRITING:

- Follow standard Fannie Mae guidelines unless otherwise noted.
- Salaried and self-employed applicants are eligible.
- A reasonable relationship must exist between all of the loan characteristics (i.e., field of employment, stated income, assets, and credit).
- Online sources that provide compensation data – such as "salary.com" or "CareerJournal.com" – should be used to validate stated income.
- All loans must receive an "Approve/Eligible" recommendation from DU.
- ☞ IRS Form 4506 must be signed by the borrowers at application and closing.
- Maximum qualifying debt-to-income ratio is 41%.
- Employment and income are stated on the 1003 but income is not verified. The applicant's income must not be documented **<u>anywhere</u>** in the loan file; otherwise, full/alt documentation is required. The applicant's 1003 must include the specific source(s) of income with a minimum of two years employment in the same line of work. For all self-employed applicants, the applicant's business must be in existence for at least two years.
- The applicant's employment/income source must be verified as follows:

Employment/Income Source	Acceptable Verification Sources
Salaried	Verbal VOE
Self-Employed	Business existence must be documented for all self-employed applicants through: • evidence of a business license; and • verbal confirmation of a phone directory listing. A signed confirmation of the business must be obtained from the applicant's accountant where a license is not required for the business.
Retirement **Social Security** **Annuity** **Trust**	▪ Awards Letter with income "blacked out"; **or** ▪ Verify annuity funds; **or** ▪ Letter from Trustee
Schedule B **Dividend & Interest Income**	▪ Verify assets supporting income; **or** ▪ Sch. B with income "blacked out"

- All assets must be listed on the 1003 and should be consistent with the income stated. Asset verification is required on all loans, regardless of the DU recommendation.
- The applicant must disclose liquid assets that are sufficient to cover funds needed to close the transaction. The funds to close must be verified according to Fannie Mae Selling Guide requirements.

- Refer to the "Loan Limits" section for the minimum credit score requirement.
- Applicants without credit scores are not eligible.
- Cash reserves are not required.
- Non-permanent resident aliens are acceptable per Fannie Mae guidelines.
- First-time homebuyers are eligible.
- Non-occupant co-borrowers are not acceptable.
- Second homes or investment properties – applicants may not own more than five (5) financed properties, including their primary residence.
- Special Feature Code (SFC): 442

Appendix B

IndymacBank

Conditional Approval Notice

Date: January 11, 2006	IndyMac Loan Number: 122675401 Rate Lock Number: Exception Number:	Credit Report Expiration: ** 3/21/2006 Conditional Approval Expiration: 1/18/2006 Ratelock Expiration:
To: Global Financial Inc ATTN: Dana Russell Seller Phone: (516) 791-3232 Ext: 122 Seller Fax: (516) 977-8996		IndyMac Review Date: Jan 9, 2006
Seller Number: 19880	Seller Loan Number: FergusonS	

TERMS

Note Rate: 1.250% Not Locked	Loan Amount: 445,000.00	Loan Product: 12 MAT B
Prepay Penalty Type: 3 Years	Sub. Lien:	Occupancy: Primary Residence
ARM Margin: 3.250%	Appraised Value: 740,000.00	MI Coverage Level:
Loan Priced with Impounds?: Yes	Sales Price:	Lien Position: 1st
Construction Period (if applicable) :	LTV: 60.14	**Decision Credit Score:** 666
Purpose: Cash Out	CLTV: 60.14	
Documentation: No Income No Asset	Debt Ratios: 0.00 / 00.00	
Property Type: 2 Unit / Duplex	Reserves : 0.00 Month(s)	

The following conditions must be received by the Conditional Approval Expiration Date shown above or the loan will be subject to cancellation by IndyMac Bank, F.S. B.

All conditions must be sent/faxed together at one time. Conditions sent individually will not be reviewed until all conditions are received. A copy of this Conditional Approval Notice must be included with the conditions as the cover sheet. Please handwrite the IndyMac Bank loan number and condition number on each page of the conditions being sent.

Direct General Inquiries to:	
Customer Advocacy Group: (800) 601-4961	**Processing Center: Mt.Laurel** **Mailing Address:**
Business Development Manager : William Carmack (516) 692-0340 Ext:	IndyMac Bank, B2B Lending Operations 303 Lippincott Dr, 3rd Floor
Customer Account Manager : Meredith Ewen (800) 300-9266 Ext: 3482	Marlton, NJ 08053

Prior To Doc

Contact: Randi Dubois
Send Conditions to Processing Center Fax: (626) 440-7533 or via Email to: B2B_NJ_UW@Indymacbank.com****

e-MITS Prior-to-Doc: External

#	Condition	Condition Comment	Received Date
32	MISCELLANEOUS #904: Awaiting e-MITS Data Correction. Following our review of this credit package, required data corrections were attempted but resulted in a "requested parameters not available" response from e-MITS. We have attempted to contact the Seller to review these. The Seller is advised to contact the underwriter to discuss alternatives. The necessary data corrections are as follows:	emits is currently down. the loan will be run in emits once all conditions are received. add'l conditions may apply	

e-MITS Prior-to-Doc: Internal

#	Condition	Condition Comment	Received Date
21	PTD #126: IndyMac in-house appraisal review and approval required. Additional conditions may follow.		Jan 9 2006 9:49AM
1	PTD #240 - Internal Condition: This loan is subject to reverification of employment/income. Please note that additional conditions may be issued as a result of this reverification.		

Prior To Doc - e-MITS Conditions

Contact: Randi Dubois
Send Conditions to Processing Center Fax: (626) 440-7533 or via Email to: B2B_NJ_UW@Indymacbank.com****

Loan Application

#	Condition	Condition Comment	Received Date
4	Completed typed 1003 Application (rev. 01/04) with no reference to income or assets. The file must not contain any documents that reference income or assets.	borrower to provide employment info, name, address and phone number. no income	
5	Completed initial 1003 Application (rev. 01/04) signed by all borrowers with no reference to income or assets.	borrower to provide employment info, name, address and phone number. no income	

Employment/Income

#	Condition	Condition Comment	Received Date

Appendix C

Ms. Avonia Carson

Ms. Avonia Carson is a 66-year-old African American. She has lived in her home in southeast Atlanta since 1971. Her adult son has lived with her since 2001 after an accident that rendered him blind and in need of 24-hour care. Ms. Carson also has custody of her three-year-old great-granddaughter, for whom she has been caring since birth. Ms. Carson is on a fixed monthly income of $1,160.00 from Social Security. In 2006, Wachovia Bank made her a mortgage loan she could not possibly afford. Five months later, JPMorgan Chase Bank made her a second mortgage she had no way of paying.

Loan Summary

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

Ability to pay

Both Wachovia and Chase made mortgage loans without regard to Ms. Carson's ability to pay. At the time of each closing, Ms. Carson's monthly income was about $1,135. The debt-to-income ratio in the first mortgage is 78%. When the first and second mortgage payments are combined ($1,265.49), the debt-to-income ratio is 112%.

Income verification

Neither Wachovia nor Chase had a loan application or any documentation of Ms. Carson's income in the respective loan files.

Wachovia apparently extended the first mortgage based on the value of the home ($167,000 per Wachovia's appraisal), not her ability to pay.

Coverage

Neither loan would be prohibited under the proposed rules. The APRs for both the first and second mortgages fall below the trigger for "higher priced loans."

Status

A demand letter was sent to Wachovia December 20, 2007. Wachovia stopped its foreclosure scheduled for January 2, 2008. Wachovia states it will respond to the demand letter at a later date.

Appendix D

Ms. Josephine Reese

Ms. Josephine Reese is a 55-year-old African American. She bought her home in southwest Atlanta in 1982 and has lived there for the past 26 years. Ms. Reese is both mentally and physically disabled. She and her 15-year-old son struggle financially, as their only support is her fixed monthly income of $1,384 from Social Security disability and a pension. On October 13, 2006, Wachovia Bank made her two mortgage loans she could never afford.

Loan Summary

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

* Interest rate and monthly payments are unknown as Wachovia did not provide these documents. Ms. Reese did not know she had a second mortgage and only learned about it after she sought legal assistance and legal aid attorneys examined the deeds filed at the county real estate record room.

Ability to pay

Wachovia made both mortgage loans without regard to Ms. Reese's ability to pay. Ms. Reese's monthly income then was about the same as it is now ($1,384). The first mortgage payment alone of $778.18 comprises 56% of her monthly income.

Income verification

Although Wachovia's loan file contains no loan application, Wachovia documented her income for its loan file with a printout of Ms. Reese's Wachovia checking account history for the previous six weeks (showing direct deposits of her Social Security and pension checks).

Wachovia apparently made these loans based on the value of her home ($126,000 according to the Wachovia loan officer), not her ability to pay.

Coverage

Neither loan would be prohibited under the proposed rules. The APR of the first mortgage falls below the trigger for "higher priced loans." The second mortgage would be excluded as it is a home equity line of credit.

Status

A demand letter was sent to Wachovia November 16, 2007. Multiple follow up telephone calls were made, but no response to the demand has been received.

Appendix E

OAKERETA WILLIAMS

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

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

Loan Summary

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

Ability to Pay:

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

Ms. Williams had substantial equity in her home. At the time of the loan, her house was appraised at $525,000.

Coverage:

Ms. Williams's loan would not violate the proposed rules because the APR falls below the trigger for "higher priced loans."

Status

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

Appendix F

HELOC Loan Pool Data – selected pools

Loan Pool	Dollar volume	No. of HELOCs	% that are 2^{nd} or junior liens	% that are cash out/refi	% that are stated income	Performance data – delinquencies
IndyMac Home Equity Mortgage Loan Asset-Backed Trust, Series 2007-H1	$650 million	8,659 (80% originated by IndyMac Bank)	98%	80%	78%	as of August 2007: 6.18% of the 2005 HELOCs, 5.89% of the 2006 HELOCs, and 3.97% of the 2007 HELOCs.
IndyMac Home Equity Mortgage Loan Asset-Backed Trust, Series 2006-H1	$490 million	8,012 (82% originated by IndyMac Bank)	98%	63%	95%	as of August 2007, 5.23% of the 2005 HELOCs, and 10.3% of the 2006 HELOCs
CWHEQ Revolving Home Equity Loan Trust, Series 2007-E	$900 million	13,213 (59% originated by Countrywide Bank, FSB and 41% by Countrywide Home Loans, Inc.)	98%			No performance data found
CWHEQ Revolving Home Equity Loan Trust, Series 2006-E	$1.5 billion	13,325	100%			No performance data found
SACO I Mortgage-Backed Notes Trust, 2006-8	$356 million	5,282 (31% originated by American Home Mortgage, 20% by SouthStar)	99%	32%	48%	As of March 2006, 3.84%
CitiGroup HELOC Trust 2006-NCB1	$794 million	18,041 (originated by National City Bank)	95%	14% refis, 66% stand alones	28% stated income; 100% interest only	No performance data found, but Moody's issued possible downgrade watch for several tranches.
First Horizon HELOC Notes 2006-HE1	$300 million	6,043	97%	76%	35%	As of Sept 2007, 5.62%. Moody's issued possible downgrade watch.
MSCC HELOC Trust 2007-1	$846 million, of which $730 million are HELOCs	8,632, of which 7,439 are HELOCs	76% of loans in pool are 2^{nd} liens; 80% of HELOCs in pool are 2^{nd} liens			Moody's issued possible downgrade watch for a tranche.
TOTAL	**$5.72 billion**	**80,014**				

In the 3rd quarter of 2005, S&P rated 10 HELOC transactions totaling $13.553 billion. See "Trends in U.S. Residential Mortgage Products: Closed-End Seconds and HELOCs Sector, Third-Quarter 2005," Standard & Poor's, Jan. 18, 2006.

Appendix G

Ms. Nessia Jones

Ms. Nessia Jones is a 55-year old African American who has lived in her home in Decatur, Georgia for 27 years. Ms. Jones has received Social Security widow's benefits since 1988. Her mental and physical health is poor and requires an extensive medication regime. Ms. Jones's adult daughter who lives with her has been disabled since an infant, is profoundly mentally retarded, and suffers from seizures. In 2006, GreenPoint Mortgage Funding made her two mortgage loans that should never have been made.

Loan Summary

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

Ability to pay

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

Income verification

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

Coverage and effect of proposed FRB rules

The second mortgage would not have been prohibited as it was a HELOC. The first mortgage would be considered a "higher priced loan." However, prevailing on a claim for an ability to pay violation would required Ms. Jones to prove that GreenPoint Mortgage engaged in a "pattern and practice" of lending without regard to repayment ability - something extremely difficult to do as she could not easily obtain information about other loans involving GreenPoint.

Status

A demand letter was sent June 18, 2007. GreenPoint denies liability. Litigation is being prepared.

Appendix H

MARY OVERTON

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

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

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

Loan Summary

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

Issue: Pattern and Practice

In October 2005, Ms. Overton (represented by South Brooklyn Legal Services) sued Ameriquest in federal court. To prove that Ameriquest engaged in a pattern and practice of extending unaffordable loans to borrowers, we asked Ameriquest to produce loan files for borrowers around New York. Ameriquest initially refused to turn over the documents. After a lengthy court battle, Ameriquest was ordered to produce about 50,000 pages of documents. The documents proved to be an enormous drain of resources on our office: two attorneys expended hundreds of hours reviewing the documents, and, as a result, were forced to turn away other low-income homeowners in need of legal assistance. Moreover, we are unable to share the documents with other attorneys or use them in any future cases because they are subject to a protective order.

Status

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

[redacted]

MARY OVERTON

SOCIAL SECURITY [redacted] NUMBER
(only the last 4 digits are shown to help prevent identity theft): XXX-XX-3641 D

Your Social Security benefits will increase by 2.7 percent in 2005, because of a rise in the cost of living. You can use this letter when you need proof of your benefit amount to receive food stamps, rent subsidies, energy assistance, bank loans, or for other business.

How Much Will I Get And When?

- Your new monthly amount (before deductions) is ______ $598.00
- The amount we are deducting for Medicare is ______ $88.00
  (If you did not have Medicare as of Nov. 19, 2004, or if someone else pays your premium, we show $0.00.)
- The amount we are deducting for voluntary federal tax withholding is ______ $0.00
  (If you did not elect voluntary federal tax withholding as of Nov. 19, 2004, we show $0.00.)
- After taking any other deductions, we will deposit into your bank account on Jan. 3, 2005. ______ $512.00

If you disagree with any of these amounts, you should write to us within 60 days from the date you receive this letter.

What If I Have Questions?

We invite you to visit our website at *www.socialsecurity.gov* on the Internet to find general information about Social Security. You also can call us at 1-800-772-1213 and speak to a representative from 7 a.m. until 7 p.m. on business days. If you have a touch-tone phone, recorded information and services are available 24 hours a day. Our lines are busiest early in the week and early in the month so, if your business can wait, it is best to call at other times. If you are deaf or hard of hearing, you may call our TTY number, 1-800-325-0778. If you are outside the United States, you can contact any U.S. embassy or consulate office, or the Veterans Affairs Regional Office in Manila. Please have your full nine-digit Social Security claim number available when you call or visit and include it on any letter you send to the Social Security Administration. If you are inside the United States, you also can visit your local office.

1640 FULTON STREET
BROOKLYN NY

BNC#: 04B1073A04898

Over ➤

SOCIAL SECURITY ADMINISTRATION
SOUTHEASTERN PROGRAM SERVICE CENTER
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BIRMINGHAM AL 35285-0001

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our website: *www.socialsecurity.gov*

AUTO 5-DIGIT 11216
MARY OVERTON
552 LAFAYETTE AVE
BROOKLYN NY 11216-1020

IMPORTANT SOCIAL SECURITY INFORMATION

Avon
652 Lafayette Avenue
Brooklyn, NY 11216

Gross income (JAN 04- DEC 31 2004).

	$12,609
LESS EXPENSES	$(1,800)
NET PROFIT	10,809

MARY OVERTON

AM 0156

Apr 20 05 07:03p p.1

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2004** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

Your first name and initial: MARY	Last name: OVERTON
Your social security number	[redacted]
If a joint return, spouse's first name and initial	Last name
Spouse's social security number	
Home address (number and street). If you have a P.O. box, see page 16. Apt. no.	652 LAFAYETTE AVE
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.	BROOKLYN NY 11216

⚠ **Important!** ⚠ You must enter your SSN(s) above.

Presidential Election Campaign (See page 16.) Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? You ☐ Yes ☑ No Spouse ☐ Yes ☐ No

Filing Status Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☑ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions
6a ☑ Yourself. If someone can claim you as a dependent, do not check box 6a
b ☐ Spouse
Boxes checked on 6a and 6b: 1
c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
TIMOTHY	OVERTON	[redacted]	GRANDSON	☐
				☐
				☐
				☐

If more than four dependents, see page 18.
No. of children on 6c who: • lived with you: 1 • did not live with you due to divorce or separation (see page 18) Dependents on 6c not entered above
d Total number of exemptions claimed. Add numbers on lines above ▶ 2

Income
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
If you did not get a W-2, see page 19.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	Taxable interest. Attach Schedule B if required	8a	
b	Tax-exempt interest. Do not include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 20) — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	12,609 18
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions 15a — b Taxable amount (see page 22)	15b	
16a	Pensions and annuities 16a — b Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	(14,835 00)
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits 20a 7,173 00 — b Taxable amount (see page 24)	20b	6,144 00
21	Other income. List type and amount (see page 24)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	3,918 18

Adjusted Gross Income

23	Educator expenses (see page 26)	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	IRA deduction (see page 26)	25			
26	Student loan interest deduction (see page 28)	26			
27	Tuition and fees deduction (see page 29)	27			
28	Health savings account deduction. Attach Form 8889	28			
29	Moving expenses. Attach Form 3903	29			
30	One-half of self-employment tax. Attach Schedule SE	30	1,085 80		
31	Self-employed health insurance deduction (see page 30)	31			
32	Self-employed SEP, SIMPLE, and qualified plans	32			
33	Penalty on early withdrawal of savings	33			
34a	Alimony paid b Recipient's SSN ▶	34a			
35	Add lines 23 through 34a			35	1,085 80
36	Subtract line 35 from line 22. This is your adjusted gross income ▶			36	2,833 18

Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2004)

AM 0157

Form 1040 (2004) Page 2

Tax and Credits

37	Amount from line 36 (adjusted gross income)	37	2,833	18
38a	Check if: ☑ You were born before January 2, 1940, ☐ Blind. ☐ Spouse was born before January 2, 1940, ☐ Blind. Total boxes checked ▶ 38a 1			
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 38b ☐			
39	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	39	7,150	00
40	Subtract line 39 from line 37	40	(4,316	82)
41	If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet on page 33	41	6,200	00
42	Taxable income. Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-	42	0	00
43	Tax (see page 33). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972	43		
44	Alternative minimum tax (see page 35). Attach Form 6251	44		
45	Add lines 43 and 44 ▶	45	0	00
46	Foreign tax credit. Attach Form 1116 if required	46		
47	Credit for child and dependent care expenses. Attach Form 2441	47		
48	Credit for the elderly or the disabled. Attach Schedule R	48		
49	Education credits. Attach Form 8863	49		
50	Retirement savings contributions credit. Attach Form 8880	50		
51	Child tax credit (see page 37)	51		
52	Adoption credit. Attach Form 8839	52		
53	Credits from: a ☐ Form 8396 b ☐ Form 8859	53		
54	Other credits. Check applicable box(es): a ☐ Form 3800 b ☐ Form 8801 c ☐ Specify	54		
55	Add lines 46 through 54. These are your total credits	55	0	00
56	Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- ▶	56	0	00

Standard Deduction for—
- People who checked any box on line 38a or 38b or who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $4,850

Married filing jointly or Qualifying widow(er), $9,700

Head of household, $7,150

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	1,781	62
58	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	58		
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59		
60	Advance earned income credit payments from Form(s) W-2	60		
61	Household employment taxes. Attach Schedule H	61		
62	Add lines 56 through 61. This is your total tax ▶	62	1,781	62

Payments

63	Federal income tax withheld from Forms W-2 and 1099	63		
64	2004 estimated tax payments and amount applied from 2003 return	64		
65a	Earned income credit (EIC)	65a		
b	Nontaxable combat pay election ▶ 65b			
66	Excess social security and tier 1 RRTA tax withheld (see page 54)	66		
67	Additional child tax credit. Attach Form 8812	67		
68	Amount paid with request for extension to file (see page 54)	68		
69	Other payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	69		
70	Add lines 63, 64, 65a, and 66 through 69. These are your total payments ▶	70	0	00

If you have a qualifying child, attach Schedule EIC.

Refund

71	If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you overpaid	71		
72a	Amount of line 71 you want refunded to you ▶	72a		
b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
d	Account number			
73	Amount of line 71 you want applied to your 2005 estimated tax ▶ 73			

Direct deposit? See page 54 and fill in 72b, 72c, and 72d.

Amount You Owe

74	Amount you owe. Subtract line 70 from line 62. For details on how to pay, see page 55 ▶	74	1,781	62
75	Estimated tax penalty (see page 55) 75			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? ☐ Yes. Complete the following. ☐ No

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 17. Keep a copy for your records.

Your signature [signature] | Date | Your occupation | Daytime phone number ( )

Spouse's signature. If a joint return, both must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ TURBO TAX | EIN | Phone no. ( )

Form 1040 (2004)

AM 0158

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

▶ Attach to Form 1040 or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2004

Attachment Sequence No. 09

Name of proprietor: MARY OVERTON

Social security number (SSN): [redacted]

A Principal business or profession, including product or service (see page C-2 of the instructions): SALES REP.

B Enter code from pages C-7, 8, & 9 ▶

C Business name. If no separate business name, leave blank: AVON

D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶ 652 LAFAYETTE AVE
City, town or post office, state, and ZIP code: BROOKLYN NY 11216

F Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2004? If "No," see page C-3 for limit on losses ☑ Yes ☐ No

H If you started or acquired this business during 2004, check here ▶ ☐

Part I Income

1	Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐	1	15,369 18
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	15,369 18
4	Cost of goods sold (from line 42 on page 2)	4	960 00
5	Gross profit. Subtract line 4 from line 3	5	14,409 18
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	Gross income. Add lines 5 and 6 ▶	7	14,409 18

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising		19	Pension and profit-sharing plans	
9	Car and truck expenses (see page C-3)		20	Rent or lease (see page C-5):	
			20a	a Vehicles, machinery, and equipment	
10	Commissions and fees		20b	b Other business property	
11	Contract labor (see page C-4)		21	Repairs and maintenance	
12	Depletion		22	Supplies (not included in Part III)	960 00
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)		23	Taxes and licenses	
			24	Travel, meals, and entertainment:	
			24a	a Travel	
14	Employee benefit programs (other than on line 19)			b Meals and entertainment	
15	Insurance (other than health)			c Enter nondeductible amount included on line 24b (see page C-5)	
16	Interest:				
16a	a Mortgage (paid to banks, etc.)		24d	d Subtract line 24c from line 24b	
16b	b Other		25	Utilities	
17	Legal and professional services		26	Wages (less employment credits)	
18	Office expense	840 00	27	Other expenses (from line 48 on page 2)	

28	Total expenses before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	1,800 00
29	Tentative profit (loss). Subtract line 28 from line 7	29	12,609 18
30	Expenses for business use of your home. Attach Form 8829	30	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.	31	12,609 18

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you must attach Form 6198.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P Schedule C (Form 1040) 2004

AM 0159

Part III Cost of Goods Sold (see page C-6)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35		
36 Purchases less cost of items withdrawn for personal use	36		
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38	960	00
39 Other costs	39		
40 Add lines 35 through 39	40	960	00
41 Inventory at end of year	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	960	00

Part IV Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ ....../....../......

44 Of the total number of miles you drove your vehicle during 2004, enter the number of miles you used your vehicle for:

a Business .... b Commuting .... c Other ....

45 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

47a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48 Total other expenses. Enter here and on page 1, line 27	48	

Schedule C (Form 1040) 2004

AM 0160

SCHEDULE E (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

2004

Attachment Sequence No. 13

Name(s) shown on return: MARY OVERTON

Your social security number: [redacted]

Part I Income or Loss From Rental Real Estate and Royalties Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). Report farm rental income or loss from Form 4835 on page 2, line 40.

1 List the type and location of each rental real estate property:

A	3 FAMILY 652 LAFAYETTE AVE BROOKLYN NY 11216
B	
C	

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days or
- 10% of the total days rented at fair rental value?

(See page E-3.)

	Yes	No
A	✓	
B		
C		

	Line	Properties A	B	C	Line	Totals (Add columns A, B, and C.)
Income:						
3 Rents received	3	39,340 00			3	39,340 00
4 Royalties received	4				4	
Expenses:						
5 Advertising	5	650 00				
6 Auto and travel (see page E-4)	6					
7 Cleaning and maintenance	7	4,800 00				
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10	3,900 00				
11 Management fees	11	8,200 00				
12 Mortgage interest paid to banks, etc. (see page E-4)	12				12	
13 Other interest	13					
14 Repairs	14	9,916 00				
15 Supplies	15	4,575 00				
16 Taxes	16	5,386 00				
17 Utilities	17	2,864 00				
18 Other (list) ▶ HEATING	18	3,240 00				
WATER	18	2,100 00				
19 Add lines 5 through 18	19	45,631 00			19	45,631 00
20 Depreciation expense or depletion (see page E-4)	20	8,544 00			20	8,544 00
21 Total expenses. Add lines 19 and 20	21	54,175 00				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-4 to find out if you must file Form 6198	22	(14,835 00)				
23 Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file Form 8582. Real estate professionals must complete line 43 on page 2	23	(14,835 00)	( )	( )		

24 Income. Add positive amounts shown on line 22. Do not include any losses	24	
25 Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	(14,835 00)
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2	26	(14,835 00)

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L Schedule E (Form 1040) 2004

AM 0161

Schedule E (Form 1040) 2004 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side.
MARY OVERTON

Your social security number [redacted]

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which any amount is not at risk, you must check column (e) on line 28 and attach Form 6198. See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? ☐ Yes ☐ No
If you answered "Yes," see page E-6 before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A					
B					
C					
D					

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (g) and (j) of line 29a	30	
31	Add columns (f), (h), and (i) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-6)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below | 39 |

Part V Summary

40	Net farm rental income or (loss) from Form 4835. Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17 ▶	41	(14,835 00)
42	**Reconciliation of farming and fishing income.** Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code N; and Schedule K-1 (Form 1041), line 14 (see page E-6)	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see page E-1), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Schedule E (Form 1040) 2004

AM 0162

Form 1040

Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2003 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20 OMB No. 1545-0074

Label

(See instructions on page 19.) Use the IRS label. Otherwise, please print or type.

Your first name and initial: MARY	Last name: OVERTON	Your social security number: [redacted]
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 19. 652 LAFAYETTE AVE	Apt. no.	▲ Important! ▲ You must enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19. BROOKLYN NY 11216		

Presidential Election Campaign (See page 19.) Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You: ☐ Yes ☑ No Spouse: ☐ Yes ☐ No

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☑ Head of household (with qualifying person). (See page 20.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child. (See page 20.)

Exemptions

6a ☐ Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a — No. of boxes checked on 6a and 6b: 1
b ☐ Spouse
c Dependents: — No. of children on 6c who: • lived with you: 1; • did not live with you due to divorce or separation (see page 21); Dependents on 6c not entered above

If more than five dependents, see page 21.

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 21)
TIMOTHY	OVERTON	061 80 3189	GRANDSON	☐
				☐
				☐
				☐
				☐

d Total number of exemptions claimed — Add numbers on lines above ▶ 2

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	Taxable interest. Attach Schedule B if required		
b	Tax-exempt interest. Do not include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		
b	Qualified dividends (see page 23)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		9,303 93
13a	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		
b	If box on 13a is checked, enter post-May 5 capital gain distributions	13b	
14	Other gains or (losses). Attach Form 4797		
15a	IRA distributions 15a	b Taxable amount (see page 25) 15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 25) 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		(7,464 00
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a 7,176 00	b Taxable amount (see page 27) 20b	6,144 00
21	Other income. List type and amount (see page 27)		
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶		7,983 93

Adjusted Gross Income

23	Educator expenses (see page 29)	23		
24	IRA deduction (see page 29)	24		
25	Student loan interest deduction (see page 31)	25		
26	Tuition and fees deduction (see page 32)	26		
27	Moving expenses. Attach Form 3903	27		
28	One-half of self-employment tax. Attach Schedule SE	28	657 30	
29	Self-employed health insurance deduction (see page 33)	29		
30	Self-employed SEP, SIMPLE, and qualified plans	30		
31	Penalty on early withdrawal of savings	31		
32a	Alimony paid b Recipient's SSN ▶	32a		
33	Add lines 23 through 32a			657 03
34	Subtract line 33 from line 22. This is your adjusted gross income ▶			7,326 90

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 77. Cat. No. 11320B Form 1040 (2003)

AM 0163

Tax and Credits

Standard Deduction for— • People who checked any box on line 35a or 35b or who can be claimed as a dependent, see page 34. • All others: Single or Married filing separately, $4,750; Married filing jointly or Qualifying widow(er), $9,500; Head of household, $7,000

35	Amount from line 34 (adjusted gross income)			35	7,326 90
36a	Check if: ☐ You were born before January 2, 1939, ☐ Blind. ☐ Spouse was born before January 2, 1939, ☐ Blind. Total boxes checked ▶ 36a				
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 35b ☐				
37	Itemized deductions (from Schedule A) or your standard deduction (see left margin)			37	7,000 00
38	Subtract line 37 from line 35			38	326 90
39	If line 35 is $104,625 or less, multiply $3,050 by the total number of exemptions claimed on line 6d. If line 35 is over $104,625, see the worksheet on page 35			39	6,100 00
40	Taxable income. Subtract line 39 from line 38. If line 39 is more than line 38, enter -0-			40	0 00
41	Tax (see page 36). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972			41	
42	Alternative minimum tax (see page 38). Attach Form 6251			42	
43	Add lines 41 and 42 ▶			43	0 00
44	Foreign tax credit. Attach Form 1116 if required	44			
45	Credit for child and dependent care expenses. Attach Form 2441	45			
46	Credit for the elderly or the disabled. Attach Schedule R	46			
47	Education credits. Attach Form 8863	47			
48	Retirement savings contributions credit. Attach Form 8880	48			
49	Child tax credit (see page 40)	49			
50	Adoption credit. Attach Form 8839	50			
51	Credits from: a ☐ Form 8396 b ☐ Form 8859	51			
52	Other credits. Check applicable box(es): a ☐ Form 3800 b ☐ Form 8801 c ☐ Specify	52			
53	Add lines 44 through 52. These are your total credits			53	0 00
54	Subtract line 53 from line 43. If line 53 is more than line 43, enter -0- ▶			54	0 00

Other Taxes

55	Self-employment tax. Attach Schedule SE			55	1,314 60
56	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			56	
57	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required			57	
58	Advance earned income credit payments from Form(s) W-2			58	
59	Household employment taxes. Attach Schedule H			59	
60	Add lines 54 through 59. This is your total tax ▶			60	1,314 60

Payments

If you have a qualifying child, attach Schedule EIC.

61	Federal income tax withheld from Forms W-2 and 1099	61			
62	2003 estimated tax payments and amount applied from 2002 return	62			
63	Earned income credit (EIC)	63			
64	Excess social security and tier 1 RRTA tax withheld (see page 56)	64			
65	Additional child tax credit. Attach Form 8812	65			
66	Amount paid with request for extension to file (see page 56)	66			
67	Other payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	67			
68	Add lines 61 through 67. These are your total payments ▶			68	0 00

Refund

Direct deposit? See page 56 and fill in 70b, 70c, and 70d.

69	If line 68 is more than line 60, subtract line 60 from line 68. This is the amount you overpaid			69	
70a	Amount of line 69 you want refunded to you ▶			70a	
b	Routing number ▶ c Type: ☐ Checking ☐ Savings				
d	Account number				
71	Amount of line 69 you want applied to your 2004 estimated tax ▶	71			

Amount You Owe

72	Amount you owe. Subtract line 68 from line 60. For details on how to pay, see page 57 ▶			72	1,314 60
73	Estimated tax penalty (see page 58)	73			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 58)? ☐ Yes. Complete the following. ☐ No

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 20. Keep a copy for your records.

Your signature [signature] | Date | Your occupation | Daytime phone number ( )

Spouse's signature. If a joint return, both must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

Form 1040 (2003)

AM 0164

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

▶ Attach to Form 1040 or 1041. ▶ See instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2003

Attachment Sequence No. 09

Name of proprietor: MARY OVERTON

Social security number (SSN): [redacted]

A Principal business or profession, including product or service (see page C-2 of the instructions): SALES REP.

B Enter code from pages C-7, 8, & 9 ▶

C Business name. If no separate business name, leave blank.: AVON

D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶ 652 LAFAYETTE AVE
City, town or post office, state, and ZIP code: BROOKLYN NY 11216

F Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2003? If "No," see page C-3 for limit on losses . ☑ Yes ☐ No

H If you started or acquired this business during 2003, check here ▶ ☐

Part I Income

1	Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐	1	11,347	93
2	Returns and allowances	2		
3	Subtract line 2 from line 1	3	11,347	93
4	Cost of goods sold (from line 42 on page 2)	4	710	00
5	Gross profit. Subtract line 4 from line 3	5	10,637	93
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6		
7	Gross income. Add lines 5 and 6 ▶	7	10,637	93

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising	8			19	Pension and profit-sharing plans	19		
9	Car and truck expenses (see page C-3)	9			20	Rent or lease (see page C-5):			
					a	Vehicles, machinery, and equipment	20a		
10	Commissions and fees	10			b	Other business property	20b		
11	Contract labor (see page C-4)	11			21	Repairs and maintenance	21		
					22	Supplies (not included in Part III)	22	710	00
12	Depletion	12			23	Taxes and licenses	23		
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13			24	Travel, meals, and entertainment:			
					a	Travel	24a		
14	Employee benefit programs (other than on line 19)	14			b	Meals and entertainment			
15	Insurance (other than health)	15			c	Enter nondeductible amount included on line 24b (see page C-5)			
16	Interest:								
a	Mortgage (paid to banks, etc.)	16a			d	Subtract line 24c from line 24b	24d		
b	Other	16b			25	Utilities	25		
17	Legal and professional services	17			26	Wages (less employment credits)	26		
18	Office expense	18	624	00	27	Other expenses (from line 48 on page 2)	27		

28	Total expenses before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	1,334	00
29	Tentative profit (loss). Subtract line 28 from line 7	29	9,303	93
30	Expenses for business use of your home. Attach Form 8829	30		
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.	31	9,303	93

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you must attach Form 6198.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

AM 0165

Schedule C (Form 1040) 2003 Page 2

Part III Cost of Goods Sold (see page C-6)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35		
36 Purchases less cost of items withdrawn for personal use	36		
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38	710	00
39 Other costs	39		
40 Add lines 35 through 39	40	710	00
41 Inventory at end of year	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	710	00

Part IV Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ ____/____/____

44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:

a Business ______ b Commuting ______ c Other ______

45 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

47a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48 Total other expenses. Enter here and on page 1, line 27	48	

Schedule C (Form 1040) 2003

AM 0

SCHEDULE E (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

2003

Attachment Sequence No. 13

Name(s) shown on return: MARY OVERTON

Your social security number: [redacted]

Part I **Income or Loss From Rental Real Estate and Royalties** Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-2). Report farm rental income or loss from Form 4835 on page 2, line 40.

	1 Show the kind and location of each rental real estate property:	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.)		Yes	No
A	3 FAMILY 652 LAFAYETTE AVE BROOKLYN NY 11216		A	✓	
B			B		
C			C		

			Properties A		Properties B		Properties C			Totals (Add columns A, B, and C)	
Income:											
3	Rents received	3	37,680	00					3	37,680	00
4	Royalties received	4							4		
Expenses:											
5	Advertising	5	600	00							
6	Auto and travel (see page E-4)	6									
7	Cleaning and maintenance	7	4,500	00							
8	Commissions	8									
9	Insurance	9									
10	Legal and other professional fees	10									
11	Management fees	11	8,200	00							
12	Mortgage interest paid to banks, etc. (see page E-4)	12							12		
13	Other interest	13									
14	Repairs	14	9,093	00							
15	Supplies	15	5,225	00							
16	Taxes	16	4,976	00							
17	Utilities	17	2,934	00							
18	Other (list) ▶ HEATING WATER	18	1,941	00							
19	Add lines 5 through 18	19	37,469	00					19	37,469	00
20	Depreciation expense or depletion (see page E-4)	20	7,675	00					20	7,675	00
21	Total expenses. Add lines 19 and 20	21	45,144	00							
22	Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-4 to find out if you must file Form 6198	22	(7,464	00							
23	Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file Form 8582. Real estate professionals must complete line 43 on page 2	23	(7,464	00)	(	)	(	)			

24	Income. Add positive amounts shown on line 22. Do not include any losses	24		
25	Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	(7,464	00)
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2	26	(7,464	00

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L Schedule E (Form 1040) 2003

Schedule E (Form 1040) 2003 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side.
MARY OVERTON

Your social security number [redacted]

Part II Income or Loss From Partnerships and S Corporations Note. If you report a loss from an at-risk activity for which any amount is not at risk, you must check column (e) on line 28 and attach Form 6198. See page E-1.

27 Are you reporting losses not allowed in prior years due to the at-risk or basis limitations, passive losses not reported on Form 8582, or unreimbursed partnership expenses? ☐ Yes ☐ No
If you answered "Yes," see page E-5 before completing this section.
Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A					
B					
C					
D					

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1
A					
B					
C					
D					
29a Totals					
b Totals					

30 Add columns (g) and (j) of line 29a	30	
31 Add columns (f), (h), and (i) of line 29b	31	( )
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
34a Totals				
b Totals				

35 Add columns (d) and (f) of line 34a	35	
36 Add columns (c) and (e) of line 34b	36	( )
37 Total estate and trust income or (loss). Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38 (a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-6)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40 Net farm rental income or (loss) from Form 4835. Also, complete line 42 below	40	
41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17 ▶	41	(7,464 00
42 Reconciliation of Farming and Fishing Income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 14 (see page E-6)	42	
43 Reconciliation for Real Estate Professionals. If you were a real estate professional (see page E-1), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

AM 0168

LEASE AGREEMENT

LEASE AGREEMENT made this March 10 (Month & Day), 2004 (Year), between James thompson, with an address at 652 Lafayette Ave Brooklyn NY 11216 (hereinafter referred to as "Landlord") and Mary overton, with an address at Same As Above (hereinafter referred to as "Tenant").

IT IS THEREFORE AGREED:

1. PREMISES: The Landlord shall lease to the Tenant the premises located at: 652 Lafayette Ave Brooklyn NY 11216

2. LEASE TERM: The term of this lease shall be for a period of (2) year(s), commencing March 10 (Month & Day), 04 (Year), and terminating March 30 (Month & Day), 06 (Year). The lease term can be extended only by mutual agreement of the parties hereto.

3. RENTAL AMOUNT: The Tenant shall pay to the Landlord an annual sum of ______ ($25,200) to lease the property. Rental payments shall be paid in monthly payments, each of which shall be in the amount of 2100 ______ ($ 2100), and each of which shall be paid on the 10 day of the month.

4. OPTION TO RENEW: The Tenant shall have an option to renew this lease on the premises for a (______) year period upon the following terms and conditions: N/A

The Tenant's option to renew must be exercised in writing and must be received by the Landlord no less than (____) days before the expiration of this lease or any extensions thereof.

5. ARBITRATION: Any controversy or claim arising out of or relating to this lease agreement or the breach thereof shall be settled by arbitration in accordance with the rules then obtaining of the American Arbitration Association, and judgment upon the award rendered may be entered and enforced in any court having jurisdiction thereof.

6. NO VIOLATION OR BREACH: The Landlord and the Tenant warrant and represent each to the other that the performance of this agreement does not violate any laws, statutes, local ordinances, state or federal regulations, regarding controlled substances, or otherwise, or any court order or administrative order or ruling, nor is

such performance in violation of any loan document's conditions or restrictions in effect for financing, whether secured or unsecured.

7. BENEFIT: This agreement shall be binding upon and inure to the benefit of the parties hereto and their legal representatives, successors and assigns.

8. NOTICES: Any notice required or desired to be given under this agreement shall be deemed given if in writing sent by certified mail to the addresses of the parties to this lease agreement as follows:

Landlord: N/A (Name & Address)

Tenant: N/A (Name & Address)

9. CAPTIONS: Captions are used in this agreement for convenience only and are not intended to be used in the construction or in the interpretation of this agreement.

10. INVALID PROVISION: In the event any provision of this agreement is held to be void, invalid or unenforceable in any respect, then the same shall not affect the remaining provisions hereof, which shall continue in full force and effect.

11. ENTIRE AGREEMENT: This agreement contains the entire understanding of the parties. It may not be changed orally. This agreement may be amended or modified only in writing that has been executed by both parties hereto.

12. INTERPRETATION: This lease agreement shall be interpreted under the laws of the State of New York.

Landlord ________ Date 3/10/04

Tenant James Thompson Date 3/10/04

Account Overview

PRINT THIS PAGE

Participant Name: MARY OVERTON

YOUR BALANCES as of 03/31/2005		PERSONALIZED RATE OF RETURN*	
Total plan balance	$54,231.54	Last month	1.77%
Outstanding loan balance	$12,497.03	Last quarter	-.47%
Plan balance	$41,734.51	Year to date	2.46%
Vested balance	$54,231.54	One year	7.51%

INVESTMENT SUMMARY as of 03/31/2005

Go to Investment Source Summary

DEFERRED SALARY PLAN OF THE ELECTRICAL INDUSTRY

Your Investments	Share price	Share balance	Market value	Percent
JIB CAPITAL PRESERVATION FUND	$1.000	28,063.810	$28,063.81	52%
LOAN BALANCE	N/A	N/A	$12,497.03	23%
PUTNAM NEW OPPORTUNITIES Y	$42.610	264.746	$11,280.83	21%
DSP S&P500	$18.140	34.273	$621.71	1%
PUTNAM INVESTORS FUND Y	$12.690	37.056	$470.24	1%
PUTNAM BOND INDEX FUND	$14.030	29.640	$415.85	1%
PUTNAM EQUITY INCOME FUND Y	$17.400	17.743	$308.73	1%
PUTNAM ASSET ALLOC GROWTH Y	$11.130	18.901	$210.37	<1%
PUTNAM ASSET ALLOC CONSERV Y	$9.130	15.519	$141.69	<1%
GEORGE PUTNAM FUND OF BOSTON Y	$18.080	6.852	$123.88	<1%
PUTNAM ASSET ALLOC BALANCED Y	$10.600	9.189	$97.40	<1%
Total Plan Balance				$54,231.54

Total investment summary percentages may be shown as slightly higher or lower than 100% because of rounding.

Cash Reserves

Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus or an offering statement containing this and other information about any fund, please click on the prospectus link in the top navigation bar or call your plan's toll-free number. Read the prospectus or offering statement carefully before making any investment decisions.

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PUTNAM INVESTMENTS

Cash Reserves