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Pat V. Combs, ABR, CRS, GRI, PMN
President

August 15, 2007

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Home Equity Lending Market; Notice of Hearings (request for comments), Docket No. OP-1288

[transmitted by email to regs.comments@federalreserve.gov]

Dear Ms. Johnson:

On behalf of more than 1.3 million members of the National Association of REALTORS® (NAR), I am pleased to recommend to the Board of Governors of the Federal Reserve System (the Board) that the Board issue regulations prohibiting unfair, deceptive, and abusive acts and practices in the mortgage market under the authority granted by section 129(l)(2) of the Home Ownership and Equity Protection Act of 1994 (HOEPA).

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

REALTORS® have a strong stake in preventing abusive lending because:

- Abusive lending erodes confidence in the Nation's housing system.
- In a credit-driven economy, the legislative and regulatory response to lending abuses can go too far and inadvertently limit the availability of reasonable credit for prime as well as subprime borrowers.

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

EQUAL HOUSING OPPORTUNITY

- Abusive lending strips equity from homeowners and harms citizens of communities, including REALTORS®, especially when the irresponsible lenders concentrate their activities on certain neighborhoods and create a downward cycle of economic deterioration that affects the entire community.

I. NAR Supports Board Rulemaking

The financial markets are struggling with the results of abusive lending practices in the subprime mortgage market, including significant repricing of mortgage-backed and related securities, the failure of more than 100 subprime lenders, and the collapse of several investment funds that invested heavily in subprime mortgages. NAR continues to believe that borrowers who have demonstrated the financial capacity to meet their mortgage obligations, whether prime or subprime, should continue to have access to mortgage loans made by responsible lenders.

NAR urges the Board to adopt regulations applicable to mortgage originators (including mortgage lenders and mortgage brokers) to combat unfair, deceptive, and abusive mortgage lending acts and practices based on its HOEPA authority. A rule has the potential to reassure investors and borrowers and help stave off or recover from an unnecessary overreaction that could deny mortgage loans to borrowers who are willing and able to meet their obligations under their mortgages—whether prime, Alt-A, or subprime.

Too many homeowners and home buyers today are the victims of failure of the free market, the scope and impact of which remain unclear. It is clear, however, that abusive lending practices require a government response. Some subprime mortgage originators premised their business plan on a housing market with ever-increasing home prices and repeated refinancings by borrowers seeking to escape unaffordable mortgages. Aside from the faulty premise of assuming that home prices only go up, making loans designed to be refinanced multiple times over a short time constitutes equity stripping because they generate high fees that are often hidden in a new, higher principal amount. Families who could have realized and retained significant home equity and sustainable homeownership if they had been offered a traditional 30-year, fixed rate subprime mortgage now struggle to retain their home and even face foreclosure due to the hybrid adjustable rate mortgage (ARM) product they were sold.

NAR has welcomed the efforts of the federal banking agencies and their state counter-parts to address abusive lending practices by issuing the Interagency Guidance on Nontraditional Mortgage Product Risks[1] and the Statement on Subprime Mortgage Lending[2]. While billed as guidelines, not requirements, it is clear that an insured depository institution that ignores the guidelines does so at its peril, because banking examiners are likely to determine that ignoring the guidelines is in itself unsafe and unsound, the cardinal sin of banking regulation. But many mortgage lenders that are not federally insured banks, thrifts, or credit unions (or their affiliates) are not covered by the agencies' guidelines in states that have not yet adopted parallel guidance. In any case, they may not be subject to the level of supervision that is likely to result in consistent compliance. The Board should address this potential regulatory gap.

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[1] 71 Fed. Reg. 58609 (Oct. 4, 2006)
[2] 72 Fed. Reg. 37569 (July 10, 2007)

Accordingly, in light of the market impact of irresponsible lending practices and the need to ensure that strong standards apply to all mortgage originators, NAR urges the Board to adopt regulations to prevent unfair, deceptive, and abusive mortgage lending. In addition, NAR continues to believe that each state should retain its authority to establish higher standards designed to combat the problems it finds in its own housing and mortgage markets.

II. NAR Response to Specific Questions Raised by the Board

NAR supports the general principle that all mortgage originators should act in "good faith and with fair dealings" in a mortgage transaction and treat all parties honestly. NAR encourages the Board to use such a standard of care as a guiding principle when drafting regulations. Such a standard should not be used to create a new federal duty that would be too general and, therefore, too difficult to enforce. NAR's Code of Ethics already imposes a similar requirement on REALTORS®, who are required to treat everyone in the transaction honestly. REALTORS® are not asking mortgage originators to do anything they don't already ask of themselves.

A. Prepayment Penalties.

In 2005, NAR adopted its policy opposing prepayment penalties for all mortgages. Prepayment penalties often trap borrowers in loans they cannot afford by making them too expensive to refinance. While some lenders may, in fact, offer lower rates in exchange for a borrower agreeing to a prepayment penalty, in the experience of many REALTORS®, that option is not typical. A 2005 study by the Center for Responsible Lending concluded that borrowers with subprime loans and prepayment penalties do not receive lower interest rates, and may actually pay higher rates.[3] The use of prepayment penalties with terms that extend beyond the initial fixed interest rate period that is a feature of many adjustable rate mortgages is particularly egregious. Some originators encourage consumers to accept these loans by reassuring them that they can always avoid a jump in payments by refinancing before the reset period. But then, when they do refinance, assuming they can in the current credit environment, the lender charges a prepayment penalty. This is one of the most unfair practices engaged in by irresponsible lenders.

If complete prohibition of prepayment penalties is not feasible for all categories of mortgages, NAR urges that the Board bar their use for subprime mortgages and other categories of mortgages where it identifies the worst abuses. Failing that, the Board should permit prepayment penalties only for the shortest time and the lowest amount possible. For example, a borrower with a 2/28 mortgage should be able to refinance by the end of the initial two-year "teaser" rate period without having to pay a prepayment penalty.

Because there are serious questions about whether borrowers benefit from agreeing to prepayment penalties, if the lender is permitted to and does offer a mortgage with a prepayment penalty, it should offer an appropriate choice of mortgages, with and without prepayment

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[3] "Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages," Center for Responsible Lending (January 2005).

penalties, so the borrower can make a real choice based on how long they plan to keep the mortgage.

B. Escrow for Taxes and Insurance on Subprime Loans

Unlike lenders making prime mortgage loans, subprime lenders typically do not require borrowers to include an additional amount in their monthly mortgage payment, to be placed in an escrow/reserve/impound account by the lender or the mortgage servicer for payment to the insurance company and taxing authority. NAR knows of no reasonable explanation for this counter-intuitive practice. One inappropriate reason is to make refinancing, together with another round of fees, necessary for many borrowers as they face unplanned-for tax and insurance bills they cannot afford to pay. Another possible explanation is that lenders have intentionally chosen to underwrite subprime loans without considering the costs of taxes and insurance in order to approve more loans and, in turn, receive more fee income.

NAR urges the Board to require subprime lenders to require an escrow for taxes and insurance, with limited exceptions. Similar to the exception for prime loans in some jurisdictions, borrowers that make at least a 20 percent downpayment should have the option to budget for these payments on their own. The regulations should specify other reasonable criteria, or permit lenders to do so in writing, for exceptions to this policy. Of course, any exception to the general rule must be limited and not become the general rule.

NAR opposes limiting the mandatory monthly payment of amounts for taxes and insurance to only the first year or two of the mortgage. This would not adequately protect subprime borrowers, since most of the borrowers with subprime loans will continue to benefit from the discipline that is typical for those with prime mortgages.

C. "Stated Income" or "Low Doc" Loans

Because mortgages based on "stated income" or "low doc" underwriting typically have higher rates, lenders making subprime loans should, as a general rule, underwrite loans based on verified income and verified assets. In too many cases, borrowers are not aware that the faster processing that can come with a "stated income" or "low doc" loan comes at a high cost—higher rates and higher mortgage payments for the life of the loan. Practically all borrowers are in a position to supply documents lenders may use to verify their income and assets so they can qualify for the lowest possible rate.

NAR believes that the Board should allow exceptions when there are mitigating factors, consistent with the federal banking agencies' Statement on Subprime Mortgage Lending. The rule should make clear that any exception to this policy should be limited to a small percentage of loans and the circumstances should be documented.

In all cases, lenders should offer borrowers the option of documenting income and assets, even if they fit within an exception.

D. Unaffordable Loans.

NAR supports strong underwriting standards that require all mortgage originators, not just subprime lenders, to verify the borrower's ability to repay the loan based on all its terms, including taxes and insurance, without having to refinance or sell the home.[4] Lenders should consider all relevant facts, including the borrower's income, credit history, future income potential, and other life circumstances. Lenders should not makes loans to borrowers that make loss of the home through deed in lieu of foreclosure or foreclosure likely if the borrower is unable to refinance the mortgage or sell the home.

- **Underwriting Subprime Loans with "Teaser Rates."** Some subprime loans are structured with a significant jump in monthly payments often resulting in "payment shock" for the borrower. While these mortgages may be a reasonable choice for the few subprime borrowers who can afford a significant increase in their monthly payment, a majority of subprime borrowers do not understand the unique terms and conditions of these risky mortgage products that can result in a significant "payment shock." NAR recommends that lenders should exercise more caution when underwriting these loans for subprime borrowers to make sure the borrower is able to afford the mortgage payments at the reset rate. Examples of these risky mortgage products include loans with a short-term "teaser" interest rate for the first two or three years (such as 2/28s and 3/27s).

- **Reasonable Debt-to-Income Ratio.** NAR supports requiring lenders to adopt a written policy to assure that their subprime loans result in a reasonable debt-to-income ratio for the borrowers. Borrowers should have enough residual income after making their monthly mortgage payment, including taxes and insurance, to meet their needs for food, utilities, clothing, transportation, work-related expenses, and other essentials. Requiring underwriting at a fully amortizing, fully indexed rate is meaningless if the lender uses such high debt-to-income ratios that the family doesn't have enough income remaining to pay for other necessities.

  NAR does not recommend a rigid percentage cap on debt-to-income ratios, because each circumstance is different and acceptable debt-to-income ratios have increased dramatically over the last 30 years. However, we ask the Board to consider providing guidelines that take into account income, family size, and regional cost of living to help lenders in developing their policies.

- **Flexibility for Life Circumstances.** NAR believes that a standard for determining a borrower's ability to repay must be flexible to accommodate borrowers with unique circumstances. The Guidelines and the Statement do not provide this flexibility, but since they are not regulatory requirements, we think that lenders could adopt the "fully indexed, fully amortizing" underwriting standard as a general rule but permit limited exceptions that should be documented in writing. If the Board does not accept NAR's

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[4] The limited exceptions to this general principle would include prime borrowers with sufficient verifiable assets to handle a balloon mortgage or a significant jump in mortgage payment.

recommendation and issues the "fully indexed, fully amortizing" underwriting standard without permitting exceptions, we think some borrowers will unnecessarily and inappropriately be denied homeownership. NAR believes a Board rule should provide flexibility in circumstances such as:

- Borrowers who have demonstrated the ability to make monthly payments, over a long term, that are higher than underwriting standards would otherwise allow. Lenders should consider, for example, the borrower's history of making rent, utilities and student loan payments.
- Borrowers with high assets but low income who, for cash management or other financial planning reasons, elect a mortgage with a monthly payment that their current income is not sufficient to cover.
- Borrowers who anticipate a jump in income or assets due to life events such as graduation, completion of professional training, completion of payment obligations for student or car loans, or another member of the household entering the work force when young children start school.

III. Additional NAR Recommendations

NAR has the following additional recommendations for Board rulemaking.

A. Anti-Mortgage Flipping. NAR recommends requiring mortgage originators making or arranging for a loan that refinances an existing residential mortgage to verify that the new loan provides a significant benefit to the borrower. One test often proposed is the loan must provide a "reasonable net tangible benefit" to the borrower. The lender should consider the circumstances of the borrower, as discussed above, all terms of the new loan including taxes and insurance, the fees and other costs of refinance, prepayment penalties, and the new interest rate compared to that of the refinanced loan.

B. Improvements for Assessing Creditworthiness.

- **Alternative Credit History.** Borrowers with little or no credit history, as traditionally measured, usually have lower credit scores and must pay more every month for their mortgage than those with higher scores. NAR supports ongoing efforts to take into account consumer payment history not typically considered, such as rent, utility, telephone, and other regular payments and has urged HUD, the federal bank regulators, the Government-Sponsored Enterprises (GSEs), and lenders to work to strengthen these efforts. Use of alternative credit approaches will be especially beneficial for low- and moderate-income first-time homebuyers and borrowers with problematic loans that need to refinance their mortgage to avoid foreclosure. NAR recommends that the Board encourage the lending industry to expand use of alternative credit histories in connection with its rulemaking.

- **Periodic Reporting.** Some borrowers are trapped in mortgages they can't afford because the lender fails to report their good mortgage payment histories to the consumer reporting agencies. NAR has heard reports that many problematic

subprime lenders purposefully withhold information on timely mortgage payments from the credit agencies to prevent their customer from refinancing with another lender. The result is obvious—the borrowers have earned lower cost mortgages but are stuck in mortgages they cannot afford or that require them to make unnecessarily high payments. NAR supports requiring all institutional prime and subprime mortgage lenders (or the mortgage servicers acting on their behalf) to report payment history of all borrowers to at least the three national credit bureaus on a monthly basis.

C. Mortgage Choice for Borrowers. NAR supports requiring mortgage originators to offer borrowers one or more mortgages with interest rates and other fees that appropriately reflect the borrower's credit risk. It should remain the responsibility of borrowers to decide which is the best mortgage for their needs and circumstances, but this is only possible if they understand all the facts and have reasonable options, so they can make informed decisions. The following are suggested principles for the Board's consideration:

- For originators that offer nontraditional mortgage products, the originator should:
  - offer all borrowers a choice of several significantly different mortgage options;
  - include at least one traditional mortgage loan[5] as one of the options for the borrower to consider, if the borrower qualifies for a traditional mortgage loan offered by the originator; and
  - before application acceptance, disclose information about the maximum potential payment over the life of the loan and the date the initial payment will increase to a fully amortizing, fully indexed payment amount.

- For subprime borrowers, originators that offer FHA-insured mortgages or VA home loan guaranty mortgages should consider whether these types of mortgages should be offered as an appropriate option.

- If the originator does not offer mortgages with rates and fees appropriate for the borrower's credit risk, the originator should inform the borrower that a lower interest rate may be available from another originator or that the borrower may wish to seek housing counseling, to give the borrower an opportunity to shop elsewhere or receive counseling before proceeding. For example, a prime borrower that applies for a loan to a lender that only makes subprime loans should be advised that other options may be available.

- For loans originated by a mortgage broker, the broker should offer mortgage options that are among the lowest-cost products appropriate for the borrower.

D. Improved Consumer Mortgage Disclosures. Lenders have a responsibility to ensure that consumers understand the loans they receive, including their terms and all associated costs. Consistent with this principle, NAR recommends that the Board work with HUD to

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[5] Such as a 30-year or 15-year fixed rate mortgage or a traditional ARM with reasonable annual and lifetime interest rate caps.

improve consumer disclosures under the Real Estate Settlement Procedures Act (RESPA). In particular, NAR believes that consumers should receive a summary GFE, accompanied by a detailed GFE with explanations of each subcategory of fees to help consumers more fully understand the services they are receiving and the cost of each service. The detailed GFE should track the HUD-1 settlement form to simplify comparing the up-front estimate and actual costs at closing.

Thank you for the opportunity to make recommendations for how to address unfair, deceptive, and abusive lending practices in the mortgage markets. Please contact Jeff Lischer, Manager, Financial Services (202.383.1117; jlischer@realtors.org) if you have any questions regarding our comments.

Sincerely yours,

Pat V. Combs, ABR, CRS, GRI, PMN
2007 President, National Associations of REALTORS®