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Office of Chief Counsel
Department of Banking
Attention: Public Comment on Regulation 3-43
17 N. Second Street, Suite 1300
Harrisburg, PA 17101-2290

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DEPARTMENT OF BANKING
LEGAL SECTION

Via: Facsimile 717-783-8427 and Regular Mail

Dear Rulemakers:

Community Legal Services, Inc. (CLS) is pleased to submit these comments in response to the Department of Banking's Proposed Rulemaking on the proper conduct of lending and brokering in the mortgage loan business. Throughout its history, CLS has committed substantial resources to protecting consumers from exploitation in the credit marketplace and, more specifically, assisting low-income homeowners who are in danger of losing their homes because of predatory mortgage schemes.

We are pleased that the Department of Banking has proposed regulations to address the growing foreclosure crisis in Pennsylvania. As revealed by the Banking Department's 2005 study, *Losing the American Dream: A Report on the Residential Mortgage Foreclosures and Abusive Lending Practices*, the crisis has been fueled in large part by the subprime mortgage market which provides loans to borrowers with impaired or limited credit histories.

Subprime mortgage lending has increased dramatically, growing from a $20 billion industry in 1993 to $665 billion in 2005. While subprime lending is often described as making credit available to the previously underserved, that has not been the experience of CLS clients. For the most part, subprime mortgages are offered to homeowners who already have existing mortgages, and often other forms of credit as well. In most cases, these homeowners are putting their homes at risk in order to borrow cash for repairs, to pay back taxes, or to consolidate credit card debt. Nationally, only about 10% of subprime mortgages go to first-time home buyers. On the other hand, 20% of subprime mortgages have or will end in foreclosure.

Subprime lending-- which is often pushed by home improvement contractors and mortgage brokers and targeted at senior citizens and other vulnerable populations – has channeled countless homeowners into high-cost mortgage transactions they did not seek and cannot afford. As documented in Banking Department's 2005 study, reckless, abusive practices in the subprime mortgage industry have undermined the efforts of hardworking families to retain the dream of homeownership. These abuses include charging excessive fees, misrepresenting critical loan terms, selling unsuitable mortgage products, and promoting refinancing that does not benefit the borrower.

Foreclosure data bears out the cause for alarm about subprime loans: according to a nationwide study by the Center for Responsible Lending (CRL), one out of every five homeowners who took out a subprime loan in 2005-06 will lose their homes through foreclosure.[1] In the first quarter of 2007, approximately 14% of subprime borrowers were delinquent in their mortgage payments. CRL estimates that close to 17% of Philadelphia-area borrowers with subprime loans originated in 2006 will lose their homes in foreclosure.

Other studies confirm that the subprime mortgage industry is a significant contributor to the foreclosure crisis.[2] According to the Mortgage Bankers Association's National Delinquency Survey for the second quarter of 2006, the foreclosure rate for subprime mortgages in Pennsylvania, including the abusive ones targeted at low-income homeowners, was 8.6 times higher than for prime mortgages: only 1.11% of prime mortgages were 90 days past due or in foreclosure, compared to 9.34% of subprime mortgages. The survey also revealed that approximately 60% of Pennsylvania mortgages in or approaching foreclosure are subprime, even though only 15% of all mortgages in Pennsylvania are subprime.

Homeownership is the most accessible tool available to help families achieve a secure economic future, but today's market failures and abusive lending practices are stripping the benefits of homeownership from hardworking families throughout Pennsylvania. The epidemic of home losses on subprime mortgages—as many as one in five— is a wake-up call, providing strong evidence that the current system of mortgage regulation must be updated to take into account the drastically changed mortgage marketplace.

The Department's proposed regulations are an important move in the right direction. As detailed below, CLS supports the Department's action to establish the proper conduct of lending and brokering in the mortgage business to ensure that (1) borrowers understand the loan products offered to them, and (2) mortgage lenders and brokers document and verify a borrower's ability to repay the loan, considering the loan features such as possible rate increases, balloon payments, and prepayment penalties. To ensure the effectiveness of the proposed rules, we suggest the following amendments and additions.

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[1] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending (December 2006).
[2] See, e.g., Sen. Charles E. Schumer, Chairman, Special Report by the Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm.*

1. **Mortgage lenders and brokers should evaluate and validate the borrower's ability to repay the loan.**

The Banking Department must restore prudent underwriting practices by requiring lenders and brokers to analyze whether the borrower can actually afford the loan, including any increases allowed by an adjustable rate clause, balloon payments or prepayment penalties. As Comptroller of the Currency, John Dugan, has stated, "Sound underwriting—and, for that matter—simple common sense—suggest that a mortgage lender would almost always want to verify the income of a riskier subprime borrower to make sure that he or she has the means to make the required monthly payment. Most subprime borrowers are salaried employees for whom verifying income by producing copies of W-2 forms is just not that difficult."[3]

Far too often, however, brokers and lenders are making loans that a borrower simply cannot afford to repay. CLS routinely sees homeowners – typically individuals with fixed monthly incomes from Social Security or disability benefits-- facing foreclosure because a loan originator provided them with a loan that was designed to fail.

These loans are made because the individuals and entities involved in the lending process earn enough money on the loans regardless of whether the borrower ultimately is forced to refinance or face foreclosure. While the lenders may defend these practices on the grounds that consumers need access to credit, such arguments are without merit. Loans without adequate documentation of repayment ability—so called "low-doc" or limited documentation loans-- are designed to fail. According to research by the Center for Responsible Lending, loans that were originated with low or no documentation of the borrower's income had a 63.7% greater risk of foreclosure than loans with full documentation. Borrowers need access to affordable, constructive credit; not just *any* credit.

Currently, a significant portion of subprime loans – 80%, by some estimates – are adjustable-rate mortgage (ARM) loans. ARM loans are characterized by an introductory "teaser" interest rate, which is in effect for the first two or three years of the loan after which the interest rate adjusts upward for the balance of the loan term. To the extent subprime lenders qualify borrowers for loans at all, based on an analysis of the borrower's income, assets, and current debt, they do so based upon the lower "teaser" rate. These borrower then face payment shock when the rate substantially adjusts upwards after two or three years and they are unable to make the new payment amounts.

To address this problem, the Banking Department should require licensees to ensure that borrower has the ability to repay the loan, considering the effect of all the loan features. We support the proposed §46.2 (e), but recommend the following amendments:

[3] John C. Dugan, Comptroller of the Currency, "*Remarks Before the Neighborhood Housing Services of New York*," (May 23, 2007) at 3, available at: http://www.occ.treas.gov/ftp/release/2007-48a.pdf.

***All loans should be covered by the regulation, including high-cost mortgage loans.***

As currently drafted, the proposed regulation does not cover high-cost mortgage loans, "covered loans," as defined by 63 P.S. §456.503. While *some* "covered loans" already have a repayment ability standard established by statute, 63 P.S. § 456.512(b), certainly loans that are exempt from that provision should be governed by the proposed regulation. Pennsylvania's Act 55 of 2001, the "Consumer Equity Protection Act" established certain standards for high-cost mortgage loans. The repayment ability standard, however, only applies to "covered loans" that are made to borrowers "whose income, as reported on the loan application, is no greater than 120% of the median family income." As such, "covered loans" that are made to borrowers with incomes above 120% of the median family income should be included within the standards established by the Department's proposed regulations. To do otherwise, would create a loophole for borrowers who are most vulnerable to abusive lending practices, as they are by definition in extremely high-cost loans.

Moreover, the repayment ability standard for "covered loans" established by 63 P.S. § 456.512(b) does not set a standard for brokers. It only applies to lenders, and then only to the extent that it governs a lender's "pattern and practice" of making covered loans. It does not establish a standard requiring lenders to evaluate every borrower's ability to repay a loan. Given the limitation of the scope of coverage for "covered loans" under the Consumer Equity Protection Act, the Department should be able to include "covered loans" in its proposed regulations. Finally, the legislature charged the Department with the authority to issue regulations regarding covered loans pursuant to 63 P.S. § 456.524, and the proposed regulations, if they were amended to include "covered loans," would be promulgated within the scope of that authority and would not conflict with the statute.

***Lenders should include in the repayment analysis the cost of hazard insurance and property tax costs.***

In Section 4 of these comments, we urge the Department to require lenders to escrow for property taxes and hazard insurance. Regardless of whether the Department adopts that recommendation, however, it should require the cost of property tax and insurance to be considered in determining the repayment analysis. If the borrower can afford the mortgage payment, but not the tax and insurance payments, the loan is designed to fail just as surely as if the borrower could not afford the mortgage payment for principal and interest.

***For hybrid ARMs, lenders should ensure that the borrower has the capacity to repay the loan based on the maximum possible rate and payment which could apply under the terms of the loan.***

As proposed, the regulation establishes a standard to determine repayment capacity which includes an evaluation of the borrower's ability to repay the debt "by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule." While this is an important first step for deterring lenders from qualifying borrowers only for the teaser rate, it does not go far enough.

The "fully indexed rate" is a fictional rate which is based on the index at the time the loan is made plus the margin increase that will apply at the end of the first period of fixed rates (usually 2-3 years). Determining 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. By only requiring underwriting to the fully indexed rate, and ignoring the highly likely effect of the payment increases resulting from the interest rate increases, the proposed regulation essentially ignores the effect of likely interest rate increases on payments.

To ensure that individuals and entities in the mortgage lending business are not taking advantage of borrowers by placing them in loan products they are not reasonably capable of repaying, the Department should adopt the following standard: "A licensee shall not offer a loan without having reasonably determined, based on the documents and information provided under this subsection, that the applicant will have the ability to repay the loan, including taxes and insurance, based on the maximum possible rate and payment which could apply under the terms of the loan."

***For loans with prepayment penalties, to the extent such loans are permitted, lenders and brokers should consider the applicant's ability to refinance the loan or sell the subject property within the prepayment penalty period.***

Prepayment penalties have been shown to increase the risk of foreclosure. These penalties prevent homeowners who fall behind from selling or refinancing their home to avoid foreclosure. This is because the penalties, added to the mortgage balance, can result in the homeowner owing more on the mortgage than the value of the home.[4] Research has also shown that consumers do not get a significant interest rate reduction in return for accepting prepayment penalties; instead it appears that the savings are pocketed by brokers and other middlemen.[5] Most troubling of all, research reveals that African-American and Latino borrowers are much more likely to be subjected to prepayment penalties than White borrowers.[6] Prepayment penalties are banned or restricted in at least a dozen states, including North Carolina and New Jersey, and subprime mortgages are widely available in those states.

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[4] Roberto Quercia, et. al, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina (Jan. 2005), available at: http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf

[5] Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*, Center for Responsible Lending (Jan. 2005), available at: http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf

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

Over 70% of subprime loans include prepayment penalties. CLS encourages the Department to prohibit licensees from making loans with a prepayment penalty. If the Department does not accept our recommendation, then it should require lenders and brokers to consider the applicant's ability to refinance the loan or sell the subject property within the prepayment penalty period when evaluating the borrower's ability to repay the loan.

***For loans with balloon payments, lenders and brokers should consider the applicant's ability to make the balloon payment when due.***

The proposed regulations require licensees to determine that an applicant will have the ability to repay the loan in accordance with the loan terms and conditions by final maturity. Presumably, this standard would ensure that the evaluation of an applicant's ability to repay the loan includes an analysis of the borrower's ability to make any balloon payments. We urge the Department to clarify that for loans with a balloon payment feature, the evaluation should consider the applicant's ability to make the balloon payment when due.

**2. Establish a fiduciary duty on mortgage brokers.**

Mortgage brokers originate over 60% of loans in the United States, including two-thirds of subprime loans. As most loans are immediately sold to investors on the secondary market, a broker does not have a long-term interest in the performance of the loan and has incentive to close the loan with the highest combination of fees and interest rates he think he can get away with.

In many cases, mortgage brokers will accept a fee from the lender in exchange for arranging a loan with an interest rate higher than what the borrower would otherwise qualify. This fee is called a "yield spread premium." While a yield spread premium can be legitimate where the borrower is seeking to reduce up-front mortgage fees, many borrowers are not even aware that their loan contains such a provision. In these cases, yield spread premiums serve to increase the borrower's interest rate and the broker's overall compensation, without lowering upfront cash payments for the borrower. Brokers can often get away with this practice given the complexity of the mortgage transaction, coupled with borrower's belief that the broker is acting as his or her trusted advisor.

Pennsylvania courts have found in several recent cases that mortgage brokers have a fiduciary duty to the customer, the homeowner. A fiduciary duty requires the broker to act in the best interest of the consumer. The proposed regulations seem to recognize some of the duties to avoid fraud and negligence, but they should state explicitly that brokers have a fiduciary duty to the mortgage borrower.

often listed in various newspapers' real estate sections, subprime loans are generally secret, placing borrowers at a disadvantage. Improved, simplified disclosures should help rectify that imbalance of information.

It is important to note, however, that improved disclosures are not a quick fix to the problem of abusive, predatory lending practices. Unsophisticated borrowers who lack the capacity to understand the relatively complex subprime mortgage products are not going to be protected through disclosure alone. As currently conceived, the proposed regulations reflect this reality and contain an appropriate mix of both improved disclosures as well as other substantive protections.

We support the §46.2(b), and recommend the following amendments and additions:

***Require Written Broker Fee Agreements***

Mortgage brokers should be required to establish the dollar amount of their fee in a written agreement BEFORE making any loan applications for a home buyer or homeowner. As currently drafted, the regulation may condone a common practice whereby brokers "estimate" their fees, and then disclose the actual fee only at closing, amidst dozens of other legal documents. Homeowners should know up front the exact broker fee they will be paying for assistance in arranging the loan.

***Disclosures should include details about other expected loan terms.***

We recommend that the disclosure include information about the borrower's monthly payment as well as details about any variable interest rate feature, such as the reset period and the maximum interest rate.

***Brokers and lenders also should make oral disclosures.***

CLS encourages the Department to establish the standard for oral disclosures that it had proposed in its July 2006 proposed rulemaking: licensees shall orally explain to an applicant the loan process and the terms and conditions of any offered loan and may not solely rely on documents related to the loan transaction to inform an applicant of the terms and conditions of the offered loan. An oral explanation of key loan terms will help ensure that borrowers with limited reading proficiency understand the terms and conditions of offered loans. Oral disclosures also will amplify the effect of written disclosures for all borrowers.

***Require disclosures in the applicant's primary language.***

Since 1970, the U.S. Census Bureau has recorded a dramatic resurgence in immigration such that the proportion of the population that was not born in the US has nearly returned to the levels seen in the early twentieth century following a period of heavy European immigration. Although Pennsylvania has seen less a less dramatic influx of immigrants, the population has nevertheless grown significantly. According to the 2005 American

**3. Impose an affirmative duty on mortgage brokers and lenders to provide suitable loans to their customers.**

The Department of Banking should amend the proposed regulations to impose a standard that requires brokers and lenders to reasonably ensure that any loan offered is suitable for the borrower's purposes, including but not limited to, the purpose of the loan; the effect of the loan on the borrower's current and future equity in the home; the borrower's current income, and current and expected obligations.

Suitability does not require an originator to make the best loan, but simply to refrain from making an unsuitable loan. The standard would allow borrowers to choose among appropriate loan products and simply require that the originator refrain from offering products that are not suited to the needs and ability-to-repay of the borrower. This approach would not prohibit any product in a blanket fashion but simply ensure that originators are doing what borrowers already believe their lenders are doing: helping them take out a loan that works for them.

A suitability standard would also reduce the volume of loan delinquencies and foreclosures that are harming Pennsylvania's homeowners and their communities.

**4. Require payment escrows for taxes and insurance for subprime loans.**

When lenders include an escrow amount for property taxes and hazard insurance as part of the borrower's monthly house payment, they help ensure that funds will be available for these expenses when they become due. Most prime lenders require escrow payments. Paradoxically, subprime borrowers—typically low-income borrowers with higher debt burdens—are most often sold loans without escrows for taxes and insurance. Generally, omitting an escrow for taxes and insurance is a way to mislead a borrower into believing that the loan is affordable. Numerous CLS clients have reported that when refinancing they were promised lower monthly payments, when in fact they ended up paying more each month because their earlier mortgage payments included taxes and insurance and the new mortgage payments did not.

The failure to escrow for monthly mortgage payments often leaves low and moderate income homeowners facing foreclosure when suddenly faced with delinquent tax bills or payment increases for costly force-placed insurance premiums. Lenders should not be permitted to understate the cost of homeownership by failing to escrow payments for taxes and insurance. CLS urges the Department to require payment escrows for taxes and insurance for subprime loans.

**5. Improve the imbalance of information through adequate disclosures.**

CLS supports the Department's proposed regulations which are designed to ensure that borrowers understand the loan products offered to them. Most of our clients who are victims of predatory lending practices have extremely limited knowledge of the fees, terms, and interest rates associated with their loans. Unlike prime loans where rates are

Community Survey of the Census, about 6.3% of the state population was born in another country or in Puerto Rico. Over a million state residents age 5 or older, or 9.1% of Pennsylvanians, speak a language other than English at home. 3.5% of state residents, or over 390,000 persons, report that they speak English less than very well.

Pennsylvanians who grew up speaking a language other than English and who have not yet mastered English face distinct disadvantages in consumer transactions. When a mortgage lender conducts business with an applicant with limited English proficiency, the utility of disclosures and forms in English is undermined. This is the case whether the discussions with the lender are conducted in English or in another language, and regardless of whether a bilingual lender or an interpreter is involved.

CLS suggests several additions to the proposed mortgage loan regulations that would increase the chances that the new chapter will benefit limited English proficient consumers:

§ 46.1 Definitions

*Applicant with limited English proficiency. An applicant whose primary language is not English and who has a limited ability to speak, understand or read English.*

§ 46.2(b)

*(6) If any oral or written contact between a licensee and an applicant with limited English proficiency is conducted in a language other than English or with the assistance of an interpreter, the disclosure and any redisclosure required by §46.2(c) shall also be provided in the applicant's primary language.*

§ 46.2(f)(6)

*(iv) Requesting or allowing a limited English proficient applicant to sign documents without providing a contemporaneous copy of the document accurately translated into the applicant's primary language.*

These proposed additions are similar to existing state law which requires translation of contracts or receipts and notices of cancellation in door to door deals for goods or services which are conducted in languages other than English. 73 P.S. 201-7(b). (That law does not apply to real estate purchases.) Many other states have language related protections for limited English proficient consumers.

**6. Prohibit Equity Stripping Refinancing**

Proposed §46.2(f)(3) would prohibit lenders and brokers from inducing an applicant to refinance an existing loan without performing an ability to repay analysis. CLS encourages the Department to establish the standard for refinancing evaluations that it had proposed in its July 2006 proposed rulemaking: lenders and brokers may not advise or induce an applicant to refinance when not appropriate in view of the financial resources of the applicant. By considering the total financial resources of the homeowner prior to advising him or her to refinance, the lender and broker will ensure that the refinance is suitable for their needs and circumstances. Homeownership is how many working families build assets and wealth. As outlined in detail above, lenders and brokers should be ensuring that loan products, including additional refinancing, are suitable for a borrower's needs.

**Conclusion**

CLS applauds the Banking Department for proposing regulations that will help lead to a cessation of abusive lending practices that are decimating so many communities. We urge the Department to swiftly enact these regulatory reforms.

Submitted by,

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