Testimony before the

BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

regarding

"The Impact of the Proposed RESPA Rule on Small Businesses and Consumers"

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Mr. Chairman, Senator Sarbanes, and Members of the Committee, the **National Consumer Law Center**[1] thanks you for inviting us to testify today regarding HUD's proposal to rewrite the RESPA rules. We offer our testimony here on behalf of our low income clients, as well as the **Consumer Federation of America, Consumers Union,** and the **U.S. Public Interest Research Group.**[2]

We wish to commend Secretary Martinez for the dramatic approach to RESPA[3] reform advocated in these proposed rules. Clearly, the Department has recognized that the current state of RESPA's consumer protection is a murky mess. The stated goals and orientation of the Proposed Rule are wonderful – to protect consumers. We credit the hard work and creativity of HUD staff in the conception of this Rule. We applaud the many positive features of these proposals, and we commend HUD's steadfast commitment to ensuring that consumers benefit from these changes.

There are real complexities in these new proposals for RESPA compliance, with dramatic impact on

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[1]The **National Consumer Law Center** is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues. As a result of our daily contact with these advocates, we have seen examples of predatory practices against low-income people in almost every state in the union. It is from this vantage point – many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities – that we supply these comments. We have led the effort to ensure that electronic transactions subject to both federal and state laws provide an appropriate level of consumer protections. We publish and annually supplement twelve practice treatises which describe the law currently applicable to all types of consumer transactions.

[2]The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

Consumers Union is the nonprofit publisher of Consumer Reports magazine, is an organization created 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. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. Consumers Union's publications carry no advertising and receive no commercial support.

The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

[3]The Real Estate Settlement and Procedures Act ("RESPA"), 12 U.S.C. § 2601, *et seq*.

determining compliance with the Truth in Lending Act and the Home Ownership and Equity Protection Act. In this testimony, we strive to make clear our support for HUD's efforts to protect consumers through the proposed RESPA rules. While we have concerns[4] regarding a number of important details, this should not be regarded as diminishing our overall support for the basics of HUD's proposals –

- **Yield Spread Premiums.** Consumers need better protections from overcharges resulting from improper payments of yield spread premiums ("YSP") from lenders to brokers. The proposed rule on new disclosures for yield spread premiums does give consumers important information to assist them in ensuring that yield spread premiums are used as they direct. However, the rule, as currently proposed, lacks an effective enforcement mechanism.
- **More Meaningful Good Faith Estimate.** Currently the GFE provides no information upon which a borrower can rely. HUD's proposal appropriately requires that the loan originator – who is in the best position to know the prices for the required services – provide estimates for closing costs that are reasonably close to what actually will be charged to the consumer.
- **Guarantee of Costs and Interest.** The innovative proposal for a Guarantee Mortgage Package Agreement (GMPA) will simplify the mortgage *shopping* process for those consumers in the prime mortgage who carefully evaluate their mortgage options. Because the GMPA will effectively mask many of the initial disbursements, we are concerned that the package not be allowed to be used by lenders to shield predatory loans from legal scrutiny.

There are several overarching concerns and a myriad of important details which must be worked through to ensure that the Rule does in fact protect consumers, instead of simply providing a shield behind which mortgage originators can hide inappropriate, unfair, and illegal activities. While the overall concepts are excellent, we have been advocating some significant changes in the details of the rules to prevent substantial

[4]As this testimony can only provide a summary of the many issues which must be addressed in the proposed rules, we point you to the comprehensive comments that we filed with HUD, available on our website at www.consumerlaw.org. Our comments to HUD were provided on behalf of our low income clients, five national consumer advocacy groups, as well as the clients of 17 legal services programs in urban and rural areas throughout the nation. Portions of our comments to HUD are reiterated in this written testimony.

harm to consumers. However, we want to be absolutely clear that our most important concern has to do with the Rule's potential to *facilitate* predatory lending.

T**he single most critical point for the representatives of low and middle income consumers providing these comments is that HUD limit the Guaranteed Mortgage Package Agreement ("GMPA") to prime loans. If subprime loans are permitted to be made through the GMPA structure, *predatory lending* will be facilitated and protected by the GMPA exemption.** This means that HUD must go *beyond* its current proposal to exclude only HOEPA loans from the GMPA exemption, and exclude all loans with subprime characteristics.

Summary of Concerns

I. To avoid facilitating predatory lending, the GMPA should be limited to prime loans.

The idea behind the Guaranteed Mortgage Package Agreement ("GMPA") is to simplify the mortgage shopping process by both bundling the loan closing costs with the loan points, and providing an interest rate guarantee based on the borrower's credit qualifications. This would accomplish two important goals: 1) It would allow borrowers to shop for loans based simply on the interest rate and the money required to obtain the loan; and 2) It would permit borrowers to apply to numerous lenders and receive guarantees of the loans for which they actually qualify, subject only to verification of the information the consumer has provided about the value of the home, the borrower's income, and other assets. The most important aspect of the GMPA is that it allows borrowers to obtain loan guarantees based on their actual credit rating very early in the process. This will prevent tremendous misunderstanding and allow borrowers with less than perfect credit to participate fully in the shopping process.

The GMPA is a creative and novel proposal which, if implemented properly, will enable borrowers in *certain mortgage markets* to shop more effectively. However, HUD must keep in mind that this shopping does not occur among all consumers – those who are today already the victims of predatory mortgages and those who will be targeted in the future. Predatory lending in the subprime market thrives in an atmosphere in which lenders and brokers target homeowners and experience little pressure to provide the best products. Indeed, the

incentives run in the other direction – borrowers are steered to the worst products. The GMPA must not provide a new means for lenders in the subprime market to avoid liability for non-compliance with consumer protection laws in that segment of the marketplace which most needs *more* substantive consumer protection.[5]

As the GMPA streamlines disclosure of specific charges and services it will allow mortgage originators to hide illegal fees and insulate lenders from legal challenges under both RESPA and the Truth in Lending Act ("TILA").[6] It was HUD's intent to encourage packaging by trading compliance with the specific requirements of RESPA's Section 8.[7] However, an *inadvertent* result of the GMPA will be to conceal information needed to determine the accuracy of TILA disclosures as well, providing legal insulation from both federal laws. One of the effects of the bundling of loan fees under the Guaranteed Mortgage Package ("GMPA") will be that TILA compliance will no longer be discernable by a comparison of the TILA disclosure and the HUD-1.[8] High cost loans may be successfully camouflaged from challenge under TILA regulations, or even HOEPA compliance, as a result. Neither bank regulators nor others reviewing mortgage loans will be able to perform accurate compliance reviews.

As the purpose of the GMPA is to encourage shopping in the open marketplace of competitive mortgage lending, the GMPA should only be provided to that section of the market which is most capable of using competitive pressures in the open marketplace to protect themselves – the prime market. This is essential. **To**

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[5]We have supported the concept of the GMPA in the past in the context of statutory change in the law. Amending the RESPA and TILA *statutes* would allow all the overlapping issues of disclosures under both statutes, enforcement, and protections against predatory lending, to be addressed together. Attempting to address the disclosure problems of RESPA only through regulation unfortunately creates serious implications for enforcing TILA requirements and removes existing protections against predatory lending. *See* Margot Saunders, Testimony Regarding the *Rewrite of Truth in Lending Act and Real Estate Settlement Procedures Act* (Sept. 16, 1998), available on-line at http://www.consumerlaw.org/initiatives/predatory_mortgage/sen_mortg.shtml.

[6]15 U.S.C. § 1601 *et seq*. Currently, compliance with TILA's required allocation of fees between amount financed and finance charge can be tested only by comparing the disclosure of specific fees provided on the RESPA HUD-1 with the statements of the disclosures provided on the TILA form. Though TILA generally requires the lender to provide the borrower with an itemization of the amount financed unless the consumer opts out, lenders need not give this itemization if they provide both the GFE and the HUD-1. Official Staff Commentary § 226.18(c)-4.

[7] 12 U.S.C. § 2607.

[8]This situation may change if the Federal Reserve Board issues new regulations or new comments under TILA requiring otherwise. These comments evaluate the effect of the Proposed RESPA Rule on existing interpretations of TILA rules.

ensure that HUD's new GMPA does *not* facilitate and protect predatory loans from legal scrutiny, any loan that meets any one of the following triggers should *not* be permitted to be made as a GMPA –

- Any HOEPA loan
- Any loan with a prepayment penalty.
- Any loan with a guaranteed mortgage package price (the single fee) – which equals or exceeds 5% of the principal of the loan.

A. HOEPA loans can be mischaracterized, yet protected from challenge in a GMPA

The Home Ownership and Equity Protection Act, passed in 1994,[9] does not cure the problem of abusive home equity lending. The law continues to allow high rate home equity loans to be made and does not regulate excessive interest rates or fees *per se.* Its coverage is limited, excluding loans with high rates and fees just under the trigger amounts, open-end home equity credit, and reverse mortgages.[10] Extraordinarily abusive loans can continue to be made without triggering HOEPA protections because lenders can easily circumvent HOEPA by charging rates and fees just under the HOEPA trigger amounts.

As a result, in many high cost loans, there is litigation regarding whether the fees charged by the lender have been properly allocated to the HOEPA points and fees trigger. Many loans are treated by lenders as non-HOEPA loans, only to be determined later by regulators or attorneys for consumers to have been wrongly excluded from HOEPA. Once it is shown that a loan should have been covered by HOEPA, but was not, considerable consumer protections then apply.[11] A lender who violates the requirements of HOEPA faces enhanced statutory penalties as well as rescission of the loan.[12] The protections of HOEPA are thus most often

[9]Codified at Section 129 (15 U.S.C. § 1639) and in Sections 31 and 32 of Regulation Z (12 C.F.R. § 226.31 and 226.32).

[10] 15 U.S.C. §1602(aa)(1).

[11]For example, only HOEPA loans require the extra disclosure required three days before closing, as well as limitations of the circumstances in which prepayment penalties can be charged (15 U.S.C. § 1639(c)), special requirements for payments made to home improvement contractors ((15 U.S.C. § 1639(i)), and prohibitions on extending credit without regard to the consumer's payment ability (15 U.S.C. § 1639(h)).

[12]15 U.S.C. § 1640(a) and 15 U.S.C. § 1635.

helpful to consumers when they have been breached – because they provide substantial assistance in avoiding foreclosure on loans which included abusive terms.

The HUD-1 required by RESPA satisfies the requirement under TILA that an itemization of the amount financed be made available to the borrower. This itemization is critical for determining not just TILA compliance but also whether the loan is covered by HOEPA. The GMPA would make it impossible for consumers - or regulators - to determine whether a loan presented as a non-HOEPA loan was actually a HOEPA loan.

This is why the GMPA cannot be permitted to mask the fees of loans which are anywhere in the neighborhood of HOEPA loans – else substantially abusive loans will be made under the rubric of the GMPA, thus denying to consumers the ability to test these loans for compliance with the Truth in Lending Act and appropriate exclusion from HOEPA.

B. All subprime loans should be excluded from the GMPA.

We know the *characteristics* of *predatory* loans. HOEPA only covers a small percentage of subprime loans.[13] HUD has proposed only to exclude HOEPA loans from the GMPA. This does not provide nearly enough protection. Currently advocates estimate the bulk of predatory loans finance between 5 to 8% of the principal of the loan as points, fees and closing costs.[14] HUD has already stated that financing more than 3% of points and fees is a sign of a predatory loan.[15] Further, in its regulations of the GSEs HUD has prohibited the

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[13] Federal Reserve Board, Final Rule, Statement of Basis and Purpose, 66 Fed. Reg. 65604, 65607 (Dec. 20, 2001).

[14]This information is gleaned from the hundreds of loan documents reviewed each year by the attorneys providing these comments. See also Washington Department of Financial Institutions, Expanded Report of Examination for Household Financial Corporation III as of April 30, 2002, at 48 (finding that Household charged 7.4% in upfront costs on most loans), *available from* the National Center on Poverty Law as Clearinghouse No. 54,580.

[15]*See,* Joint HUD-TREASURY Report on Recommendations to Curb Predatory Home Mortgage Lending, June 20, 2000, at page 11. http://www.hud.gov/library/bookshelf18/pressrel/pr00-142.html. The agencies noted the dangers to homeowners of financing high fees:

> Financing points and fees may disguise the true cost of credit to the borrower, especially for high interest rate loans. Restricting the financing of points and fees for HOEPA loans would cause these

provision of housing credits for loans in which more than 5% of the principal has been charged.[16] It is also important to note that many of the new anti-predatory lending laws passed by the states have used 5% points and fees as a trigger for coverage.[17]

Thus, to ensure that HUD's new GMPA does *not* facilitate and protect predatory loans from legal scrutiny, any loan that meets any one of the following triggers should *not* be permitted to be made as a GMPA: any HOEPA loan. any loan with a prepayment penalty, and any loan with a guaranteed mortgage package price (the single fee) – which equals or exceeds 5% of the principal of the loan.

In other words, in addition to HOEPA loans, any loan which has *either* a prepayment penalty, *or* the price for the GMPA is equal to or more than the 5% of the loan principal must not be eligible for the exemption outlined in the Proposed Rule. Any lender making a loan with either of these criteria would still be required to itemize the fees paid to settlement service providers pursuant to the rules for the Good Faith Estimate.

1. GMPA should not be permitted for loans with high points and fees

As predatory loans generally charge high points and fees it is essential that the GMPA not be permitted to be provided for these loans. The most meaningful mark of a predatory loan is in the high amount of points and fees[18] financed by the borrower. The more the borrower is charged up-front, the more the immediate financial gain achieved by the lender. This is why many of these loans are not affordable to the homeowner – the lender has an incentive to make them non-performing loans. If that loan does not perform such that the homeowner is forced to refinance, it just means more profit for the lender at each refinancing. For the

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costs to be reflected in the interest rate, enabling borrowers to better understand the cost of the loan, and to shop for better terms.

[16] *See* 24 CFR 81.16(b)(12) and 24 CFR 81.2. These regulations do allow third party fees paid for closing costs to be excluded from the 5% calculation. However, as these third party fees would not be itemized on the GMPA, excluding some fees would not be possible. It is also far better, at this point of the development of this new product to exclude too many loans, rather than to include too many, which would have the effect of limiting enforcement of existing law on predatory mortgages.

[17] *See, e.g.* N.C.G.S. S.L. 1999-332; Ga. Code Section 7-6A-1 *et seq.*; 2001 N.Y. A.B. 11856 (SN) (Oct. 3, 2002).

[18] We include in our definition of fees the high costs of single premium credit insurance.

homeowner, it means more equity is stripped from the home each time.

Using 5% of the principal as the trigger for exclusion from GMPA eligibility will still allow loans with very high up-front costs to be made with a GMPA. According to various studies, closing costs on conventional mortgages rarely exceed 2% of the loan amount.[19] Using 5% as the trigger allows ample (perhaps too much?) room to ensure that all prime loans for which a GMPA might be appropriate would be eligible for the competitive benefits of the GMPA. However, this figure also ensures that loans which are not truly competitive are excluded from the exemption.[20]

2. GMPA should not be permitted for loans with prepayment penalties

Prepayment penalties also are the mark of a predatory loan, and lenders providing GMPAs should not be permitted to include prepayment penalties.

When a lender extends considerable expenses in the making of a loan, the lender does risk loss if the loan is prepaid before the regular payments on the loan allow the recoupment of these expenses. In the prime mortgage market, the effect of competition protects lenders: the low interest rate the borrower currently has discourages the borrower from prepaying the loan. Typical prime mortgage loans stay on the books for an average of five years. Thus only 2% of prime loans have a prepayment penalty.[21]

However, fully 70% of subprime loans have prepayment penalties because of lack of perceived options

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[19]According to the Federal Housing Finance Board's "*Monthly Interest Rate Survey,"* Table 1: Terms on Conventional Single-Family Mortgages, Annual National Averages, All Homes*, available at* www.fhfb.gov/MIRS/mirs_t1.xls, initial fees and charges average less than one point from 1995 through 2000 on conventional residential mortgages.

[20]For example, a loan of $150,000 would be permitted to have a GMPA package cost of $7,499. A $200,000 loan could have a GMPA price of $9,999. These up-front costs are actually much higher than most competitive, prime loans would ever charge for up-front closing costs. To the extent that the figure of 5% may represent too small a sum to compensate lenders for their up-front costs when making small loans (for example loans of less than $75,000), the 5% trigger could be adjusted upwards. However, just as this figure is adjusted upwards for smaller loans, the 5% trigger should also be adjusted lower for loans of larger amounts.

[21]See Freddie Mac, Frequently Asked Questions on Prepayment Penalties, *available at* http://www.freddiemac.com/singlefamily/ppmqanda.html

on the part of the borrowers.[22] In the subprime mortgage market, the brokers are generally the gatekeepers for the loans, and they operate on the reverse competition method of yield spread premiums. The higher the premium paid to a broker, the more likely the broker will match a lender up with an unwitting borrower. The hefty price paid to the broker in the yield spread premium is an expense that the lender must recoup in order to avoid a loss, especially considering that the same broker has an incentive to market aggressively another loan to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by yield spread premiums.

If prepayment penalties were disallowed, unreasonable yield spread premiums would not be paid by lenders, because they could not afford the risk. This would not mean that loans would not be made – they are made every day in the prime market without hefty premiums and prepayment penalties. As yield spread premiums are completely masked in the GMPA – unreasonable yield spread premiums should not be encouraged by allowing loans with prepayment penalties to be included in the exemptions offered by the GMPA.[23]

It is clear to many that prepayment penalties on subprime loans have virtually nothing to do with lowered interest rates.[24] It therefore cannot be argued that precluding loans with prepayment penalties will deprive most borrowers of a viable way to decrease interest rates.

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[22]*See* Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. *Also see,* North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, *Inside Mortgage Finance,* and the following articles on conforming mortgages: "*Freddie offers a new A-, prepay-penalty program,*" Mortgage Marketplace, May 24, 1999; Joshua Brockman, "*Fannie revamps prepayment-penalty bonds,*" American Banker, July 20, 1999.

[23]Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some 70% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California). The real reason is that conventional mortgage markets are competitive and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take. In addition, predatory lenders favor prepayment penalties as a way of preventing borrowers from seeking more competitive rates and terms once they realize what has happened.

[24]*See e.g.* Amy Crew Cutts, *On the Economics of Subprime Lending*, FTC Roundtable: Economic Perspectives on the Home Mortgage Market, Washington, D.C. October 16, 2002, Slide 2.

II. The GMPA should not be implemented without resolving its effect on TILA compliance

To ensure that the GMPA does not create havoc with compliance and enforcement of TILA, HUD should move forward on the GMPA portion of the Proposed Rule only after coordinating with the Federal Reserve Board to ensure that compliance with TILA maintains the current degree of transparency in home mortgage loans. TILA and RESPA are connected in several ways. Overhauling RESPA as suggested will create havoc to the balance currently struck between RESPA and TILA.[25]

In transactions to which RESPA applies, TILA rules say that the lender need not give an itemization of the amount financed if it provides the both the GFE and HUD-1.[26] Mortgage lenders have consistently used the GFE and HUD-1 as a replacement for the itemization of the amount financed.[27]

The importance of the consumer receiving an itemization of the closing costs for TILA compliance purposes cannot be overstated. This is the only way both regulators and consumers can determine if the APR, finance charge, and amount financed disclosures are accurate. The effect of the Proposed GMPA disclosure is to eliminate the itemization of the closing charges, at least on any form provided under RESPA. Since the HUD-1 substitutes for the TILA itemization, the effect of using the proposed truncated HUD-1 will be that neither consumers nor regulators will be able to review the TILA cost of credit disclosures for accuracy.[28]

Given the interplay between TILA and RESPA, it is imperative that HUD not move forward on implementation of the GMPA unless TILA and HOEPA compliance can be enforced.

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[25]Of relevance to this discussion, TILA requires the lender to give the consumer an itemization of the amount financed, including the sum of the prepaid finance charges. However, the lender need not give the itemization if the consumer opts out of receiving it. 15 U.S.C. § 1638(a)(2)(B); Reg. Z § 226.18(c).

[26]Official Staff Commentary on Regulation Z, § 226.18(c)-4.

[27] TILA and RESPA also intersect when the mortgage transaction involves the purchase, acquisition, or construction of the home securing the mortgage. In the purchase-money context where the mortgage loan is subject to RESPA, TILA requires that a good faith estimate of the TILA disclosures be given within 3 days of application (in effect, concurrently with the GFE). 15 U.S.C. § 1638(b)(2); Reg. Z § 226.19(a)(2).

[28]HUD proposes that the HUD-1 contain a list of the finance charges that the lender used to calculate the APR. This suggestion does not cure the problems just described. Whether a particular lender violates the finance charge disclosure rules requires an independent review of all of the closing costs, not just those that the lender treated as finance charges. Under the proposal, regulators and consumers would be unable to make that independent review.

III. The GMPA rules must be tightened.

If designed properly, with all of the issues relating to compliance with TILA resolved, and limited to the prime market, the Guaranteed Mortgage Package should prove helpful for consumers who shop in a competitive marketplace for their mortgages. In such a market, the GMPA would facilitate the ability of consumers to compare mortgage products that are actually available to them. With automated underwriting, mortgage lenders can (and already do in some instances) easily provide consumers guaranteed information about closing costs, interest rate and points early enough so that they can shop and make informed choices in a quick and timely manner. Only this type of inclusive disclosure would clearly meet the purposes of RESPA and offer American homeowners a real opportunity to choose the best loan available for their individual needs.

Under the current scheme of mortgage financing, very few consumers know with certainty the interest rate or the total points and closing costs they will be charged for a mortgage loan before they have to pay the fees for application, credit report, appraisal, etc. Instead, consumers must generally pay a fairly sizeable sum to apply for a mortgage loan, the full cost of which they will not know until some later time. The effect of the current industry practice is that even sophisticated consumers find it next to impossible to ensure that they are receiving the best loan that fits their needs. Moreover, unscrupulous brokers and lenders have a virtually free hand to increase the junk fees, points and/or interest rates on the loans.[29] Essentially, mortgage borrowing today is like what some folks call "buying a pig in a poke." You pay before you know what you're getting.

The better system is one in which the consumer can apply, at little charge, to the several lenders receiving the credit report, answer any additional questions the lenders request, and then receive from the each of lenders a guarantee of a loan at a specific rate, with a fixed amount of points charged, and a guarantee of the full amount of closing costs to be charged.[30] This guarantee should be subject *only* to two contingencies: 1) that the information supplied by the consumer regarding income and assets could be verified; and 2) that the value of

[29] The numerous class action lawsuits challenging the payment of yield spread premiums to mortgage brokers is a primary example of consumers who have found they received mortgage loans which were more expensive than they should have.

[30] All closing costs charged by the lender to close the loan would be included in this guarantee. Some expenses would be excluded from the guaranteed closing costs package, such as certain truly optional expenses like owner's title insurance, as well as expenses unrelated to the loan itself like hazard insurance and property taxes.

the collateral – the consumers' residence – was sufficient to secure the loan. Under this method, consumers would actually know the full price for a mortgage loan before they paid for it.

Assuming that HUD clarifies that "final underwriting" only means *verification* of information provided by the consumer – and requires that all of the credit qualifications of the consumer be approved *prior* to the offer of the GMPA – the GMPA should indicate the minimum requirements the consumer must meet. The GMPA will be based on information provided by the consumer on income, value of home, other assets, and similar information. The preliminary underwriting performed by the lender is based on the consumer's information and the consumer's actual credit status (as determined from credit reports). However, the GMPA will offered contingent of the consumer fitting certain preconditions. For example rather than a precise statement of the consumer's exact income, a maximum debt-to-income should be sufficient.[31]

A. Section 8 Exemption Is Not Justified without a Clear Guarantee

Unfortunately, the Guaranteed Mortgage Package outlined by HUD in these Proposed Rules *only seems* to be describing a program like this, but the crucial elements of exactly what is promised, and what is left open to later decision – "final underwriting" – are not addressed.

We have long recommended to HUD that it design a form for consumers to use when applying to lenders. Consumers could fill out this form once, and send it along with any other information a particular lender requires to a number of lenders. Each lender would then conduct a credit underwriting of the consumer's application, based on the consumer's *actual* credit, and the information provided by the consumer about income, value of the home, other assets, etc. The GMPA must then be offered to the consumer contingent only upon the lender's verification of the information provided by the consumer. Unless HUD clarifies the meaning of "final underwriting" to mean just this, the entire GMPA has minimal value for consumers – only offering lenders a way of avoiding compliance with Section 8 of RESPA, and virtually all of the important provisions of TILA.

[31]For example, if the consumer provides information indicating annual income of $70,000 a year, and the terms of the loan offered in the GMPA require annual income of $60,000, the GMPA should state this. So if this consumer actually had annual income of $69,000, the GMPA should still be valid. If the consumer's information turns out to be incorrect in a de minimus amount, that should not alleviate the lender's obligations under the GMPA.

It may be completely unnecessary for HUD to provide an exemption from section 8 liability to create the incentive in the marketplace to offer the guaranteed interest rate and guaranteed closing costs. There is little in current law that would stop a lender from providing these guarantees now. We do agree with HUD's principle that removing the barrier of Section 8's prohibition of volume based discounts would allow lenders to shop for settlement services and thus reduce costs. However, HUD can remove the barrier this places on the marketplace without creating the problems that will result from the exemptions from RESPA and TILA. All HUD need do is remove the current regulatory barrier for volume based discounts by requiring that the average value of volume based discounts be passed along to consumers. This seems a far simpler solution than the current construct for the GMPA.[32]

B. Lender's breach of the GMPA promise must create a presumption that Section 8 has been violated.

HUD must effectively hold lenders to the promises made in the GMPA. It is completely ineffective to provide that a lender's failure to keep the undertakings made in the GMPA simply causes the lender to lose the exemption from Section 8. **If the GMPA is not abided by, the consumer has no way of determining whether a Section 8 violation has occurred, and no way of alleging one in a legal complaint.** HUD must provide that a lender's failure to keep the promises made in the GMPA to the consumer results in a *presumption* of a violation of Section 8.

IV. Requirements for yield spread premiums must be tighter.

HUD has made good recommendations on how to deal with the cantankerous issue of lender payments to mortgage brokers. The Proposed Rule would amend 24 C.F.R. § 3500.7, to add a new subsection (d)(5)

[32]Indeed, it seems quite likely that HUD need do nothing to facilitate this type of guarantee and fixed price for closing costs. At least one large lender – ABN AMRO – has been providing this product quite successfully for some time. This lender is providing the product, with all the guarantees that we advocate (guarantee of the interest rate as well as points and closing costs) and is doing it without the exemption from section 8 liability, and with full compliance with the Truth in Lending Act. *See* www.mortgage.com. Indeed, according to one commentator, several other large lenders are now providing the same type of guaranteed packages, also without requiring a change in the law. *See,* Ken Harney, *Bundled' Settlement Fees Attracting Rate Shoppers,* Washington Post, Real Estate Section, February 10, 2003. www.washingtonpost.com/wp-dyn/articles/A8995-2003Feb14.html.

requiring that all yield spread premiums paid by the lender must be disclosed in the GFE as a payment to the borrower. This is very helpful to consumers – as far as it goes. However, this proposed rule change is a significant benefit to the borrower which must be included, not only in that section of the rules relating to disclosures, but also in the substantive protections of the regulations interpreting RESPA's section 8,[33] that is, in 24 C.F.R. § 3500.14. Otherwise, there will be a change in form without any real enforcement, somewhat nullifying the value of the change.

HUD's Proposed Rule on the treatment of yield spread premiums would be far effective if it were *not* couched entirely in the context of a disclosure. There is no private right of action under RESPA for violating its disclosure provisions.

Consumers who do business with mortgage brokers generally have the understanding that the brokers will provide them the loan at the lowest rate that the broker finds for them.[34] Consumers have generally understood and agreed to a specific broker's fee to be paid directly by them – either in cash or by borrowing more – to the mortgage broker to compensate the broker for obtaining the loan. What consumers do not understand, and have not agreed to, is the mortgage broker receiving an additional fee from the lender. Extensive academic analysis has proven this observation to be true.[35]

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[33] 12 U.S.C. § 2607(a); 24 C.F.R. § 3500.14(b).

[34] The fact that mortgage brokers hold themselves out as representing the consumer to find the best loan for them, and to represent their best interest, should be beyond much dispute at this point. Consider for example, the illustrations published recently in a White Paper by a lender's group:

> [A] quick Internet search for the phrase 'why use a mortgage broker' brings up numerous broker promotions on mortgage broker websites, including the following:
>
> - "[We] shop the market for you so you can be assured that you are receiving the best mortgage rates and terms available."
> - "For us, nothing is more important that making sure you get the best loan in today's fast changing market."
> - "We will select the best lender from our many sources to provide you with a loan that meets your individual needs."
> - "Best of all, a Mortgage Broker can usually save you money because of a variety of loan programs and pricing available to them. A broker will do the "rate shopping" for you to find the best possible interest rate at the least cost."

Anne Canfield, *The Lending Report - "Mortgage Brokers and Lenders: Understanding the Difference,"* April 1, 2003 at 2.

[35] *See, e.g.* Statement of Prof. Howell E. Jackson, Harvard Law School, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Jan. 8, 2002, *available at* http://banking.senate.gov/02_01hrg/010802/jackson.htm.

To date, yield spread premiums are generally paid by the lender to the broker solely in compensation for the higher rate loan. In other words, because the broker brings to the lender a loan at a higher rate than the consumer would otherwise qualify the broker is paid a fee, or kickback. These fees are an extra fee that the broker is able to extract from the deal. In most cases, the borrower is not only paying an upfront broker fee, but is also paying a higher interest rate as a result of this kickback. As this practice clearly provides an incentive for brokers to obtain above par loans for consumers, the dynamics of the marketplace closely resemble the marketplace that Congress attempted to control with its passage of RESPA. This is what is going on in the marketplace today, and this is why the rule proposed by HUD is so sorely needed.

As the Secretary has indicated, the goal is to change the current practices of allowing yield spread premiums to operate simply to increase the profit of mortgage brokers and lenders while providing little or no benefit to consumers. Given the statements of the Secretary, and the extensive testimony at the 2002 Senate Hearings,[36] the lack of correlation between the fees paid to a mortgage broker on a given loan and the amount of work performed by the mortgage brokers on that loan should be an accepted fact at this point. However, for HUD to make the Secretary's promise[37] a reality, several more decisive steps must be taken.

- HUD must *substantively* change the regulations regarding payments of the yield spread premium, not just the sections relating to disclosures.
- Before any payment is made to the broker, the borrower and the mortgage broker must enter into a *binding fee agreement* regarding the total compensation, however denominated, to be paid to the broker.
- The borrower must be offered a choice of how to pay the broker fee, whether in cash, by borrowing more, or by increasing the interest rate and having the lender pay the broker fee.
- This choice should be offered after loan approval but before the settlement.
- The amount the broker is paid must be the same whether paid by the borrower or the lender. The amount paid the broker by the lender reduces, by the exact amount, the amount owed by the borrower to the mortgage broker.

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[36] *See* Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums." January 8, 2002. http://banking.senate.gov/02_01hrg/010802/index.htm .

[37] Regarding this new rule, the Secretary said: "The new policy will make clear that it is illegal for a settlement service provider to mark-up fees when it is making a payment to another settlement service provider, unless it provides additional value to the homebuyer in the process, or when a provider does no work for the fee and charges an unreasonable amount." *See* HUD No. 01-105, October 15, 2002, "Martinez Moves to Protect Homebuyers; Calls for Simplified Mortgage Process."

- The total amount paid by borrower and lender must be reasonable compensation for goods, services and facilities actually provided.

These principles accomplish several things. First, the consumer knows upfront how much the mortgage broker will charge. Second, the consumer is given the opportunity to choose how this payment will be paid. Third, and most importantly, the broker compensation remains the same regardless of method of payment. This point is crucial, because it eliminates any anti-competitive incentive the broker has to place the borrower in a loan with an interest rate greater than that for which the borrower would otherwise qualify. In other words, whether the borrower chooses a below par loan, a par loan, or an above par loan with a yield spread premium, the broker compensation will remain the same. This is not how the system works today and it must be changed.

HUD's current proposal on how to treat yield spread premiums is a variation of these principles. However, as currently configured, they are neither clear enough to offer real protections to consumers, nor are they enforceable by consumers. For example, under the new proposal it is not at all clear how and when the consumer actually exercises the choice of whether to *use* the yield spread premium. The proposed information to be included in the GFE does not necessarily include loan terms which are actually available to the consumer. It is not clear how the consumer should indicate the choice actually made.

We strongly recommend that HUD make good on the Secretary's promises and make the yield spread premium a useable – and enforceable – credit for the consumer. This can best be done by requiring two separate agreements to be executed between the consumer and the broker, one at the beginning of the relationship in which the broker states the total amount of compensation to be received for the loan, and another when the loan has been approved in which the consumer is informed of the various options by which he/she can pay the broker's fee and other closing costs, and the consumer exercises that option.

Because of extensive litigation flowing from the industry's continued refusal to comply with the mandate of RESPA, in 1998, Congress issued a directive to HUD to write a Statement of Policy.[38] Despite the

[38]"The conferees expect HUD to work with representatives of industry, Federal agencies, consumer groups, and other interested parties on this policy statement." See the Conference Report on the Departments of Veterans Affairs and Housing an Urban Development, and Independent Agencies Appropriations Act, 1999, H.R. Conf. Rep. No. 1050769 at 260 (1998).

issuance of the 1999 Policy Statement, the industry continued as before – lenders continued to pay broker fees without evaluating either the services provided by the broker or whether the payment of the lender fee reduced the fees otherwise owed by the borrower. Because the benefit to the brokers and lenders was so great (higher fees for brokers, higher interest rates for lenders), the mortgage industry's strategy was to continue its illegal practice, pay off the few individual actions brought against it and mount a massive effort to fight class action cases challenging the payment of these fees, which might actually cost the industry real money and cause the industry to change its behavior.

Despite industry's plan, the Eleventh Circuit ultimately held that consumers could join together in class actions and challenge this activity.[39] The industry reacted strongly to this case (*Culpepper II)* and pushed HUD to save it from class action liability by "clarifying" its policy statement. HUD accepted the invitation and issued its second policy statement on the subject on October 18, 2001. The crux of HUD's "clarification" comes on page 11, with the statement:

> HUD's position is that in order to discern whether a yield spread premium was for goods, facilities or services under the first part of the HUD test, it is necessary to look at each transaction individually. . .[21]

In addition, HUD explicitly repudiated the decision in *Culpepper II* and stated its standard to be: the total compensation paid to the broker from any source (not just the lender-paid fee) must be for goods, services, or facilities. Unfortunately, the effect of HUD's 2001 Policy Statement had the intended impact on the payment of lender paid broker fees. Providing the "clarification" of the 1999 Statement as sought by the mortgage industry has had the effect of completely eliminating class actions as a form of redress for illegal lender paid broker fees.[40] Now, without class actions as a means to litigate the legality of these fees, the industry has no incentive to change its practices or even to comply with a new regulation – because there are insufficient legal resources in this nation to represent consumers in individual actions involving claims of only a few thousand

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[39] *Culpepper v. Irwin Mortgage Corp*., 253 F.3d 1324 (11th Cir. 2001).

[40] This has been the exact decision of several courts, including *Glover v. Standard Fed. Bank,* 283 F. 3d 953 (8th Cir. 2002); *Shuetz v. Banc One Mortgage Corp.,* 292 F.3d 1004 (9th Cir. 2002)*; Heimmermann v. First Union Mortgage Corp.,* ___ F.3d ___, 2002 WL 31067330 (11th Cir. Sept. 18, 2002).

dollars.

V. The new rules for the GFE, while basically good, must be tweaked to be fully protective of consumers.

We applaud the bright line rules proposed by HUD to severely limit the gaming currently rampant in the marketplace on closing costs. The GFE should be a true reflection of actually anticipated costs, not an opportunity for lenders to mislead consumers – as it is currently. Lenders who make numerous loans do have the capacity to determine their own charges and those of settlement service providers that they choose and require.

There are a number of significant changes, however, which must be made to the construct of the proposed GFE, for example –

- The language regarding the broker's relationship to the consumer is incorrect in many states and must be deleted.
- The comparison chart on the GFE form should be uniform and reflect actual terms available to the consumer.
- There is no longer any justification to exclude home equity lines from RESPA coverage, so the rules should require they be covered.
- The disclosures in section II of the GFE should include critical loan terms such as prepayment penalties and balloon terms.
- The credit from the lender must *not* appear simply as a credit against closing costs, rather it should appear as a cash credit in the 200 series of the HUD-1.

We have provided more detailed information about our recommendations in the comments submitted to HUD.

VI. There must be effective enforcement mechanisms for an originator's failure to comply with all aspects of these new rules.

Even perfect consumer protection rules will only work in the marketplace if they are enforced in a meaningful way. Lenders must have incentives to comply with the rules. The potential cost of lack of compliance must be greater than the profit. The Proposed Rule does not currently include *any* mechanisms to punish transgressors. The proposal only provides that once the transgression is caught, the remedy is for the

lender to provide what was promised all along. This rewards *lack of compliance* because the cost of being caught breaking the rules is the same as compliance. This is frankly absurd. HUD must provide a means to make it cost originators if they violate these rules – or else the rules are virtually meaningless. We propose several specific measures to make the new RESPA rules meaningful:

- Civil enforcement of each element under the rule is essential. This includes the requirements for treatment of the yield spread premium, the new rules for the Good Faith Estimate, as well as for a lender's failure to keep the promises in the GMPA.

- HUD must remove its stated prohibition against enforcing violations of section 8 through class actions. The 2001 Statement of Policy explicitly requires a court's individual review of each transaction, eliminating the efficient enforcement mechanism of class actions. Once HUD's Proposed Rules provide the new rules of the road, there is no reason a court cannot evaluate and enforce the yield spread requirements in class reviews – as the only issue will be whether the mortgage broker actually gave the consumer the full benefit of the payment from the lender.

- A lender's failure to follow the rules for the new Good Faith Estimate must be actionable in some manner, other than merely regulatory enforcement, as regulatory enforcement has shown that it is not sufficient to encourage the industry to comply with the law. As RESPA does not provide a private right of action, HUD can and should articulate that the failure to comply with these rules is unfair and deceptive. This will enable some private enforcement under state and federal prohibitions against unfair and deceptive acts and practices.

- A lender's failure to follow the rules when offering a GMPA or to close on a loan that does not conform to the GMPA must presumptively violate RESPA's Section 8. The current proposal results in the lender losing its exemption from Section 8 coverage and only allows the consumer a potential contract action against the lender for not keeping the promises in the GMPA. This is completely ineffective. Few consumers will have the means to bring a case to court for the few thousand dollars which would be obtained in a contract action on most failed GMPAs. Also, consumers will not have the means to allege a *prima facie* case of a violation of Section 8 as the GMPA scenario dictates that neither the initial estimate, nor the HUD 1 will provide details on the payments of fees for services provided by third parties. HUD must state that if a lender fails to comply with the promises made in the GMPA, there is a *presumption that the lender has violated Section 8.*

Conclusion

Given the complexities of the mortgage closing process, the potential effect of the changes in RESPA's rules on predatory lending we have extensive and detailed concerns on every aspect of the HUD's proposed rules on RESPA. For a full explanation of all these concerns we respectfully refer you to our comprehensive comments filed with HUD.[41]

[41]These comments are available on NCLC's website at www.consumerlaw.org.

We have met several times with officials from HUD and we appreciate their willingness to hear our concerns and proposals. We remain seriously concerned, however, about the effect of the final changes in the RESPA rules on the low and moderate income homeowners who are already facing massive problems in the mortgage marketplace. We are hopeful, however, that HUD will attend to these issues and not exacerbate the crisis situation facing this nation's communities.

Thank you for the opportunity to testify today.