DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 43
Docket No. OCC-2011-0002
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FEDERAL RESERVE SYSTEM
12 CFR Part 244
Docket No. 2011 - 1411
RIN 7100 AD 70

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 373
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U.S. SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 246
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FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1234
RIN 2590-AA43

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Credit Risk Retention[1]

Comments of the
National Consumer Law Center
on behalf of its low income clients
and the
National Association of Consumer Advocates

The National Consumer Law Center[2] ("NCLC") respectfully submits the following comments on behalf of its low income clients, as well as for the National Association of Consumer Advocates,[3] on the proposed credit retention rule and its exceptions.

[1] 76 Federal Reg. 24090, April 29, 2011.

[2] The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (7th ed. 2010), *The Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (3rd ed. 2010), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics.

To us, the issue is not how to enlarge the definition of the exception from risk retention for mortgage loans (and likewise the exception for risk retention for auto loans) to fit as many potential borrowers as possible within it. Our primary concerns are how to ensure that the exceptions from risk retention do not have the effect of polarizing credit for the borrowers who are not able to qualify for the loans permitted to avoid risk retention—no matter how these loans are defined. To accomplish this goal, risk retention should be the general rule in the marketplace, and the exceptions to that risk retention requirements remain narrow and carefully delineated.

We very much appreciate the thoughtful and careful approach the agencies have taken in the development of these rules on both risk retention and the exceptions to risk retention. As representatives of low income consumers, we generally support the proposed rules on risk retention. We also agree with the agencies that the exceptions from the risk retention requirement should be very narrowly drawn to ensure that only the safest loans will be excused from the risk retention requirement.

In these comments, we focus on three issues: 1) the terms of the Qualified Residential Mortgage ("QRM") exception; 2) recommendations for servicing standards to be applicable to the entire mortgage industry, rather than just to those loans defined as QRM loans; and 3) the terms of the exception to risk retention for auto loans.

I. Terms of the Qualified Residential Mortgage Exception

A. Background

The exemption for QRM mortgages from the risk retention requirements must –

> (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and
> (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[4] (Emphasis added).

The context for our discussion of how broad or narrow the definition of the QRM should be is based on the premise that the general risk retention requirement imposed by Dodd Frank[5] is

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NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by NCLC attorneys Carolyn Carter, Alys Cohen, Margot Saunders, Diane E. Thompson and John Van Alst.

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

[4] 15 U.S.C.A. § 78o-11(e)(2).

[5] Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

intended to address real problems in the securitization process. The goal is to make lending safer for all participants—borrowers, creditors, securitizers, and investors.[6]

The new requirements should ensure that all players in the lending marketplace have incentives that are realigned to ensure safe and sustainable lending.[7] As Treasury noted in its recent study –

> [A]vailable academic literature suggests that securitizations that have some form of risk retention may perform better, because risk retention helps to align incentives between originators and investors.[8]

Securitizers retaining risk will have more incentive to take care with the loans included in the security. The process of securitization reduces the creditors' and securitizers' incentives to review the loan files, because others will take the loss from bad loans. The problem is that there is real question about whether the risk retention requirement, by itself, will make much difference to investors. Retaining 5% risk may not be sufficient to change behaviors.[9] It is well recognized that before the financial crisis, many involved in the securitization process held even more than 5% credit risk in their securitizations. Securitizers often desired to participate in the potential for the high returns promised in the riskiest tranches.[10]

Yet, regardless of whether the risk retention requirement encourages investors to take the extra care to avoid investing in bad loans, there is little question that the *exceptions* to the risk retention requirements will drive some behaviors. The loans subject to the exceptions will be deemed by regulatory mandate—and thus by investors—to be safer and more sustainable. As a result the loans subject to the exceptions will probably be less expensive. The extent to which these loans will be less expensive, no one can really know at this point.[11] Indeed, some argue that the

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[6] *See,* 15 U.S.C.A. § 78o-11(e)(2).

[7] U.S. Treasury Department, "Macroeconomic Effects of Risk Retention Requirement," January, 2011, available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf.

[8] U.S. Treasury Department, "Macroeconomic Effects of Risk Retention Requirement," January, 2011, available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf at 27; citing See D. Diamond, "Financial Intermediation and Delegated Monitoring," Review of Economic Studies, vol. 51 (1984).

[9] *See, e.g. Felix Salmon*, *"The anti-risk-retention lobby's bizarre logic,"* Reuters, June 1, 2011, pointing out that the extra cost of risk retention on a 30 year mortgage for $225,000 at 4.9% would cost $1 a month. Available at http://blogs.reuters.com/felix-salmon/2011/06/02/the-anti-risk-retention-lobbys-bizarre-logic/.

[10] *See, e.g.* Zandi, "The Skinny in the Game," Moody's Analytics, March 11, 2011.

[11] The mortgage industry's promises of huge differentiations between the QRM and the non-QRM are so extreme as to make them patently unbelieveable. *See, e.g. "Proposed QRM Harms Creditworthy Borrowers and Housing Recovery," (www.mbaa.org/files/ResourceCenter/MIRA/QRMWhitePaper.pdf)*, citing a 2009 report by JP Morgan Securities that estimates the potential impact on mortgage rates of a "combination of [accounting standards] SFAS 166/167, risk retention, and Basel II" that could result in issuers of securities having to keep 100% of the mortgages backing an MBS on their books under certain (easily avoidable) circumstances. Available at: www.zigasassociates.com/Text/JPMorgan_analysis.pdf, pp. 3-22.

QRM will be slightly *more* expensive, just because the banks packaging the deals with those loans are *not* retaining any risk.[12]

The agencies are also, no doubt, well aware of the concern expressed by much of the mortgage industry and some consumer groups that the proposed QRM definition would have the effect of limiting the accessibility to mortgage credit on affordable terms for many necessitous homeowners.[13] We disagree with this analysis. To us, the issue is not how to enlarge the definition of the QRM exception to fit as many potential borrowers as possible within it, but how to ensure that the definition itself does not have the effect of polarizing credit for the borrowers who are not able to qualify for the QRM loans—no matter how they are defined. Improving the sustainability of mortgage credit by requiring risk retention should be the goal via enhanced lending standards. Exceptions to that risk retention requirement should remain narrow and carefully delineated.

It is clear that the exception to the risk retention requirements is the driving force in the current debate. We find this to be unfortunate. We are not convinced that risk retention will succeed in realigning incentives sufficiently to protect our low income clients from unsustainable loans. Yet we are certain that regardless of the exact parameters of these exceptions, many of our clients will always fail to qualify for the loans that are not subject to risk retention. Our primary interest, therefore, is in the market outside of the risk retention exceptions. We seek to ensure that the exceptions from risk retention do not swallow the good purposes of the rule.

If the definition for QRM loans is too broad, the positive effects of risk retention—realigning incentives among all the parties in the credit and the securitization—will be lost.

We strongly agree with the agencies that the QRM needs to be defined to encourage the markets for non-QRM loans to be sufficiently healthy to support low-cost, sustainable loans to our credit-challenged clients. To that end, we encourage the agencies *to further limit* the definitions for the Qualified Residential Mortgage.

B. Proposed changes to QRM Definitions

We basically support the approach of the agencies for defining the QRM. Our suggestions regarding necessary changes to the QRM definitional terms will (with one exception, regarding the proposed LTV requirement for purchase money loans) further limit the number and types of loans eligible for the QRM exception. Limiting the QRM will both ensure that loans made without risk retention are truly sustainable and will enlarge—and thus enliven—the pool of non-QRM loans.

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12 *See, e.g. "Felix Salmon, "The anti-risk-retention lobby's bizarre logic,"* Reuters, JUN 1, 2011, pointing out that "investors, burned during the financial crisis by the originate-to-distribute business model, are going to require a risk premium on any securitized paper where the underwriting bank doesn't retain at least 5%. For that reason, too, it seems reasonable to believe that QRM loans would if anything be more expensive than other loans, rather than cheaper. Available at http://blogs.reuters.com/felix-salmon/2011/06/02/the-anti-risk-retention-lobbys-bizarre-logic/

13 *See, e.g.* "[T]he Qualified Residential Mortgage (QRM) will define who will and who will not get the most affordable mortgage products, potentially prohibiting a significant segment of qualified borrowers from being able to achieve homeownership." Risk Retention Resource Center, available at http://www.mbaa.org/files/Advocacy/2011/RiskRetentionPresentation.pdf. *Also see*, Mortgage Bankers Association, "The Proposed Risk Retention Regulations Reduce Credit Options for Qualified Borrowers" available at http://www.mbaa.org/files/Advocacy/2011/RiskRetentionBrochure.pdf.

Our recommendations regarding the QRM definition are as follows:

1. Eliminate the LTV requirement for purchase money loans.

The LTV minimum of 80% required for purchase money loans should be eliminated because it unfairly affects people of low wealth. It is also unnecessary. We do not disagree with the agencies' finding that the more equity the homeowner has in the home the more unlikely the homeowner will be to default. However, there are other, well-proven methods of assuring repayment, such as verifying income, establishing debt to income ratios, and enforcing a minimum residual income requirement. Combining these requirements with a full and thorough evaluation of credit reports, credit scores, and alternative credit histories goes a long way to ensuring repayment. To the extent there is any merit in the argument that QRM loans will be less expensive and easier to access than non-QRM loans, wealth should not be a criterion for that access. Maintaining the 20% equity/downpayment requirement for QRM loans unreasonably stigmatizes lending to low-asset individuals and families who may nonetheless be excellent credit risks. This requirement, which hurts only people who have limited wealth, regardless of how responsible and careful they have been in the past, and how clearly they can afford the terms of their mortgage, is inappropriate and unfair. Moreover, the reliance on LTV as a measure of responsible lending smacks of nothing so much as the old asset-based predatory lending. A high LTV alone does not guarantee repayment. We urge the agencies to reject this requirement.

2. Maintain or increase the strict LTV requirements for refinance loans.

Conversely, the LTV ratios for refinance mortgage debt should be maintained, or even tightened. The mortgage industry's push to refinance mortgage debt every few years with new loans was a primary cause of the American financial collapse of 2008.[14] The refinance boom was premised on the originate-to-distribute model, which compensated originators and securitizers based on volume, rather than on quality.[15] This model incentivized the industry to refinance mortgage debt every few years with new loans—which led to the mortgage meltdown.[16] Rather than allowing the

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[14] *See, e.g.* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown,* 41 Conn. L. Rev. 1257, 1289–1291 (2009); Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Riskbased Mortgage Pricing*, 60 S.C. L. Rev. 677, 701 (2009); *Wall Street and the Financial Crisis: The Role of High Risk Home Loans: Hearing Before the Subcomm. on Investigations of S. Comm. on Homeland Security and Governmental Affairs*, 111th Cong. 2d Sess. 5 (2010) (memorandum by Sen. Carl Levin, Chair, & Sen. Tom Coburn, Ranking Minority Member).

[15] U.S. Treasury Department, "Macroeconomic Effects of Risk Retention Requirement," January, 2011, available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf, at 3, pointing out that "[t]here is also evidence that the expansion of mortgage supply through securitization helped accelerate price increases in the housing market to unsustainable levels and, therefore, contributed to the ensuing decline in housing prices and the economy."

[16] In many cases, lenders tolerated widespread subversion of underwriting policies in exchange for an increase in subprime originations. *See, e.g.*, Wall Street and the Financial Crisis: The Role of High Risk Home Loans: Hearing Before the Subcomm. on Investigations of S. Comm. on Homeland Security and Governmental Affairs, 111th Cong. 2d Sess. 4 (2010) (memorandum by Sen. Carl Levin, Chair, & Sen. Tom Coburn, Ranking Minority Member) ("Despite fraud rates in excess of 58% and 83% . . ., no steps were taken to address the problems. . . .").

equity in the home to grow and become a source of savings and asset building, the refinance boom caused a huge loss of wealth and set the stage for the foreclosure crisis.[17]

A positive goal of the QRM exception should be to discourage unnecessary refinance loans. This can be accomplished by maintaining the requirement that the homeowner own at least 25% equity for rate and term refinancing mortgage loans now in the QRM exception.[18] However, we would recommend that no cash-out mortgage loans should be permitted to be QRMs.

Even as we argue for maintaining strict LTV requirements for QRM refinance loans, we remain most concerned about the message this regulation is sending to the mortgage market about non-QRM loans. The agencies should be careful to accomplish two goals simultaneously. The QRM standards should indeed be strict. But, it should be absolutely clear that there can be many safe and sustainable loans which do not qualify for the QRM exception. The rule should be risk retention. The exception for QRM should be very, very tiny. The smaller the QRM exception, the more likely the market for non-QRM loans will remain vigorous.

3. Exclude PMI as consideration for mortgages from the QRM.

We agree with the agencies that the presence of mortgage insurance should not be relevant to the determination of whether the loan qualifies for the QRM exception. PMI insurance reduces losses for the investor. It does not necessarily make the loan safer and more affordable for the homeowner. In fact, the opposite is true—the PMI premiums increase the cost of the loan to the homeowner, making it less affordable, and thus more likely to default.

4. Exclude all adjustable rate mortgages from the QRM.

Adjustable rate loans have traditionally been the most risky of all loans. This is clearly true across all types of loans—prime, subprime, FHA and VA.[19] Consider the message from the following graph showing the delinquency data from the MBA quarterly delinquency studies in the past five years.[20] *Adjustable rate loans routinely have substantially higher default and delinquency rates than fixed rate mortgages*. This is true whether the mortgages are prime or subprime. If the purpose of the QRM

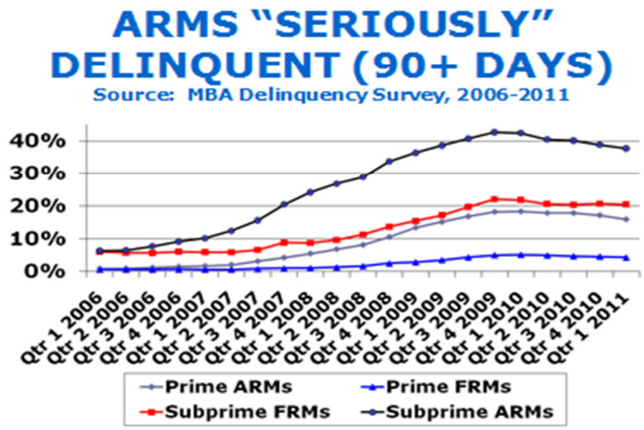
[17] Amir E. Khandani, Andrew W. Lo, Robert C. Merton, *Systemic Risk and the Refinancing Ratchet Effect,* Working Papers, Harvard Business School, September, 2009, revised July, 2010 (finding that cash-out refinancing contributed significantly to the 2008 financial crisis). Available at http://hbswk.hbs.edu/item/6291.html.

[18] Subpart D, __§ .15(c)(9)(ii).

[19] Few borrowers would have chosen these mortgages had they understood the risks. See Patricia A. McCoy, A Behavioral Analysis of Predatory Lending, 38 Akron L. Rev. 725 (2005) (discussing the cognitive barriers to decision making in the predatory lending context); Ronald H. Silverman, Toward Curing Predatory Lending, 122 Banking L.J. 483, 546 (2005) (borrowers, due to a variety of psychological effects, tend to underestimate the risk of foreclosure); A. Mechele Dickerson, Bankruptcy and Mortgage Lending: The Homeowner Dilemma, 38 J. Marshall L. Rev 19, 42–47 (2004) (discussing limitation of financial literacy and disclosures due to cognitive biases). *Cf.* Kristopher Gerardi, Lorenz Goette, & Stephan Meier, *Financial Literacy and Subprime Mortgage Delinquency: Evidence from a Survey Matched to Administrative Data* 15 (Fed. Reserve Bank of Atlanta, Working Paper No. 2010-10, 2010), *available at* www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/ 3615/wpmeier.pdf (reporting that average interviewee, a borrower with a subprime mortgage originated in 2006 or 2007 when most subprime mortgages were adjustable rate mortgages, would choose thirty-year fixed mortgage over a mortgage that adjusts after two years, if there is 50-50 chance that the mortgage payment will either increase by more than $184 dollars a month or decrease by $500 a month.

[20] Mortgage Banker's Ass'n, National Delinquency Survey Q1 2006- Q1-2011.

is to define the safest loans, that definition cannot and should not include any variable rate loans.



5. No High Cost Loans in QRM.

While the QRM exception appropriately limits points and fees for QRM loans to 3%,[21] there is no limit on the interest rate that can be charged on a QRM loan. As a result a higher cost loan,[22] or even a HOEPA loan,[23] could be a QRM loan. These loans are by definition riskier to both investors and borrowers (they cost more) and should be excluded from the QRM definition.

6. Maintain the current DTI ratios in the QRM.

Front-end debt-to-income ratios are a critical part of the evaluation of a mortgage loan's affordability. Unlike the back-end ratio of total scheduled debt to income, the mortgage payment obligation is fixed for the life of the mortgage loan and as such it is a permanent measurement of the affordability of the loan. On the other hand, the back-end DTI ratio changes from month to month, forever dependent on the consumer's current outstanding short term loan debt. We agree that both ratios should be criteria for the QRM loan definition. We further agree with the suggested percentages in the QRM definition of 28% for monthly housing debt, and 36% of total monthly debt.[24]

7. Full documentation is a good thing.

We endorse the proposal to require full documentation of income requirements as is required by HUD standards. Only loans with fully documented income should be permitted in the

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[21] Subpart D, __§ .15(d)(7).

[22] Higher cost loans could be qualified mortgages so long as the point limit were not exceeded. They are considered "higher risk" mortgages if the annual percentage rate exceeds the average prime rate offer for a comparable transaction by more 1.5%. 15 U.S.C. § 1639(f)(2)(A).

[23] HOEPA loans which are first mortgages have annual percentage rates 6.5% higher than the average prime rate offer. 15 U.S.C. § 1602(bb)(1)(I).

[24] Subpart D, __§ .15(d)(8).

QRM, as such a high percentage of the no-documentation or low-documentation loans in the past decade were problematic.

8. QRMs should be assumable as provided for in Garn-St Germain.

The proposal contains a blanket bar against assumability for any QRM mortgage.[25] This flies in the face of established federal law, which provides that mortgages should be freely assumable between family members living in the home, whether they acquire title through death or divorce or devise.[26] While we support a narrow definition of QRM, it should not be an illegal definition. There is no reason to bar a surviving family member from assuming a mortgage; indeed, allowing the surviving family member to assume the mortgage reduces the risk of an otherwise nearly certain default when the refinancing market is sluggish or there is little equity in the home. The proposal should be revised to bar assumability *except as provided by Garn-St Germain or other law.*

9. Restrict the time allowed for repurchase on mistaken QRM loans.

The agencies have proposed to allow sponsors to evade the QRM requirements by repurchasing a loan within 90 days after it is determined that a given loan is not a QRM. This open-ended escape hatch provides little incentive for sponsors to insure that loans sold on the secondary market as QRM are in fact QRM loans. At a minimum, sponsors should have no more than 90 days *after the loan is sold* to repurchase the loan, thus placing the obligation on the sponsor to accurately determine at inception the QRM status of the loans offered for sale. Ninety days from sale is more than enough time to correct errors that happen from inadvertence. Ninety days from determination, as the agencies propose, is not a meaningful restriction. Moreover, if as many as five percent of the loans are determined not to be QRM loans, then the sponsor should be required to repurchase the entire pool.

10. QRM loans should incorporate robust servicing rules.

As we explain in the next section, QRM loans—which are permitted to avoid the risk retention requirement—must have clear and vigorous servicing to avoid foreclosure. Yet, the agencies' proposal for servicing standards for QRM loans proposes lower standards for these loans than are generally being employed for many loans which in the future are unlikely to qualify for the exception. It would make little sense for the industry default for servicing standards (non-QRM loans subject to risk retention requirements) to be lower than the general standards currently employed. The servicing standards themselves are not an after-thought. They are a critical means of ensuring mortgage loans are sustainable and safe for both homeowners and investors. We urge the agencies to establish standards for *both* QRM loans and loans subject to risk retention which will facilitate avoidance of unnecessary foreclosures throughout the industry. In the next section, we describe in some detain, our recommendations for servicing standards.

[25] 76 Fed. Reg. 24,090, 24,167 (Apr. 29, 2011) (proposed Subpart D, _.15(d)(12)).

[26] 12 U.S.C. §1701j-3(d). *See also* 12 C.F.R. § 591.5 (implementing regulations, which impose only one condition on assumability, that PMI, if required, be maintained).

II. All Mortgage Loans, Including Qualified Residential Mortgages, Should Be Subject to Robust, Sustainable Mortgage Servicing Rules

The proposal asks whether a final QRM rule should include mortgage servicing rules. The presumptive purpose of the QRM rules is to reduce risk throughout the life of loan. Even loans impeccably originated can fall into default, and adverse economic conditions may erode even substantial initial equity positions, leaving investors at risk in foreclosure. As the agencies note, "[t]imely initiation of loss mitigation activities often reduces the risk . . . ."[27] Poor servicing increases risk . When servicers fail to use loss mitigation appropriately to convert distressed loans to performing loans and instead push performing loans into foreclosure, investors lose money. The risk created by poor servicing is real and must be addressed. Indeed, the incorporation of robust servicing standards promotes the statutory framework of QRM. Robust servicing standards are "in the public interest" and "for the protection of investors."[28]

Servicing standards promote rational risk management, as envisioned by Congress in enacting the statute. The signal goal of risk retention is to reduce the risk of default, which appropriate and robust loan servicing does. Thus, the QRM rules should include rigorous servicing standards, whether directly or through incorporation of existing and future servicing standards. In no event should the QRM rules, either explicitly through the adoption of weak or vague servicing standards or implicitly through silence, fail to address the need for risk reduction through appropriate servicing.

The QRM proposals for servicing paradoxically adopt a lower level of servicing standards than currently applied in many areas of the market. GSE loans and loans eligible for HAMP are currently subject to much more stringent servicing standards than those proposed by the agencies for QRM loans. GSE and HAMP loans must have loss mitigation initiated significantly before the proposed standards for QRM loans would require, and both GSE loans and HAMP to various degrees address the problem of wrongful foreclosures occasioned by the dual-track processing of loan modifications and foreclosures while the proposed QRM standards are entirely silent on this point. QRM loans are meant to be less risky for investors than non-QRM loans; the QRM standards must be at least as rigorous as applied outside of the QRM context.

The evidence is mounting that loans held in portfolio, where all the risk is retained, have deeper, faster, and more effective loss mitigation than those serviced by third parties.[29] Even holding a junior interest in the pool encourages servicers to delay foreclosure and explore loss mitigation.[30] QRM servicing standards should ensure that loans sold to investors are serviced at

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[27] 76 Fed. Reg. 24,090, 24,127 (Apr. 29, 2011).

[28] 15 U.S.C.A. § 78o-11(e)(2).

[29] *See, e.g.,* Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, Douglas D. Evanoff, *The Role of Securitization in Mortgage Renegotiation* (Fed. Res. Bank of Chi., Working Paper No. 2011-02, Mar. 2011)*, available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1739915&; Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 6, 36 (2011), *available at* http://www.ots.treas.gov/_files/490069.pdf.

[30] Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications*, 18 Housing Pol'y Debate 279, 282 (2007); Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008)(reporting on Ocwen's use of

least as well as loans held in portfolio, for which the risk is retained. To do otherwise undermines the basic premise that QRMs are so safe that no risk need be retained. In order to achieve par with loans held in house, QRM rules must set specific loss mitigation protocols and provide for complete transparency.

Under the agencies' proposal for servicing QRM loans, servicers (and sponsors) would generally be allowed to set their own servicing standards. Servicers are required to mitigate losses, and to have policies in place, but they are not required to adopt policies or procedures to achieve actual loss mitigation. The only two positive mandates are that 1) loss mitigation must be instituted within 90 days after default or delinquency, well past the 30 days mandated by the GSEs, and 2) servicing rights not be transferred without the new servicer assuming the existing default mitigation obligations.[31] While requiring subsequent servicers to honor the default mitigation obligations of their predecessors is important, this is hardly sufficient to ensure risk reduction of QRM loans or even minimally competent servicing. Leaving servicers to their own discretion to develop and implement servicing standards has already been established as a policy that has miserably failed.[32]

The agencies ask what impact servicing conditions will have on the origination of QRMs.[33] Robust servicing conditions should have little impact on originators' willingness to originate loans, but should assure greater market transparency to all participants and support meaningful risk retention. Improved servicing would help align loan performance with rational expectations. While certain industry participants repeatedly claim that any increased regulation will affect credit access, such claims are unfounded. Unfettered markets were the cause of the current crisis. Prudent lending and servicing will return the market to a place where innovation can occur while originators and other participants also take into account what have been for some, until now, externalities (loan performance, for example).

Robust servicing standards would improve loan performance and reduce risk. But the proposed servicing standards are both vague and lacking in rigor. The proposed rules are lower than many current standards; implementation of the proposed rules would excuse servicers' failure to meet servicing obligations under existing contracts. The proposed approach would cost homes, decimate communities, and allow continued wealth transfer from investors to servicers. Rather than

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principal reduction loan modifications to reduce losses to its interests in the pool); Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 14 (Oct. 2007) (servicers in a first-loss position delay instituting and completing foreclosures compared to servicers in a junior loss position); Joseph R. Mason, Servicer Reporting Can Do More for Modification Than Government Subsidies 45 (Mar. 16, 2009) [hereinafter Mason, Servicer Reporting Can Do More], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331 (servicers who hold residuals or interest only strips resist making loan modifications).

31 Subpart D, __§ .15(c)(13).

32 *See, e.g.,* SIG TARP Quarterly Rpt. to Cong., Jan. 26, 2011, at 13:

> TARP's oversight bodies — SIGTARP, COP, and GAO — have all called on Treasury to get tough on servicers. Without meaningful servicer accountability, [HAMP] will continue to flounder. Treasury needs to recognize the failings of HAMP and be willing to risk offending servicers. And if getting tough means risking servicer flight, so be it; the results could hardly be much worse.

33 76 Fed. Reg. 24,090, 24,128 (Apr. 29, 2011).

reducing risk, the proposed rules would increase risk. We urge the agencies to use this opportunity to mandate uniform servicing standards for both QRM and loans subject to risk retention.

A. The Need for Robust Servicing Standards for the Entire Market

The agencies ask whether they should apply servicing standards to a broader class of securitized residential mortgages.[34] The answer is yes. We encourage the establishment of nationwide standards on mortgage servicing regardless of whether loans are within QRM, and whether or not they are securitized or portfolio loans. The recent crisis makes clear that the entire market is in need of substantial improvements to mortgage servicing standards. Comprehensive, consistent and enforceable standards affecting loan modifications, routine and default servicing fees, insurance, and application of payments are needed. They all affect risk—to the homeowner, the community, investors and the economy.

The agencies note that they are at work on a separate set of national servicing standards, and expect to request comment within a year.[35] What is less clear is how the agencies envision these two sets of standards interfacing. The QRM loans are meant to be the least risky loans, from origination through satisfaction. They should be subject to underwriting and servicing standards that are rigorous throughout the process. At a minimum, QRM loans must be explicitly subject to any national servicing standards subsequently developed, either by the agencies or through congressional action. Any inclusion of mortgage servicing rules in the final QRM rule should ensure that a) the rules are robust enough to truly provide optimal mortgage servicing and b) the rest of the market is subject to similar rules to prevent a dual market in servicing.

The proposed standards by the agencies are not clear, nor rigorous. In the sections that follow, and in response to the agencies' request for the proposal of alternative servicing standards,[36] we will review what we believe to be the necessary servicing standards that should apply to the entire market, QRM and non-QRM loans alike.[37] We look forward to the opportunity to comment in greater detail on the agencies' national servicing standards when that proposal is ready for comment. The servicing standards adopted for QRM loans must be no lower than the standards set for the national floor in the agencies' subsequent rulemaking, and should clearly be no lower than existing standards for servicing applied in any segment of the market. To the extent the QRM rules condone poor servicing, the agencies are promoting riskier loans for investors.

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[34] 76 Fed. Reg. 24,090, 24,128 (Apr. 29, 2011).

[35] 76 Fed. Reg. 24,090, 24,127 (Apr. 29, 2011).

[36] 76 Fed. Reg. 24,090, 24,128 (Apr. 29, 2011).

[37] A longer version of NCLC's analysis and recommendations, including many case examples, can be found at Testimony of Diane E. Thompson before the United States Senate Subcommittee on Housing Transportation, and Community Development of the United States Senate Committee on Banking, Housing, & Urban Affairs (May 12, 2011), *available at* http://www.nclc.org/issues/testimony-uniform-mortgage-servicing-standards.html.

B. The Loan Modification Process Must Be Improved

1. Loan Modifications That Yield More Than Foreclosure Should Be Mandated.

Servicers have largely failed to implement loan modifications, even where doing so is in the interests of investors.[38] Thus, the agencies are right to propose that loss mitigation that passes a net present value test be required.[39] In order to protect investors and minimize conflict between classes, however, the agencies must provide for a standard and transparent NPV test.

The NPV test used by servicers must be public. The inputs themselves must also be disclosed to the homeowner at the time of denial. The proposed QRM standards would require an NPV, but would not mandate either a standard or public NPV. Both elements are necessary

2. Loan Modification Reviews and Offers Should Be Done Prior to Initiating Foreclosure

Processing loan modifications and foreclosures at the same time inevitably leads to accidental foreclosures and accompanying financial and emotional tolls on homeowners. Foreclosure and loan modification are handled by different departments at the servicer, with only imperfect communication.[40] Once a foreclosure is put in place, even high-level bank officials may not be able to stop it. Homeowners assured that they will be receiving a loan modification by one department may nonetheless find themselves facing a foreclosure.[41]

In part because loan modifications may require more deviations from the norm, loan modifications often take more time to work out than foreclosures do. But the two-track system pushes the foreclosure forward regardless, with the result that foreclosures frequently occur while homeowners are negotiating a loan modification, sometimes even after they have been approved for a loan modification.

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[38] *See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center); Jody Shenn, *Mortgage Investors with $500 Billion Urge End of Practices, Lawyer Says,* Bloomberg News, July 23, 2010, http://www.bloomberg.com/news/2010-07-23/mortgage-investors-with-500-billion-urge-end-of-practices-lawyer-says.html (reporting on letters sent to trustees of mortgage pools on behalf of a majority of the investors in the pool); Complaint, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (complaint alleges that servicer's practices regarding fees and post-foreclosure sales were costly to investors); Ass'n of Mortg. Investors Press Release, AMI Supports Long Term, Effective, Sustainable Solutions to Avert Foreclosure; Invites Bank Servicers to Join, Nov. 16, 2010 (citing servicers' profit from fees and payments from affiliates as an impediment to loan modifications that would be in the interests of investors); Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer's performance).

[39] Subpart D §_.15(c)(13)(A).

[40] *See, e.g.,* Elizabeth Renuart, Odette Williamson & Mark Benson, Foreclosure Prevention Counseling: Preserving the American Dream 102-103 (2nd ed. 2009).

[41] *See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 28–29 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center).

Even if a foreclosure never happens, the cost of the modification increases as the servicer imposes various foreclosure-related (and often improper) fees on the homeowner,[42] and the homeowner suffers the financial, credit, and emotional toll of defending a foreclosure. These fees are lucrative to the servicer, but can price a modification out of a homeowner's reach.[43]

Regardless of when the loan modification application is received with respect to the foreclosure filing, the simultaneous processing of a loan modification and a foreclosure results in many unnecessary and expensive foreclosures. Fees mount during the pendency of the foreclosure case: attorneys appear in court; advertising is ordered; title searches are prepared; fees are incurred for service. To prevent this death spiral, the QRM rule should require that foreclosures be stopped during the pendency of a loan review whether the application (or what the servicer has denominated as the application) is received before or after the servicer initiates foreclosure. To do otherwise encourages servicers to rush to foreclose (since once in foreclosure, they can proceed to sale) and to issue summary denials of loan modification requests. Ultimately, a rush to foreclosure is costly for investors and homeowners.

The proposed QRM rules fail dramatically in ignoring the pervasive problem of the dual-track system.[44] As the agencies know from their review of servicers' foreclosure governance procedures , servicers do foreclose on even those homeowners who are making payments under a modification agreement.[45] Instead of matching the existing standards in HAMP, the proposal would only require that loan modification review be initiated before the foreclosure was initiated. The loan review process must be completed before the foreclosure process is initiated. Any other rule will permit wrongful foreclosures, increasing risk to investors.

In order to end the dual-track system, and the expenses and abuses that necessarily flow from it, the QRM rules should impose the following conditions:

- Loan modification review should occur before foreclosure has been initiated.

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42 *See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims,* 87 Tex. L. Rev. 121, 144-68 (2008) (reporting that servicers appear to be imposing often improper default-related fees on borrowers in bankruptcy proceedings).

43 As fees rise, they are added to the principal balance that must be repaid. The result often is that homeowners can no longer afford the monthly payment necessary to repay the loan. Additionally, servicers sometimes demand payment of these fees upfront, which request becomes impossible to satisfy as the fees mount into the thousands of dollars. Finally, many modification programs put a limit on how far in arrears a homeowner may be, including the capitalized fees. *See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure, Part II: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 8 (2010) (statement of Donald Bisenius, Executive Vice President, Freddie Mac) (noting that it is harder to bring a borrower current the more delinquent the borrower is); *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 10-11, 14 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center). *Cf.* Hassan Shamji & Bulat Mustafin, *Measure of Modifications: A Look Across Servicers,* Moody's Resi Landscape 11, 12 (Feb. 1, 2011)(noting that capitalization of fees can doom a modification to re-default).

44 *See generally* United States Senate Subcommittee on Housing Transportation, and Community Development of the United States Senate Committee on Banking, Housing, & Urban Affairs 38-41 (May 12, 2011) (statement of Diane E. Thompson), *available at* http://www.nclc.org/issues/testimony-uniform-mortgage-servicing-standards.html

45 Fed. Res. Sys., Office of the Comptroller of the Currency, Office of Thrift Supervision, Interagency Review of Foreclosure Practices and Policies 3 (2011).

- No foreclosure-related fees should be imposed before the modification review has been completed.
- If a foreclosure is started before a loan modification application or review, both judicial and nonjudicial foreclosures must be frozen during review.

This is not an open-ended or indefinite proscription. Rather, it provides clear guidance to servicers that they can no longer continue to sit on loan modification applications indefinitely. Servicers are free to initiate or resume the foreclosure as soon as they conduct the review. Specific guidance as to necessary outreach and strict timelines should help to constrain servicers to expedite loan modification review.

Staying all foreclosures during the pendency of a loan modification review would encourage servicers to expedite their reviews, rather than delaying them, and would provide transparency and fairness to homeowners, while saving investors on foreclosure–related losses.

3. Loss mitigation should be triggered no later than 60 days delinquency

Loss mitigation should be required no later than when a borrower is 60 days delinquent, not 90 days, as proposed. HAMP and other programs use the 60-day mark. Beginning review at 60 days increases the possibility for completing the modification review before a foreclosure is initiated, since foreclosures are usually initiated after 90 days of delinquency. More importantly, at 60 days, homeowners are more likely to be able to complete a loan modification, as evidenced by the lower redefault rates.[46] Lower redefault rates mean lower risk to investors. Earlier intervention is more likely to lead to positive results. Indeed, in the recent servicing alignment orchestrated by FHFA, Fannie Mae and Freddie Mac require the borrower solicitation process to begin substantially earlier, starting with phone calls on the third day of delinquency.[47] The agencies should not step back from these existing standards.

The same standards should apply to subordinate liens, with loss mitigation triggered no later than 60 days, prior to the initiation of a foreclosure, with a loan modification mandated where consistent with net present value.

4. Loss mitigation should be available to homeowners facing imminent default

The agencies ask whether the QRM standards should permit loss mitigation when default is reasonably foreseeable. Homeowners seeking to proactively address an impending problem should not be required to default. Responsible behavior should be rewarded. Requiring that payments be objectively unaffordable and that income be documented, as HAMP and most modification programs do, guards against moral hazard among homeowners seeking modifications prior to default. Investors' interests are not served by increasing the delinquency status of mortgages—and the fees servicers can collect—prior to the modification.

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[46] *See* DIANE PENDLEY & THOMAS CROWE, FITCH RATINGS, U.S. RMBS SERVICERS' LOSS MIIGATION AND MODIFICATION EFFORTS 9 (May 26, 2009).

[47] *See, e.g.,* Freddie Mac, Borrower Contact: Freddie Mac Requirements under the Servicing Alignment Initiative (requiring borrower outreach to start between the third and 36th day of delinquency).

5. Loan modifications should include subordinate liens

Servicers holding subordinate liens may prefer to gamble on a market recovery rather than accept the incentive payments under HAMP and recognize their losses now. Many servicers have chosen not to participate in the HAMP second lien program absent a federal mandate. Failure to deal with the second lien results in unsustainable loan modifications (an affordable loan payment may not be affordable if the second lien payment is too high) and invites gamesmanship and moral hazard on the part of servicers.

The agencies ask a series of questions about the treatment of subordinate liens when the subordinate liens are owned outright as to whether there should be procedures in place for dealing with potential conflicts of interest.[48] Clear mandates and protocols that apply to both first and subordinate lien servicing are likely to be the best safeguard against conflicts of interest. Clear mandates limit discretion and so render irrelevant many conflicts of interest. Servicer discretion has not generally been a boon to either investors or homeowners. These protocols and mandates should extend to all subordinate liens, whether or not the creditor or its affiliate retained the subordinate lien. The risk that is occasioned by failure to modify a subordinate lien remains whether the subordinate lien is held by the originator or a neutral party. The proposed rule, focusing only on liens held by first mortgage creditors or their affiliates, is too narrow to provide sufficient risk retention safeguards.

The key principles for subordinate liens include the following:

- Subordinate liens should be reduced in proportion to first liens to ensure an equitable approach that maximizes home preservation.
- Subordinate liens should be evaluated for loan modification no later than the earlier of a request by the homeowner, 60 days delinquency on the first mortgage, or 60 days delinquency on the subordinate lien.
- Subordinate lien payments should be considered in determining affordability.

C. Affordable and Standardized Loan Modifications That Provide Long-Term Sustainability Should Be Required

The rules should require, as HAMP and the FDIC's loan modification protocol do, a standardized loan modification protocol. Experience with HAMP has demonstrated that standardized loan modifications that promote affordability have very low long term re-default rates, roughly half those of private loan modification programs, even ones with significant payment reductions,[49] thus lowering substantially the risk of loss to investors. These standardized loan protocols should be incorporated into the QRM servicing standards.

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[48] 76 Fed. Reg. 24,090, 24,128 (Apr. 29, 2011).

[49] Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 6 (2010) http://www.ots.treas.gov/_files/490069.pdf.

In order to make loan modifications affordable, the following standardized conditions must be met:

- Payment levels should be set sufficiently low that the risk of redefault is reduced. For homeowners with high levels of medical debt, for example, payments at the HAMP standard of 31% of income are not affordable. The agencies should require modifications below 31% where the homeowner has low residual income or high fixed expenses.
- Payment levels should include second lien payments.

In order to make loan modifications sustainable, the following principles should be implemented:

- Modifications should be based on a waterfall that prioritizes principal reduction. As a practical matter, principal reductions may be key to the success of any foreclosure mitigation program.[50] Being "underwater" increases the risk of default, particularly when coupled with unaffordable payments.[51] Moreover, principal reduction loan modifications appear to have the lowest rates of re-default of any loan modification alternative. [52]
- Modifications should reduce the interest rate before extending the term. While HAMP requires that the interest rate be reduced before the term is extended, many proprietary loan modification programs do not. By inverting the order of the waterfall, these proprietary programs produce loan modifications that are more costly to the homeowner and more risky for the investor. Homeowners with term extensions are more likely to re-default, both because they have longer to do so and because it will take them longer to pay down principal and build equity. Term-extension modifications increase the interest rate risk for both homeowners and investors. Reversing the waterfall does not protect investors from losses incurred through too great an interest rate reduction; the Net Present Value test already does that.
- Modifications should be permanent. Many proprietary modifications are limited to a period of a few years, requiring the homeowner and the servicer to revisit the modification process again. Given servicers' difficulties in getting the modification review correct in the first instance, homeowners should not be subjected to a second review. The financial markets are notorious for loathing uncertainty. Permanent modifications provide predictability for all parties.
- Trial modifications should be automatically converted to permanent modifications. As the abysmal conversion rates under HAMP have shown, without automatic conversion, servicers will often fail to timely convert trial modifications to permanent modifications. Allowing

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[50] *See, e.g.,* Laurie GoodmanRoger Ashworth, Brian Landy, & Lidan Yang, Amherst Securities Group, The Case for Principal Reductions (Mar. 24, 2011).

[51] *See, e.g.,* Kristopher Gerardi, Christopher L. Foote, & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 08-3 , June 2008); Andrey Pavlov & Susan Wachter, *Aggressive Lending and Real Estate Markets* (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf.

[52] *See, e.g.,* Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, Center for Community Capital, Loan Modifications and Redefault Risk: An Examination of Short-Term Impact (Mar. 2009), *available at* http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf; Diane Pendley et al., Fitch Ratings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts Update II at 16 (June 2010).

permanent modifications to be dependent on further action by servicers permits error and abuse in the modification process.

- Additional modifications should be available where the homeowner faces further unanticipated hardship. Homeowners may, post-modification, become disabled, lose their jobs, or suffer the death of a spouse. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Where homeowners have suffered an involuntary drop in income, foreclosing on homes without evaluating the feasibility of a further modification is punitive to homeowners already suffering a loss and does not serve the interests of investors. Evaluating homeowners for a further modification in these circumstances should be standard and mandated.

D. Homeowners' Legal Rights Should Be Protected in the Modification Process

1. Spouses, children, and ex-spouses should be offered a modification in accord with existing federal law.

The Garn-St Germain Act provides that mortgages should be freely assumable between family members living in the home, whether they acquire title through death or divorce or devise.[53] If a modification in those circumstances passes the NPV test, there is no reason not to allow it, and the weight of existing federal law supports the assumption of the mortgage and the curing of the default. As well as allowing QRMs to be assumable in accord with Garn-St Germain, the QRM standards should explicitly mandate that homeowners entitled to assume the mortgage under Garn-St Germain be offered a loan modification where it passes the NPV test.

2. Bankruptcy should not be a bar to modification

The QRM criteria – and any national servicing standards -- should allow modifications for homeowners in bankruptcy. For over a year, HAMP has required that modifications be allowed for borrowers in bankruptcy who are otherwise eligible. The QRM rule should, like the revised HAMP guidelines, explicitly provide that servicers must consider a homeowner seeking a modification even if the homeowner is a debtor in a pending bankruptcy proceeding.

Some servicers have explained their reluctance to do loan modifications in bankruptcy by citing a fear of violating the automatic stay in bankruptcy. Neither the automatic stay nor the discharge order should be a bar to offering an otherwise eligible homeowner a loan modification. HUD, in guidance to FHA servicers, has explicitly recognized that offering a loan modification does not violate the automatic stay or a discharge order.[54]

Servicers should be required, upon receipt of notice of a bankruptcy filing, to send information to the homeowner's counsel indicating that a loan modification may be available. Upon request by the homeowner and working through homeowner's counsel, servicers should offer appropriate loan modifications prior to discharge or dismissal, or at any time during the pendency of

[53] 12 U.S.C. §1701j-3(d).

[54] HUD Mortgagee Letter 2008-32, October 17, 2008

a chapter 13 bankruptcy, without requiring relief from the automatic stay, and, in the case of a chapter 7 bankruptcy, without requiring reaffirmation of the debt. The bankruptcy trustee should be copied on all such communications. All loan modifications offered in pending chapter 13 cases should be approved by the Bankruptcy Court prior to final execution, unless the Court determines that such approval is not needed. If the homeowner is not represented by counsel, information relating to the availability of a loan modification should be provided to the homeowner with a copy to the bankruptcy trustee. The communication should not imply that it is in any way an attempt to collect a debt.

Additionally, payment rules should take into account the fact that payments may be passed through the bankruptcy trustee, rather than directly from homeowner to servicer. There is often an initial lag between passing the payments from the bankruptcy trustee to the servicer; homeowners should not be penalized for a delay over which they have no control and which is occasioned solely by their exercise of their right to file bankruptcy.

Finally, the modification documents should explicitly prohibit servicers from requiring homeowners to reaffirm mortgage debts. Because reaffirmations of home mortgages have the potential to deny homeowners a fresh start, many bankruptcy judges refuse to approve them. Congress recognized this concern with an amendment to the Bankruptcy Code in 2005 that permits mortgages to be serviced in the normal course after bankruptcy even if the mortgage has not been reaffirmed. These purported reaffirmation agreements made outside the mandatory notice and review procedures of section 523(c) and (d) of the Bankruptcy Code have no effect and are not enforceable, and the government should not be involved in encouraging the practice.

3. Waiver should be forbidden in modifications

HAMP has forbidden waiver from its inception and even explicitly authorized loan modifications for homeowners engaged in active litigation with their servicer. Waivers of legal rights may not always be enforceable, but they have a chilling effect on homeowners' exercise of their rights. There is no reason to authorize servicers to require a get out of jail free card from homeowners in order to process a loan modification that is in the best financial interests of the investors. Permitting such waivers will encourage abusive servicer behavior and will impede loan modification processing for homeowners savvy enough to seek legal counsel as to the extent of their waiver.

Despite HAMP's prohibition, waiver continues to be a significant problem.[55] Recent reporting by ProPublica has found that several servicers continue to request waiver, particularly, but not exclusively, in non-HAMP, or proprietary, modifications.[56] In recent months, Bank of America has asked homeowners in New York, Maine, Indiana, Connecticut and North Carolina to waive all

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[55] *See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 29 (Nov. 16, 2010) (statement of Diane E. Thompson) (describing waiver in a PNC loan modification); *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the S. Comm. on Bank., Hous. & Urban Affairs*, 111th Cong. 22 (July 16, 2009)(statement of Diane E. Thompson)(describing problems with waivers in HAMP modifications).

[56] Paul Kiel, *Borrowing Trouble: Some lenders are modifying mortgages only after homeowners waive their right to sue,* ProPublica, May 8, 2011, http://www.slate.com/id/2293391/.

legal defenses in order to obtain a loan modification.[57] Bank of America employees have claimed both that such waivers occur when non-standard modifications are done and that such waivers are part of a standard package and cannot be removed.[58] Increasingly, homeowners in both HAMP and non-HAMP modifications are being asked to sign waivers of specific claims, often related to allegations of robosigning or standing.[59]

Servicers continue to press homeowners to waive their rights to a HAMP modification. A Colorado homeowner was told by Bank of America employees that waiver of her rights to a HAMP review was a condition of suspension of the foreclosure sale, despite the fact that there was an ongoing review of the denial of her HAMP application.

The QRM rule must follow HAMP's lead and clearly prohibit waivers. To do otherwise ultimately increases litigation risk for investors.

E. Servicing Rules Must Provide For Transparency and Accountability

1. Fees must be brought in line

Fees serve as a profit center for many servicers and their affiliates. They increase the cost to homeowners of curing a default. They encourage servicers to place homeowners in default and can doom modifications. Fees cost both borrowers and investors.

Fees include late fees, valuation, home inspection, force-placed insurance, attorney fees, title insurance, auction, legal, property preservation fees, and REO sales fees, among others. All of these fees should be reasonably related to the actual cost of providing the service. There should be no fee for home preservation services if the homeowner submitted any payment to the servicer within the 60 previous days: it is unreasonable in those circumstances to assume that the homeowner has departed for parts unknown and property preservation services are needed.

Servicers should be limited to one reasonable appraisal fee before an evaluation for a loan modification is completed. Additional valuations should be limited to no more than one every six months, absent a compelling change in circumstances. Title work should be limited to that reasonably necessary, and foreclosure attorney fees must be restricted to work actually performed.

In addition to limiting the pre-modification and foreclosure fees, the QRM rules and national servicing standards should require that payments be credited as of the date received (as the Federal Reserve Board's rules do currently),[60] that payments, even partial payments, be applied to principal and interest first, and that late fees be regulated as they are under the Uniform Consumer Credit Code.

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[57] *Id.*

[58] *See, e.g., id.*

[59] *See, e.g., id.*

[60] 12 C.F.R. § 226.36(c)(1)(i).

Sec. 2.502(2) of the Uniform Consumer Credit Code (1974 version) reads: "A delinquency charge under subsection (1) may be collected only once on an installment however long it remains in default." This is a broader reach than under the FTC Credit Practices Rule. The Credit Practices Rule prohibits charging late fees on late fees--that is, if one payment is late, and a late charge is assessed but not paid, the creditor cannot charge late fees on all subsequent payments until the late fee is paid. The UCCC standard is broader than that, and forbids pyramiding of late fees even if the underlying payment itself is not made. Under this provision, missing one payment once results in one late fee: the creditor cannot charge separate late fees on subsequent timely payments on the theory that the missed payment is still outstanding. The UCCC rule comports with common understanding of how payments should be applied, but not common practice.[61] A number of states have already adopted this language, and it should be incorporated into the servicing standards for QRMs.

2. Fees should be disclosed

No fee should be charged unless the borrower has been given advance notice of the type of fee and the circumstances in which it will be imposed. This disclosure should be made annually and whenever servicing is transferred. This notice should not include wide ranges that are meaningless but meaningful notice regarding the amount and circumstances in which the fee may be imposed.

The servicer also should be required to comply with the contract and should not be allowed to charge fees that are not explicitly provided for by the contract. There should be a requirement that any fees incurred be disclosed on the monthly statement sent to the borrower, with an annual statement that gives the cumulative total. Monthly statements should also inform the borrower how fees may be disputed.

3. Force-placed insurance requires specific safeguards

Servicers often take advantage of a real or alleged lapse in a homeowner's insurance policy to place a policy with an affiliate. These policies can be exorbitantly expensive, sometimes ten times the cost of the underlying policy, and usually do not provide coverage for the homeowner, but only for the investors as to the remaining loan balance. To combat these abuses, servicers should be required to continue an existing policy or reestablish a policy if there is a lapse in payment. Premium payment information should be provided to the creditor/servicer at closing, and updated if the policy changes, whether or not there is an escrow, so that the existing policy can be continued in the event of a lapse. If there is no escrow, the servicer should advance the fee to pay the premium and collect the premiums in increments of 1/12 per month or through creation of an escrow account under RESPA. This entire process should be disclosed at the outset.

4. Transparency in the loan modification process should be mandated

The agencies propose to provide transparency in the loan modification process by providing disclosure to homeowners at the time the loan is closed.[62] Homeowners do not need disclosure of

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[61] *See, e.g.,* Collins v. America's Servicing Co., No. 10-2962 (7th Cir., July 13, 2011) (discussing how a homeowner could reasonably believe that no late fees would be assessed while nonetheless be contractually obligated to pay late fees over an extended period of time while making timely payments as agreed).

[62] Subpart D, §_.15(c)(13)(ii).

loss mitigation procedures when the loan closes as much as they do when they are facing default or negotiating a loan modification.

Among the matters that servicers should be required to disclose to borrowers are the following after default:

- The amount of the unpaid principal balance. Servicers should be required to disclose the components of the unpaid principal balance, affording homeowners a chance to correct discrepancies. Inflated principal balances line servicers' pockets at the expense of both homeowners and investors.
- Loan modification denials should include documentation of relevant investor contracts and correspondence regarding any related limitations and efforts to modify. Such denials are often pretextual.[63] Providing homeowners documentation of the basis of the investor denial will expedite dispute resolution and provide a powerful incentive for servicers to check their facts before issuing a denial based on investor restrictions

Additionally, the QRM rule should set time deadlines for review and response. . Moreover, there should be an appeals process available to homeowners denied modifications prior to initiation of foreclosure. Homeowners should not be foreclosed upon while they are awaiting the results of an appeal.

Finally, servicers should be required to make detailed information about loan modifications publicly available. Despite their central role in the debate over foreclosures, little data is publicly available on the nature or extent of loan modifications, or who receives them. The Office of the Comptroller has begun this process with the collection and publication of data in the quarterly Mortgage Metrics Report, but more needs to be done. This information should be available by servicer at the census tract level, and should include the race of the borrower, as well as the salient characteristics of the modifications. Such public disclosure could be modeled after the disclosures mandated under the Home Mortgage Disclosure Act. Information on QRM loan modifications may be particularly important to those seeking to monitor the performance of QRMs over time.

5. Transparency throughout servicing could be improved through transfer notices and periodic statements

The agencies propose to mandate that, upon transfer of servicing, the new servicer will assume the default servicing obligations of the prior servicer.[64] The agencies make no provision for ensuring that homeowners are notified of this obligation, however. The agencies should correct this oversight with the following requirements:

- Transfer notices should advise if the homeowner is current and whether there are any unpaid fees. If a fee is not in the "goodbye letter" and "hello letter" to homeowner as having been incurred, it should be waived. At transfer of servicing, the servicer must indicate to the

[63] *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 8-17 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center).

[64] 76 Fed. Reg. 24,090, 24,127 (Apr. 29, 2011).

homeowner whether a loan modification is pending. If a loan modification was entered into prior to transfer, the servicer must acknowledge that the loan modification is in effect.

- Periodic statements, servicing transfer notices, and escrow account statements should be provided notwithstanding delinquency or default status. Many homeowners who believe they have a permanent modification and are making payments under what they understand the terms of that modification to be are caught off guard by the servicer's refusal of payments, claimed arrearages, and foreclosure action due to the non-receipt of monthly servicing statements.

F. Structural Adjustments Should Foster Quality Mortgage Servicing

The proposal raises several questions about structural organization of servicing requirements.

First, servicing compensation should promote modifications over foreclosure. While there may be more than one way to accomplish this goal, a fee for service approach should not allow for increased charging of fees to homeowners in foreclosure nor should homeowners be required to pay an up-front fee in order to obtain a modification. To the extent servicing transfers are mandated upon default, such transfer must be automatic, the two entities must be completely unaffiliated, and there must be rigorous protections in place. If the special servicer is tasked with modifying the loan, a further transfer should be required to a third unaffiliated servicer if modification is impossible and a foreclosure must go forward. Otherwise, the perverse incentives to foreclose rather than modify will simply move from one servicer to another. Moreover, given the sordid history of some special servicers, protections for borrowers against abusive, harassing, or misleading collection attempts must be enlarged and enforced. As suggested by this cursory overview, compensation is complex. The details of servicer compensation may be best left to the marketplace, provided there is a regulatory overlay which sets the boundaries to protect investors and consumers.

Second, mitigation commitments, as well as requirements regarding subordinate liens and assumptions, should be in both mortgage documents and the PSA, because they affect both the homeowner and the investor—and both may have occasion to wish to enforce those covenants. The GSEs should establish identical requirements to the extent applicable.

III. Qualifying Automobile Loans

Our concerns relating to automobile loans are similar, but not exactly the same as those for mortgage loans. We support the statute's goal of requiring risk retention to encourage automobile loans which are less risky and more affordable. As is true for mortgage loans, to the extent that the exception to the risk retention requirements defines the best automobile loans, we are concerned that the definition be appropriate, not unfairly discriminate against people of low wealth, and be sufficiently limited so that those auto loans which will still be subject to the risk retention requirement will enjoy a liquid and competitive market.

We assume that those automobile loans which are excused from the risk retention requirement will enjoy lower securitization costs, and thus will be less expensive for the creditor to make. One of our most important recommendations is to ensure that some part of these savings is passed along to those consumers who qualify for these loans. Just as we recommend that there should be an interest rate cap for QRM loans, we also recommend that there should be an interest rate cap—measured by a comparison to Treasury bills (or some other appropriate measurement) for automobile finance that is exempt from the risk retention requirements.

In these comments, we encourage the agencies to further limit the exception for automobile loans to ensure that the criteria for the exception are non-discriminatory while still excluding risky creditor behavior. The bottom line is that the interests of investors and consumers run parallel in this matter: the same criteria that reduce risk for automobile asset backed securities also make for better loans for consumers. Consumers are less likely to default on fair, affordable loans for reliable, fairly priced cars.

A consumer has a strong interest in buying and keeping a safe and reliable car. A working car is central to productivity and self-sufficiency for most families. Over 90% of workers drive to their jobs.[65] The importance of a working car is especially great for low-income families. Households with incomes below $25,000 are nine times more likely to be without a car than households with incomes above $25,000.[66] But a car does more than provide access to employment and economic success. Safe, reliable transportation expands families' options for suitable child care, affordable housing, medical care, healthy foods, financial institutions, and a host of other needs and opportunities. Without transportation, families' ability to meet their basic needs is severely limited.

On the one hand we offer a number of additional criteria for risky automobile loans that should lead to disqualification. On the other hand, we are concerned that disqualifying *all* loans involving older used cars and those with smaller down payments will lead to reduced capital available for loans to lower income consumers—who will be unlikely to qualify for the loans subject to the exception, leading to increased financing costs for those least able to afford them.

A. Prohibit or limit dealer markups

In most car purchase transactions, the dealer is the original extender of credit. The dealer's role in financing the vehicle, including the opportunity for add-ons,[67] generally creates more profit than the sale of the car itself. Before the transaction is closed, dealers provide the consumer's financial information to prospective assignees. These financing companies, many of whom later securitize the auto loans, then inform the dealer of the terms on which they will be willing to buy the loan made to that consumer for a particular car. Often the dealer places the consumer in less favorable financing than the consumer qualifies for based upon credit worthiness, and splits the extra profit from the higher interest rate with the assignee. This increase in interest rate above what

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[65] U.S. Department of Transportation, Bureau of Transportation Statistics, *NHTS 2001 Highlights Report,* BTS03-05 (Washington, DC: 2003).

[66] U.S. Department of Transportation, Bureau of Transportation Statistics, *NHTS 2001 Highlights Report,* BTS03-05 (Washington, DC: 2003).

[67] See the discussion in subsection D, *infra.*

the consumer qualifies for is called “dealer markup” or “dealer participation.” An extremely troubling feature of dealer financing markups is their disparate racial impact. There is extensive proof of these practices and their illegal impact on minorities obtained through litigation brought by NCLC and others. It has been well documented that minority car buyers pay significantly higher dealer markups than non-minority car buyers *with the same credit scores*.[68]

These dealer markups are of particular importance when assessing the riskiness of these loans. Because a markup will make the loan more expensive for the consumer than it need be, it is reasonable to expect it would increase the likelihood that the consumer would default. In a recent study the Center for Responsible lending found that this is indeed the case and that “undisclosed markups increase the odds that a subprime borrower will default by 12 percent and the odds that he or she will end up having their car repossessed by 33 percent.”[69]

Because markups increase the risk of default, tend to have a disparate racial impact, and reduce transparency, they should be prohibited for automobile loans qualifying for the exception to risk retention. In the alternative they should be capped at a fixed processing cost, such as $100.00, rather than a percentage of the sales price or the financing.

B. Exclude ALL vehicles with title brands that indicate significant damage

The proposed rules exclude loans made to purchase a salvage vehicle from being classified as qualifying. This is a good way to reduce risk, as salvage vehicles are more likely to break down or be unsafe to drive, leading to default. To better capture all significantly damaged cars, the final rule should exclude any loan for any vehicle having a branded title that indicates significant damage, such as "junk," "salvage," "flood," "rebuilt," or "non-repairable," and any vehicle that has been reported to the National Motor Vehicle Title and Information System by a junk/salvage reporting entity.

C. Prohibit or limit the financing of negative equity from a trade-in vehicle

When a car buyer owes more on a trade-in vehicle than it is worth, this negative equity is often added to the loan for the car the consumer is purchasing. Adding such negative equity to a car loan not only increases the risk of default, but also increases the size of any deficiency after repossession. A recent report indicates that “more than one quarter of loan transactions have some level of negative equity today, with an average new-car-loan negative equity of $4,250.”[70] Any loan which includes negative equity from a trade-in should be excluded from qualifying as an exempt loan.

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[68] See, e.g., Ian Ayers, Expert Report, June 2004, available at http://www.consumerlaw.org/issues/cocounseling/content/AHFCIanAyresReportExhibits.pdf; Cohen, Mark A. “Imperfect Competition in Auto Lending: Subjective Markups, Racial Disparity, and Class Action Litigation.” available at http://ssrn.com/abstract=951827.

[69] Delvin Davis and Joshua M. Frank, UNDER THE HOOD: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses, April 19, 2011, available at: http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups.pdf.

[70] Richard Apicella and George Halloran, The Rising Repossession Tide, BenchMark Consulting International (2008), available at: http://www.benchmarkinternational.com/Articles/TheRisingRepossessionTide.pdf.

D. Limit the sale of "add-ons" as a percentage of the value of the vehicle

As previously discussed, auto dealers now make more of their profit selling financing and add-ons than from selling cars.[71] They have incentives to sell various add-ons to consumers such as rust proofing, window etching, GAP insurance, credit life insurance, credit disability insurance, tire protection plans, service contracts, warranties and more. Dealers can make a handsome profit on many of these products, often charging a great deal more than the products cost the dealer and a tremendous amount more than any value they might have to the consumer. In addition, if the dealer is receiving mark-up proceeds, the amount of the dealer participation will increase as the amount financed increases with additional add-ons.

All these add-ons make the loan more expensive and increase the risk that the consumer will be unable to pay the loan. Lenders realize this and typically limit loan amounts to 120% - 140% of the blue book value of the car. These ratios do not reflect the levels at which the loans become less risky, but rather a reflection of the controls lenders can exert without losing significant business from dealers.

Rather than look at the total loan-to-value ratio, the final rule should exclude any loan for a vehicle sale transaction that includes add-ons that exceed 5% of the value of the car. Applying a limit to add-ons based on a percentage of the value of the car will reduce the risk of default.

E. Limit the interest rate that may be charged to the consumer

Loans with excessively high interest rates are more expensive and therefore more risky—for consumers and the markets. Because many states permit very high interest rates on vehicle loans, financing for these cars can be very expensive. No loan with an interest rate more than 12% above the current one-year Treasury securities rate should be classified as a qualifying loan.

F. Eliminate the down-payment requirement

To ensure that low-income consumers are not excluded from the market for qualifying financing, the final rule should not include a down payment requirement. The verification of income, combined with the analysis of the credit information is sufficient to evaluate a consumer's likelihood of repaying. High risk loans will be effectively avoided using these criteria, and low income families unable to pay the 20% down will not be excluded from the lower cost auto loans subject to the exception.

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[71] *See* 2009 F&I Statistics, F&I Management & Technology, December 30, 2008, at 28, stating that---"After experiencing slight declines in 2005, F&I's contribution recaptured some ground in 2006 and continued to rise in 2007 and 2008, representing more than half of total profits. Lower gross margins on the sale of new units has helped increase the importance of F&I contributions. Source: CNW Market Research."

G. Do not exclude loans for cars older than 5 model years

We agree with the principle behind the proposal's limit on loan terms of five years for new vehicles. However, we have concerns about the reduced loan terms for used vehicles. The risk of default does increase when the loan term exceeds the actual life of the car. However, there are serious problems with the effect of the proposed rule on used vehicles—and that means more low income consumers will be excluded from the lower cost loans subject to the exception. The rule provides that the term of the loan, plus the difference between the current model year and the vehicle's model year, cannot exceed 5 years. The effect of including the age of the car in this formula will be to limit qualified financing to cars 5 model years old and newer. The formula would, for all practical purposes, exclude even four year old cars, as there are very few auto loans with a term of only 12 months. This would mean that almost all cars purchased by lower income Americans would never be excluded from the risk retention requirement.

As cars are better built, their useful life is increasing rapidly. The average car on the road is now more than ten years old and many cars provide reliable transportation for many more years.[72] The average price paid for a three-year-old used car is now $19,248.[73]

Rather than excluding older vehicles, such cars should be subject to an inspection requirement. This would reduce the credit risk without excluding low-income families.

The quality of used cars can vary tremendously and yet be very difficult for the average consumer to detect. The condition of the vehicle affects the value of the collateral on the loan, and also impacts the ability of the consumer to pay the loan. An unreliable car can lead to lost income and even to lost employment, and to increased family assets going to repairs instead of car payments. Accordingly, to qualify for the exclusion from risk retention, we propose that <u>older used cars should be inspected by a third party licensed mechanic and a body shop prior to the extension of credit to protect both the car buyer and the lender.</u>

Conclusion

We appreciate the review of these comments and would be happy to provide more information on any of these issues.

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[72] Liz Weston, Make your car last 250,000 miles, MSN Money (2010)

[73] Carroll Lachnit, *With Used-Car Prices Up 10 Percent Over 2009, Buyers Need Shopping Discipline,* Edmunds Daily*,* August 20, 2010, http://blogs.edmunds.com/strategies/2010/08/with-used-car-prices-up-10-percent-over-2009-buyers-need-shopping-discipline.html.