COMMENTS

of the
National Consumer Law Center
and the National Association of Consumer Advocates
to the
Office of Thrift Supervision

Regarding
Advance Notice of Proposed Rulemaking
Relating to Unfair or Deceptive Acts or Practices

[Docket ID OTS-2007-0015]

November 6, 2007

“When morality comes up against profit, it is seldom that profit loses.”
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The National Consumer Law Center\(^1\) ("NCLC") submits the following comments on behalf of its low income clients, as well as the National Association of Consumer Advocates\(^2\) ("NACA") to the Office of Thrift Supervision regarding the proposed rule on unfair or deceptive acts or practices. We appreciate the comprehensive set of issues that the OTS has identified as it considers the focus and the range of a rule in this area.

The need for assertive, comprehensive and protective action is clear. Consumers are hurting. The numbers of foreclosures precipitated by abusive subprime lending standards continues to escalate. Credit card debt continues to climb – sped along by ever higher and higher fees and charges triggered by defaults impossible to

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

\(^2\) 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.
avoid. Every day, thousands of Social Security recipients, and other recipients of federally exempt benefits, see their only income illegally frozen by their banks. And this nation’s savings banks are right in the middle of all of these difficulties. No longer can consumer advocates say that mainstream financial services providers – banks and savings banks – are generally blameless for the consumer problems we see. Unfortunately, the lines between banks and these alternative providers are blurred. Sometimes the banks themselves are engaged full throttle in the abusive acts and policies; sometimes the problem lies with a subsidiary of the bank. Something must be done to protect the individuals, the families, the communities in this nation from these continuing abusive practices.

The OTS has put on the table for consideration both a general and specific scheme of defining unfair and deceptive acts and practices. We applaud the OTS for recognizing many of the consumer problems that were identified in the ANPR. Now we ask the OTS to take the next – the harder – step – and outlaw these and other specific, inappropriate, practices for savings banks.

In these comments we urge the OTS to issue a broad, general prohibition against acts or practices which are unfair or deceptive, as well as identifying specific acts and practices which are already determined to be unfair or deceptive and, as a result, should be specifically prohibited. We urge the OTS to use its rulemaking authority under both the FTC Act and HOLA to lead the federal regulators toward a comprehensive federal prohibition of unfair and deceptive acts and practices. This prohibition should ban a series of specific, identified, set of behaviors, while it establishes more general principles which can be used to determine inappropriate behaviors on a case-by-case basis.

Meaningful enforcement of unfair and deceptive practices is a critical piece of any real effort to protect consumers. Whether the OTS provides general or specific – or both as we recommend -- prohibitions or guidelines, the real value in any protection lies in the power of its enforcement. Meaningful enforcement requires more than just OTS’s actions. Meaningful enforcement requires private enforcement.

In Section I of these Comments we will set out the basic approach that we recommend for the OTS to take to ensure that consumers are protected from acts and practices which are unfair or deceptive.

In Section II we discuss preemption and enforcement. We urge the OTS to make these rules truly protective of consumers. Real consumer protections are privately enforceable. As neither the FTC Act nor HOLA includes private rights of action for violations of their provisions, consumers who are individually harmed by acts or practices defined to be unfair or deceptive by the OTS need to be able to bring actions under state law. The OTS should explicitly preserve this right.
In Section III we address the specific acts and practices that should be prohibited by the OTS as unfair or deceptive, including practices relating to credit cards, mortgage loans, deposit accounts, and other types of credit.

We attempt to answer the issues asked in the ANPR by OTS throughout these comments.\textsuperscript{3}

\textsuperscript{3} We declined to address Issues 12 through 14 regarding advertising.
Section I. OTS should establish both a broad standard along and extensive specific prohibitions.

When Congress passed the FTC Act, it exempted banks and savings and loan associations from coverage with the big caveat that the nation's regulators of these financial institutions must do the job themselves. The language requiring the regulators to take actions to stop unfair and deceptive acts and practices is not permissive: the regulators are not simply allowed to define and prohibit these practices – they are required to do so:

\[\text{T}he \text{ Federal Home Loan Bank Board (with respect to savings and loan institutions described in paragraph (3)) . . . shall prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices.}\]


Given the extensive reports of problems in every sector of the consumer credit market, the OTS – as well as the other regulators – must act now. To date, too much attention has been paid to preserving access to credit and eliminating state law interference with federally chartered banks. Now, it is incumbent upon the OTS to protect consumers with a comprehensive and specific – and enforceable – set of rules which provide both prophylactic protection and remedies. The triple goals of these rules should be –

- to give savings banks (and others covered by the rule) clear notice of the types of behaviors which will be punished;
- to give consumers a clear method of enforcing their rights under these rules; and
- to provide strong incentives for savings banks to avoid unfair and deceptive behaviors.

OTS asks in Issue 3. “What would be the impact on the industry and consumers of any of the various models and approaches discussed?”

Our answer is that the proposals that we make will improve industry, make it the financial services industry that is most friendly to consumers. If the OTS proceeds

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4 15 USC § 57a.
5 These abuses – and citations to prove the extent of their effect -- will be detailed in Section III of these comments.
as it proposes here, savings banks will become well known for their high standards of consumer protection. They will be rewarded in the marketplace for being the leaders in consumer protection and the least abusive of consumers. These proposals will allow an even playing field for honest, ethical providers of financial services.

A. A Principles Based Approach is Appropriate, But Only As One Part of a Rule that Also Prohibits Specific Unfair and Deceptive Practices.

**Issue 5** – “Should OTS consider a principles-based approach to a potential rulemaking that can evolve as products, practices and services change? If so, what principles should OTS consider in determining that a specific act or practice is unfair or deceptive?”

We answer “yes,” the OTS should provide a two-pronged approach to its UDAP rule: general principals which will address the changing marketplace, as well as a list of specified prohibited behaviors.

Deception, unfairness and unconscionability are broad and evolving standards that arguably apply to almost every consumer abuse. Because of the ever-changing marketplace and the inventiveness of those engaged in deception and unfair practices, acts and practices will unquestionably develop which have not been previously specifically identified – but that lack of identification does not mean that the activity should not be prohibited, remedied and punished.

By using a general prohibition and not attempting to limit the definitions of unfairness or deception to the specifically delineated items, the OTS would have the opportunity to give the protection broad scope and prevent evasion of its provisions. This has been the standard method of framing the 1) FTC’s rules prohibiting specific actions as unfair or deceptive, 2) FTC’s enforcement actions against individual actors in commerce who were committing acts which were unfair or deceptive under the general definition, and 3) state law UDAP statutes.6

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As has been recognized in the courts when dealing with fraud, unfairness and deception, “the fertility of man’s invention in devising new schemes” is great. There is no reason that bad acts not yet contemplated – and as a result not yet identified – should not still be addressed by the OTS’s consumer protection rule banning these bad acts.7

State UDAP statutes are generally designed to proscribe new forms of deception, encompassing wrongful business conduct in whatever context such activity might occur. OTS rules should be broadly applicable to consumer transactions and should be construed in a manner consistent with economic reality – as it evolves over time. The prevailing purpose of the OTS rule should be to have a broad impact to ensure an equitable relationship between consumers and savings banks.

However, a principles-based rule by itself is not sufficient. Most state unfair and deceptive acts and practices statutes (“UDAP”) prohibit itemized practices.8 These “laundry lists” serve the useful function of establishing clear signals to the governed industries regarding what practices are unequivocally unacceptable. The specific, identified, prohibitions are clear guidelines to all who operate in the marketplace that certain behaviors are not permitted – they set parameters that are unequivocally needed in today’s credit world.

Without specific prohibitions, the OTS’s rule is unlikely to achieve the changes that are needed in the marketplace. If the OTS adopts broad, flexible guidelines alone, creditors will find ways to justify their practices and will continue business as usual. In Section III, we set out a series of specific behaviors that we recommend the OTS include in its list of prohibited unfair or deceptive acts and practices.

By enacting a clear set of UDAP standards which will both specify identified acts which are clearly prohibited and provide a general standard against unfairness and deception, the OTS will be codifying the standards which the public has the right

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8 See generally, National Consumer Law Center, Unfair and Deceptive Acts and Practices (6th Ed. 2004); Chapter 3 includes a discussion of enumerated and general prohibitions.

Comments of the National Consumer Law Center and National Association of Consumer Advocates
to expect from commercial transactions with savings banks. Judge Learned Hand, in describing the FTC's mission, also provides an apt justification for a strong OTS rule on unfair and deceptive practices – “to discover and make explicit those unexpressed standards of fair dealing which the conscience of the community may progressively develop.”

OTS asks in **Issue 4**: “OTS's current Credit Practices rule lists specific acts or practices that are unfair or deceptive per se; it prohibits such practices regardless of the specific facts or circumstances. Would it be appropriate for OTS to determine that additional acts or practices are unfair or deceptive per se regardless of the specific facts or circumstances?”

There is a long list of activities which should be explicitly prohibited. We provide part of this list in relation to mortgage loans, credit cards, other loans and deposit accounts in Section III. However, there is also a real need for a broad prohibition against a) deceptive acts, b) deceptive practices, c) unfair acts, and d) unfair practices. The difference between an act and a practice is that an act is a one-time event which may or may not be regularly repeated, and possibly is not condoned by management. A practice is more like a repeated event which is likely to be deliberately adopted by the business enterprise, or at least an accepted part of transactions with consumers. If the activity harms consumers, whether it is a one-time act, or a standard practice, it should be prohibited. The consequences may be different depending upon the extent of the harm caused by the activity.

**B. The FTC Principles Should Be the Basis for the Both the General Principles and the Specific Prohibitions of the OTS Rule**

**Issue 6**: “Are the principles in the FTC guidance appropriate for the thrift industry? Should OTS consider adopting and incorporating them as part of an enhanced rule on unfair or deceptive acts or practices that includes standards to determine whether a particular act or practice is unfair or deceptive? Are any of the other models or approaches discussed in part III of this Supplementary Information appropriate for OTS to consider? What other models, approaches, or principles should OTS consider?”

We recommend that the OTS use the FTC model, both for a general principles portion of the OTS rule as well as for the specifically delineated prohibitions. The FTC standard is a vigorous, live standard that works well to balance the needs of consumers for protection with the marketplace issues. The FTC's unfairness standard was explicitly expressed by Congress relatively recently, when it reauthorized the

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FTC in 1994.\textsuperscript{10} It is undoubtedly the most recent and the most comprehensive articulation of Congress on the subject. Also, -- unlike all of the other methods considered in Part III of the ANPR as a basis for OTS’ rule -- it was explicitly designed to be a rule dealing with unfairness and deception in the marketplace. Finally, the FTC standard has stood the test of time and there are few, if any, complaints that it goes too far to protect consumers. Indeed, the FTC standard itself currently represents a \textit{reduction} in protection for consumers from the previously articulated unfairness standard by the U.S. Supreme Court.\textsuperscript{11}

The FTC standards have well developed measurements for evaluating determine deception and unfairness. The OTS will benefit considerably from the wealth of information and thoughtful exploration of the needs of consumers and the role of business in American society produced by the FTC and the courts in the development of the FTC rules. Basing the OTS UDAP regulations on these healthy methods of determining unfairness and deception would give OTS a big head start on addressing the plethora of problems in the marketplace.

\textbf{Issue 7} – “Can the acts or practices encompassed within any particular model or approach described in part III of this Supplementary Information be conducted in a manner that is not unfair or deceptive to the consumer? If so, how?”

If the OTS adopts the FTC approach, and provides both a set of principles defining unfair and deceptive practices and set of specified activities which are unfair or deceptive, \textit{based on the determination of unfairness or deception articulated in the FTC standard} the answer here is “no.” Once the rigorous test for unfairness or deception of the FTC standard is applied, and the activity found to be unfair or deceptive is specifically and carefully delineated, the conduct is always unfair.

For example, we recommend in Section III A that OTS declare it an unfair practice for a savings bank to foreclose on a home without considering reasonable loss mitigation approaches. Such a requirement would not prohibit foreclosure, it would simply require the \textit{evaluation of reasonable} means to save the home and some of the homeowner’s equity before foreclosure. So for example, assume the homeowner had

\begin{itemize}
  \item Whether the practice offends public policy: whether it is within at least the penumbra of some common law, statutory, or other established concept of unfairness.
  \item Whether the practice is immoral, unethical, oppressive, or unscrupulous.
  \item Whether the practice causes substantial injury to consumers.
\end{itemize}


\textsuperscript{11} The United States Supreme Court has found unfairness to be a broader standard than deception and has noted with approval the following criteria for determining whether a practice is unfair:

\begin{itemize}
  \item Whether the practice offends public policy: whether it is within at least the penumbra of some common law, statutory, or other established concept of unfairness.
  \item Whether the practice is immoral, unethical, oppressive, or unscrupulous.
  \item Whether the practice causes substantial injury to consumers.
\end{itemize}

already moved out of the home before the issue arose. A reasonable loss mitigation mechanism might be a deed in lieu of foreclosure, rather than a loan modification. The key is in properly defining the activity which is unfair – in this case we are not saying that pursuing foreclosure is unfair, just that pursuing it without considering reasonable loss mitigation strategies first, is unfair.

**Issue 8** asks: “The FTC has taken enforcement actions for violations of section 5 of the FTC Act. Should OTS draw specific examples of unfair or deceptive practices from FTC enforcement actions? If so, which examples?”

Exchange of information will be a tremendous benefit to any sustained effort to wipe out unfair and deceptive practices in the industry. Findings of unfairness or deception by one agency engaged in this effort should certainly always be the basis for an investigation into similar activities by another agency. Further, determinations of appropriate remedies should similarly be considered by an agency following down a similar path of compliance. The agencies should watch not only the investigatory actions of each other, but also the consumer complaints and the cases filed across the nation regarding relevant issues. The failure to do so will likely mean missed opportunities to resolve problems before they cause greater harm to consumers.

Just one example of an FTC enforcement action that the OTS should consider adding to its arsenal: the case of United States of America v. Fairbanks Capital Corp. In this case the FTC found consistent and repeated instances of this mortgage servicer’s improper application of payments, overcharges of late fees and other fees, pursuit of foreclosure when the homeowner was not in default, or attempted to cure the default, etc. Some relief was afforded to homeowners subjected to Fairbanks’ abusive practices as the result of the settlement. In the intervening years since this settlement there have been repeated complaints about the servicing activities of a number of federal savings banks or their subsidiaries, yet no similar strong enforcement actions have been brought by the OTS against these federal financial institutions. Had the OTS acted sooner in this regard, thousands of homeowners would doubtless have not lost their home to foreclosures brought by these savings bank servicers.

We would recommend that the OTS generally watch all of the enforcement actions initiated by its sister agencies and determine whether similar actions might be appropriate for the OTS.

**Issue 9** – “How would the practices in OTS’s current Credit Practices rule and those identified in part III of this Supplementary Information fit into any of those approaches?”

13 See, e.g. In re Ocwen Loan Servicing, LLC Mortgage Servicing Litigation, 491 F.3d 638, 643 (7th Cir. 2007).
OTS’s current Credit Practices rule mimics most of the FTC’s Credit Practices Rule.\textsuperscript{14} It was developed by the FTC using the FTC standards of unfairness and deception.

**Issue 10** – “Are the acts or practices currently listed in the Credit Practices rule the only ones that are capable of targeting specific conduct without allowing for easy circumvention or having unintended consequences?”

No, there is no reason to believe that the unfair or deceptive practices described in Section III of these Comments cannot also be described and prohibited with specificity, so that easy circumvention and unintended consequences would be minimized. The key to avoiding circumvention is minimized with vigilant updating of the specific prohibitions to address new problems as they arise in the marketplace.

**Issue 11** – “Has the current rule been easy to circumvent or created unintended consequences? What would be the impact, in this regard, of including additional acts or practices in the rule?”

The current rule has certainly been circumvented – creditors still find ways to pyramid late fees, household goods are still taken as security. Certainly the goal of the prohibitions against wage assignments is circumvented by payday loans – but that is because the specific language of the FTC rule does not address the specific structures of payday loans. It is also because the FTC has not issued any new rules like the Credit Practices Rule in over twenty years, and as the credit marketplace has evolved, the FTC has not continued to prohibit the new, unfair or deceptive, practices. The OTS, however, would not be limited to following in the FTC’s path – nothing would prevent it from striking out on its own.

1. **The FTC Standard on Deception**

Deception is different that fraud. It is a broader, more flexible standard. Common law fraud requires proof of five elements:

- A false representation, usually of fact;
- Reliance on the representation by consumer;
- Damage as a result of the reliance;
- “Scienter,” that is, the defendant’s knowledge of the falsity; and
- Damages proximately caused by the defendant’s acts.

The modern concept of deception, as shaped by federal court interpretations of

\textsuperscript{14} 16 C.F.R. Part 440.
the Federal Trade Commission Act, substantially eliminates these proof requirements. To show deception under the FTC Act, intent, scienter, actual reliance or damage, and even actual deception are unnecessary. All that is required is proof that a practice has a tendency or capacity to deceive even a significant minority of consumers. In addition, while common law fraud often must be proven with clear, convincing evidence, the UDAP standard is likely to be just a preponderance of the evidence

No intent or knowledge requirement. The FTC definition of deception does not require intent; a practice is deceptive even if there is no intent to deceive. Knowledge of a statement’s falsity, “scienter,” is not a necessary element for an FTC finding of deception.

Consumers Need Not Have Actually Been Deceived. Under the FTC definition of deceit, there need not be a finding that consumers were actually deceived. All that need be shown is that the practice is “likely” to deceive.

Vulnerable Consumers. It is important to note that vulnerable consumers are especially protected under the FTC standard of deception. In determining under the FTC Act whether a practice has a capacity or tendency to deceive, federal courts and the FTC historically have considered whether the ignorant, the unthinking, the

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17 FTC v. Algoma Lumber Co., 291 U.S. 67 (1934); FTC v. Amy Travel Service, Inc., 875 F.2d 564 (7th Cir. 1989) (intent unnecessary even for action for monetary redress); Orkin Exterminating Co. v. FTC, 849 F.2d 1354 (11th Cir. 1988), cert. denied, 488 U.S. 1041 (1989); Chrysler Corp. v. FTC, 561 F.2d 357 (D.C. Cir. 1977); Beneficial Corp. v. FTC, 542 F.2d 611 (3d Cir. 1976); Doherty, Clifford, Steers & Shenfield, Inc. v. FTC, 392 F.2d 921 (6th Cir. 1968); Montgomery Ward & Co. v. FTC, 379 F.2d 666 (7th Cir. 1967); Regina Corp. v. FTC, 322 F.2d 765 (3d Cir. 1963); Feil v. FTC, 285 F.2d 879 (9th Cir. 1960); Gimbel Bros., Inc. v. FTC, 116 F.2d 578 (2d Cir. 1941).
credulous, and the least sophisticated consumer would be deceived. If a practice affects or is directed primarily to a particular group, the FTC examines reasonableness from the perspective of that group. In addition, the FTC looks at the overall, net impression of a representation to see how it should reasonably be interpreted, including determining if there are implied claims and determining from extrinsic evidence how consumers in fact perceive a representation.

2. The FTC Standard on Unfairness

The FTC’s definition of “unfairness” is an act or practice that “causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.”

Likely to Cause Substantial Injury. To be unfair under the FTC Act, an act or practice must cause or be “likely to cause” substantial injury to consumers. Substantial injury must not be trivial or merely speculative harm, but will usually involve monetary harm or unwarranted health and safety risks. Invasion of privacy

20 FTC v. Standard Education Society, 302 U.S. 112 (1937); Standard Oil Co. of California v. FTC, 577 F.2d 653 (9th Cir. 1978); Stauffer Laboratories, Inc. v. FTC, 343 F.2d 75 (9th Cir. 1965); FTC v. Sterling Drug, Inc., 317 F.2d 669 (2d Cir. 1963); Exposition Press, Inc. v. FTC, 295 F.2d 869 (2d Cir. 1961), cert. denied, 370 U.S. 917 (1962); Royal Oil Co. v. FTC, 262 F.2d 741 (4th Cir. 1959); Charles of the Ritz Distributors Corp. v. FTC, 143 F.2d 676 (2d Cir. 1944); Aronberg v. FTC, 132 F.2d 165 (7th Cir. 1942); General Motors Corp. v. FTC, 114 F.2d 33 (2d Cir. 1940).


may be a substantial injury. Consumer injury may be “substantial” if a relatively small harm is inflicted on a large number of consumers or if a greater harm is inflicted on a relatively small number of consumers.

It is significant that this definition refers to a practice that causes “or is likely to cause” injury. Risk of harm is thus sufficient; there need not be actual proof of injury, and the injury need not yet have occurred.

As the OTS itself implicitly found when adopting its version of the FTC’s Credit Practices Rule, a practice can be unfair “where the seller takes advantage of an existing obstacle which prevents free consumer choice from effectuating a self-correcting market.” The D.C. Circuit found such an imperfect market in the extension of consumer credit because consumers cannot bargain over a contract’s creditor remedies and because creditors have no incentive to compete on the basis of the creditor remedies offered. A creditor remedy can thus be unfair even if it does not result from the creditor’s deception, coercion, or nondisclosure, as long as the remedy causes substantial consumer injury.

Not Reasonably Avoidable By Consumers. To be unfair under the FTC Act, the practice must not only cause substantial consumer injury, but also the injury must not be “reasonably avoidable by consumers themselves.” The Commission has explained that consumers cannot reasonably avoid injury when the merchant’s sales practices unreasonably create or take advantage of an obstacle to the free exercise of consumer decision-making.

Such unfair practices may include withholding important information from...
consumers, overt coercion, or exercising undue influence over highly susceptible classes of purchasers.32 Another example of injury that cannot be avoided is a provision in a standard form contract that is common to the whole industry and which cannot be negotiated.33 Consumers cannot avoid an injury if the seller does not afford them a free and informed choice that enables them to avoid the unfair practices.34

**Injury Not Outweighed By Benefits to Consumers or Competition.** An unfair practice under the FTC Act is one that is “not outweighed by countervailing benefits to consumers or to competition.”35 Congress did not intend that the FTC “quantify the detrimental and beneficial effects of the practice in every case.”36 Instead, Congress expects the Commission to “carefully evaluate the benefits and costs . . . gathering and considering reasonably available evidence.”37

**Relation to Public Policy.** The FTC Act specifies that, in determining if a practice is unfair, “the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.”38 Congress did not want the FTC to outlaw various practices simply as a matter of public policy—the practice must cause substantial harm that cannot be avoided. But public policy can be a factor in measuring the amount of injury and weighing that injury against the countervailing benefits to consumers and competition.

**Section II. Preemption and Enforcement Issues**

In this section we discuss both the scope of and limits to savings association preemption under the Home Owners’ Loan Act, the authority of the OTS to issue

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regulations under HOLA and the FTC Act, and the relationship of state UDAP acts to these federal laws. This discussion is relevant to addressing Issue 2 posed by the OTS in the ANPR: “Should OTS consider further rulemaking on unfair or deceptive acts or practices that would cover more than just the savings association, but related entities as well?” We answer this question at the end of this section.

The OTS argues that it has broad authority under HOLA to issue regulations addressing unfair or deceptive practices. However, HOLA itself contains no specific reference to unfair or deceptive practices. HOLA was passed in 1933 to “provide emergency relief with respect to home mortgage indebtedness at a time when as many as half of all home loans in the country were in default…” 39 It was not designed as a consumer protection statute and contains no language that makes this the mission of the OTS.

However, in 1975, Congress amended the FTC Act and extended authority to the OTS and certain bank agencies to prescribe regulations to prevent unfair or deceptive practices by their constituent depository institutions. 40 Congress required each such agency to establish a consumer affairs division. Moreover, the listed banking agencies, including the OTS, are to adopt rules substantially similar to those issued by the FTC within 60 days after the FTC rules take effect. Thus, OTS’ authority to identify and prohibit unfair or deceptive acts and practices arises under the FTC Act and not HOLA.

Identifying the source of OTS’ power is important in this context because the FTC Act sets a federal floor in this area, not a federal ceiling. The FTC Act does not prevent states from legislating in this context. All 50 states, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands have enacted at least one statute with broad applicability to most consumer transactions, aimed at preventing consumer deception and abuse in the marketplace. Most of these state UDAP statutes were passed in the ten-year span of the mid-1960s to the mid-1970s and were modeled after the FTC Act, but significant amendments and even some new statutes have been enacted since that period. Historically, the states have legislated when appropriate to protect their citizens under their parens patriae and/or inherent police powers. Most recently, dozens of state legislatures addressed predatory mortgage lending by passing laws that prohibit certain abusive behavior by mortgage lenders and brokers.

State UDAP laws are particularly important because the FTC Act provides for enforcement only by the FTC or, in the case of depository institutions, by the designated federal banking agency. It contains no private remedies that consumers may enforce directly against the perpetrators to obtain redress. Furthermore, while the OTS has exclusive authority to regulate the savings and loan industry, it has no

power to adjudicate disputes between these institutions and their customers.41 As the 7th Circuit recently recognized about HOLA -- “So it cannot provide a remedy to persons injured by wrongful acts of savings and loan associations, and furthermore HOLA creates no private right to sue to enforce the provisions of the statute or the OTS's regulations. In contrast, state UDAP acts allow for widespread redress of marketplace misconduct and abuse of consumers.”42

Moreover, the OTS claims exclusive visitatorial power over federal savings associations. As a result, state agencies and attorneys general have no power to enforce state law against these institutions thereby reducing the number of cops on the beat to one, the OTS. This leads to perverse results where, for example, a state attorney general can sue an appraisal company for issuing fraudulent appraisals but not the savings association who allegedly handpicked “proven appraisers” who were willing to cooperate with inflating prices.43

Pursuant to HOLA, in 1996, the OTS adopted regulations asserting its intention to occupy the entire field of lending and deposit regulation for federal savings and loan associations.44 The lending regulation lists a number of specific types of state lending laws that are preempted, but does not include UDAP statutes in the list. It explicitly preserves state laws of certain types, including contract, commercial, real property, homestead, tort, and criminal law, to the extent that they only incidentally affect the lending operations of savings and loan associations or are otherwise consistent with OTS’s purposes.

The agency issued a Chief Counsel Letter in 1996 that analyzed whether Indiana’s UDAP act applied to a federal savings association.45 Where the state UDAP act does not directly regulate the terms of the credit transaction, e.g., the interest rate, fees, term, the law is not preempted because it is not in conflict with the safe and sound regulation of federal savings associations46

Applying these standards, courts have held that the OTS regulation does not preempt:

42 In re Ocwen Loan Servicing, LLC Mortgage Servicing Litigation, 491 F.3d 638, 643 (7th Cir. 2007).
44 12 C.F.R. § 560.2 (lending regulation); § 557.11 (deposit-taking regulation).
45 OTS Chief Counsel Letter (Feb. 24, 1996).
46 Id. See also OTS Chief Counsel Letter P-99-3 (Mar. 10, 1999)(California UDAP statutes is preempted to the extent that it is used to set standards for payoff statement fees, specific disclosures, or force-placed insurance).
• state UDAP, contract, and other claims based on the lender’s payment of a yield spread premium without disclosing material facts, and its imposition of an inflated tax service fee.47
• a UDAP claim that a lender had exceeded its contractual authority to force-place insurance, by charging the consumer for insurance and services covering not only the consumer’s home but other properties.48
• a state law requiring a mortgagee to record the satisfaction of a mortgage within ninety days after payoff.49

Most recently, the Seventh Circuit discussed the interplay between the OTS preemption regulation and state UDAP statutes:

OTS’s assertion of plenary regulatory authority does not deprive persons harmed by the wrongful acts of savings and loan associations of their basic state common-law-type remedies. Suppose an S & L signs a mortgage agreement with a homeowner that specifies an annual interest rate of 6 percent and a year later bills the homeowner at a rate of 10 percent and when the homeowner refuses to pay institutes foreclosure proceedings. It would be surprising for a federal regulation to forbid the homeowner’s state to give the homeowner a defense based on the mortgagee’s breach of contract. Or if the mortgagee (or a servicer like Ocwen) fraudulently represents to the mortgagor that it will forgive a default, and then forecloses, it would be surprising for a federal regulation to bar a suit for fraud….Enforcement of state law in either of the mortgage-servicing examples above would complement rather than substitute for the federal regulatory scheme.50

Given the importance of state UDAP acts and the fact that OTS’s

47 Michalowski v. Flagstar Bank, 2002 WL 113905 (N.D. Ill. Jan. 25, 2002)(noting that the consumers were not claiming that the actual fees charged were unlawful, but were challenging the methods through which the lender imposed them).
48 Gibson v. World Sav. & Loan Ass’n, 128 Cal. Rptr. 2d 19 (2002)(observing that the lender’s duties to comply with its contract and to refrain from misrepresentation were principles of general application and part of the legal infrastructure that undergirds all contractual and commercial transactions).
49 Pincot v. Charter One Bank, 792 N.E.2d 1105 (Ohio 2003)(UDAP claim not raised but presumably a UDAP claim based on the violation of this state recordation law would not be preempted).
50 In re Ocwen Loan Servicing, LLC Mortgage Servicing Litigation, 491 F.3d 638, 643-44 (7th Cir. 2007)(upholding lower court’s refusal to dismiss a complaint alleging UDAP and common law causes of action; remanding to district court to determine whether UDAP claims are based upon behavior that relates to the loan terms or to behavior that relates to a breach of contract or the commission of a tort).
UDAP authority arises under the FTC Act, we urge the OTS to issue both broad standards and specific prohibitions that effectively protect consumers and tread carefully in order to avoid preemption of state UDAP acts. We hope that this ANPR is not simply an attempt to expand the boundaries of federal preemption and eliminate the ability of consumers to obtain redress against offensive savings association behavior through state UDAP claims.

However, if there is any preemption of state laws with these regulations, that preemption should be limited to those entities that are clearly entitled to HOLA’s preemption rights, that is, savings associations themselves and their operating subsidiaries.51 “Service providers,” agents, independent contractors, and the like do not and should not operate outside the scope of state law.52

Section III  Specific Behaviors the OTS Should Declare Unfair or Deceptive

A. Residential Mortgage Transactions

1. Introduction

For over two decades, abuses in the mortgage market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership. For many, it is their only source of wealth accumulation. Since 1980, foreclosures have increased almost 155 percent, but homeownership has increased only 5.2 percent.53 Last year, homeowners suffered over one million foreclosures, more than a 40 percent increase from the previous year.54 As of the end of the second quarter of 2007, over 5.5% of subprime loans were in foreclosure and another 3.75% were over 90 days delinquent, by the count of one source.55 The numbers are rising in the prime

51 Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559, 1571-72 (2007)(upholding preemption for operating subsidiaries of national banks because, in part, this type of subsidiary is “tightly tied to its parent by the specification that it may engage only in the ‘business of banking’…”).
52 SPGGS, LLC v. Blumenthal, 2007 WL 3036812 (2d Cir. Oct. 19, 2007)(holding that unaffiliated third party not entitled to preempt state law where that law regulated solely the behavior did not burden or interfere with the national bank’s powers).
53 NCLC analysis based on data through 2005 from Mortgage Bankers Association, National Delinquency Survey; U.S Census Bureau, Statistical Abstract of the United States; Census Bureau, American Housing Survey and American Community Survey.
55 Mortgage Bankers Association, National Delinquency Survey (Q2 2007). Compare Mortgage Bankers Association, National Delinquency Survey (Q1 2006)(subprime loan foreclosure inventory--3.5%; 90 days late--2.72%). The pressures of unaffordable loans are accompanied...
market as well: the foreclosure inventory rose from .40% in Q1, 2006 to .59% in Q2, 2007.\textsuperscript{56} Prime ARMs are in worse shape: the ARM foreclosure inventory almost tripled from .49% in Q1, 2006 to 1.29% in Q2, 2007.

The predictions regarding the size of the foreclosure tidal wave and its consequences are sobering, if not downright frightening:

- Subprime foreclosures will increase in 2007 and 2008 as 1.8 million hybrid ARMS reset in a weakening housing market environment.
- For the entire 2007 through 2009 period, if housing prices continue to decline, one Senate source estimates that subprime foreclosures alone will total approximately 2 million.\textsuperscript{57}
- Approximately $71 billion in housing wealth will be directly destroyed through the process of foreclosures.
- More than $32 billion in housing wealth will be indirectly destroyed by the spillover effect of foreclosures, which reduce the value of neighboring properties.
- States and local governments will lose more than $917 million in property tax revenue as a result of the destruction of housing wealth caused by subprime foreclosures.\textsuperscript{58}

The importance of this issue is magnified in communities of color. More than half of African-American and 46 percent of Latino families who received home loans in 2005 received subprime mortgages.\textsuperscript{59} Moreover, African-Americans suffer a loss of homeownership at a rate 2.5 times that of whites and Latino families at a rate 1.5 times that of whites.\textsuperscript{60} The average time for a homeowner to again attain homeownership after foreclosure—to recover the status most likely to lead to any wealth accumulation—is over ten years, and 3.5 to 4 years longer for people of color.\textsuperscript{61}

\textsuperscript{56} Id.
\textsuperscript{61} Id.
Accordingly, OTS’ role in restricting abuses by its constituents and their operating subsidiaries is critical in the important effort to give homeowners the ability to acquire reasonably priced credit and to remain in their homes.

Specifically:

- **The OTS should prohibit “stated income” or “low/no doc” loans.** Higher priced loans without income verification have become a standard practice in the subprime market. Many of these loans are made to borrowers who can provide (and in some cases do provide) documentation, and therefore can obtain loans that are truly affordable for them. Savings associations should be required to use the best and most appropriate form of documentation.62

- **The OTS should require that savings associations originate loans only where the borrower has the ability to repay the loan under the terms of the contract.** For too long, loan originations have been based on the assessed risk to the creditor and the investor. The borrower’s risk must be front and center in this analysis. The OTS should define origination of a loan that the borrower does not have the ability to repay as an unfair practice.

- **The OTS should require escrowing for taxes and insurance.** Subprime lenders generally do not escrow and this often results in borrowers receiving the unwelcome surprise of higher mortgage costs than expected. Failure to escrow facilitates deception and is associated with expensive and unfair force-placed insurance. The OTS should define failure to escrow as an unfair and deceptive practice.

- **The OTS should ban prepayment penalties.** Research indicates that borrowers do not receive an interest rate benefit for such provisions. Moreover, prepayment penalties are disproportionately associated with loans to people of color, and to loans that result in foreclosure.

- **The OTS should require savings associations and their servicers to engage in reasonable loss mitigation efforts before foreclosing on a home.** Currently, much of the market is operating without any enforceable mandate to engage in any loss mitigation. Requiring reasonable loss mitigation would not only prevent loss of homes, but would also deter savings associations from making unaffordable loans.

2. *The Practices Identified in These Comments Are Unfair and Deceptive.*

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62 Using the best and most appropriate documentation does not mean that savings banks cannot make loans based on income that cannot be documented in standard ways. In fact, many prime lenders already use alternative forms of documentation to allow for underwriting for a wide array of consumers.
Applying the FTC definition of “unfair” and “deceptive” as described above, each of the practices we address in these comments falls within the FTC Act’s definition of unfair or deceptive acts or practices. First, all of these practices contribute to borrowers receiving loans that are either unaffordable, or more expensive than those for which they qualify. Borrowers believe that loan originators are giving them the best deal for them, and certainly believe that the underwriting process ensures the affordability of the loan. Practices that undermine these expectations—expectations created by the loan originators—are deceptive. Yet such practices are rife in mortgage lending. Unknown to most borrowers, the broker’s incentive structure is at odds with the borrowers' interests. Lenders reward brokers for placing consumers in loans at higher interest rates, with prepayment penalties, and sometimes, most nonsensically, for arranging loans without documentation.

These practices are unfair because they cause consumers substantial injury. Abusive loans lead to grievous consumer injury in the form of loss of equity and wealth. Worse, many borrowers lose the home itself, often the major source of stability and savings for their families.

The injury to consumers - and society - caused by these practices is particularly heinous because of their disproportionate impact on minority homeowners. Disparities between whites and African Americans exist at every income level and credit level. The disparities increase as the income and credit levels

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63 Mortgage Foreclosure Filings in Pennsylvania: A Study by The Reinvestment Fund for the Pennsylvania Department of Banking 74 (Mar. 2005), available at

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of the borrowers increase. In other words, the wealthiest and most credit-worthy African Americans are, compared to their white counterparts, the most likely to end up with a subprime loan. One stark example: African Americans with a credit score above 680 and a loan to value ratio between 80% and 90% are nearly three times as likely as similarly situated whites to receive a subprime loan.65

The harm from these practices is not outweighed by benefits to consumers or competition. There is no benefit to consumers or competition from these loans. They reveal a serious lack of competition and clearly offer no silver lining to the borrower in distress. (Until recently, they did offer such solace to the investor…). Indeed, these practices cause injury to competition. For example, prepayment penalties also reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders. Allowing lenders not to escrow enables bait and switch tactics that disadvantage more responsible lenders.

Consumers cannot reasonably avoid the injury caused by these practices. Consumers generally cannot avoid these abusive mortgage lending practices. Market dysfunctions limit consumers’ ability to shop, understand the terms of the loans, or negotiate. To the extent that loan originators are compensated based on origination volume, they have a strong economic incentive to originate loans regardless of whether the loan is in the borrower's interest. This is true whether the originator is an internal loan officer or an independent mortgage broker. Lender-paid compensation to loan officers and mortgage brokers lacks transparency almost completely and rewards originators for selling borrowers loans at inflated rates. Broker and loan officer compensation is often tied to the imposition of prepayment penalties and sometimes to originating stated income loans. These perverse incentives--hidden from the borrower--apply to both brokered and retail loans.

The problems can be particularly acute for brokered loans, where the borrower may believe that the broker is acting in the borrower's interest. Lender compensation often is the lion's share of a broker's total pay. Usually, the amount of lender compensation to the broker is not disclosed until closing; seldom is the reason for the compensation disclosed; and never do the lender and broker disclose the interest rate bump or other benefit the lender receives as its part of the quid pro quo. Even weak disclosures of the yield spread premiums are often confusing and ineffective to


consumers. Compensation structures for internal loan officers are even more opaque and, therefore, possibly more pernicious.

These powerful economic incentives and the enormous imbalance in information between loan originators and borrowers produce a highly dysfunctional market. The current structure incentivizes the lender and broker to collude in misleading the borrower into a high-priced loan rather than to engage in substantive risk-based underwriting and pricing.

Any possibility that consumers might be able to avoid these practices is further reduced by the complexity, obscurity, and contingent nature of many of the disadvantageous loan terms. Consumer credit agreements surpass the document literacy of most consumers in the U.S. Identifying and comparing disaggregated fees present special hurdles. Even when consumers locate unbundled fees, they often lack the skill to perform rudimentary calculations. Most can compare two stated APRs or finance charges, priced in identical units. However, this percentage drops when pricing is not provided in identical units, even if no computation is required. Consumers uniformly experience overconfidence, blind spots, and other cognitive difficulties that hinder their ability to compare rates and numbers to assess which credit product is less expensive than another.

Lender bait and switch tactics are rife among marketers of mortgage loans. Accurate and binding Truth in Lending disclosures are required to be presented only at closing, at which point it is usually too late for the borrower to back out without significant personal and financial cost. In addition, pricing of mortgage products, at least in the subprime market, lacks transparency: lenders’ rates are not readily available to consumers, and may even be treated as trade secrets.

3. The Protections We Propose Should Apply to the Entire Mortgage Market

The restrictions we propose should apply to the entire mortgage market. A practice that is unfair or deceptive remains so no matter who the borrower is.

Moreover, the recent implosion in the mortgage market makes it clear that problems are not restricted to subprime loans.70

Every homeowner should have the right to receive an affordable loan on fair terms. If the OTS imposed certain restrictions only on one portion of the market, it would send a signal that abuses can be committed in the other portion of the market. By applying rules across the board, all savings associations must employ similar standards in all markets, and will be able to originate a diversified pool of loans without claiming that any one kind of loan is “too hard to make” because it must be affordable.

In the event the OTS still chooses to restrict some protection to the “subprime” portion of the market, the definition of “subprime” should be based on loan terms, not the borrower. Many borrowers who qualify for prime loans receive subprime loans instead, due to steering, push marketing or discrimination. Loans are subprime because of their terms, not because of who receives them. Further, any definition of subprime should be based on an objective, clear standard. We favor a link to a rate or index established by the government, such as Treasury plus several hundred basis points. Nevertheless, there may be some years when such a measure is underinclusive, depending on the spread between short and long-term interest rates. If the OTS limits new protections to the subprime market, we urge it to strive for an objective, inclusive standard that accounts for changes in interest rates and differing rate structures for fixed and adjustable rate loans.

The restrictions we propose should also apply to all loans, whether originated by brokers or by lenders themselves. The rules should not depend on whether a lender has outsourced the loan origination function to mortgage brokers rather than retaining loan origination as an in-house function.

a. Stated Income Loans Should Be Banned

Stated income loans are called “liar loans.” That name connotes that it is the borrower who is doing the lying, that it is the borrower who wants to qualify for a higher payment loan than the income on the tax return will justify. The predominant problem, however, comes from the loan originator, not the borrower. The loan originator creates the fictional income to qualify the unsuspecting homeowner into a loan which is destined to fail because the homeowner generally cannot afford the payments.

Many cases have documented falsification of borrowers’ qualifications by loan

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Comments of the National Consumer Law Center and National Association of Consumer Advocates

If the borrower detects the unaffordable payment amount at closing (not an easy task given the great number of documents presented at closing and the speed with which the borrower is often urged to sign them) and complains about it, the originator typically promises that the loan will be refinanced after some short period of on-time payments. (Indeed, it may be impossible for the borrower to ascertain the monthly payment, even at closing, for the adjustable rate loans that have come to dominate the mortgage market. Under current Truth in Lending rules, no disclosure is required of the amount that the monthly payment may reach when the index rate goes up. Disclosures for payment option ARMs are particularly uninformative.)

Typical stated income loans include:

- homeowners who live exclusively on Social Security, yet their applications include falsified income from babysitting, an export business, or the like;
- homeowners whose income is entirely derived from wages reflected on a W-2, yet the amount of the wages is inflated on the loan application;
- homeowners whose income is solely derived from public benefits but the amount of those benefits is inflated.

Lenders and related channels have sold stated income loans in ever greater numbers. Data available for the subprime market reveals an increase from almost 25% to almost 41% between 1999 and 2004.72 No document loans lead to foreclosures much more frequently than full documentation loans.73

Savings associations originate, purchase, and may act as trustee of a pool of loans that do not include income verification. Of even greater concern is the fact that at least one large savings association affirmatively instructs its production channels to not document income anywhere in the loan file. When the income source is retirement, social security, annuity, or dividend or trust, any income information must be “blacked out.”74

One reason that stated income loans have proliferated is the pricing structure.

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73 Id. at 21.
74 Chevy Chase, F.S.B. Wholesale Lending Division, Loan Origination Guidelines, attached as Exhibit A.
Lenders typically offer brokers additional compensation, above and beyond what the broker's contract with the consumer requires, for upselling the borrower into a higher interest rate loan. These yield spread premiums have become a standard fixture in much of the subprime marketplace. Most empirical evidence of broker pricing confirms that brokers do no additional work for additional compensation from lenders,\textsuperscript{75} and practitioners report that individual brokers confirm this at deposition.

Additionally, lenders charge a higher interest rate for loans arranged with no documentation, whether it was the broker or the borrower who sought the no documentation loan. Borrowers are seldom, if ever, told the cost of applying for a loan without documentation; the broker and the lender agree as to the cost between themselves without disclosure to the borrower.

Even where the lender is not paying the broker more for a stated income loan, the broker - whose compensation typically depends on origination volume - has the incentive to minimize the work involved in originating the loan by instructing the borrower to seek a loan application with reduced or no documentation.

Stated income loans have a history of being unaffordable. Increasing the interest rate for stated income loans does not insulate the lender from the increased risk and, for marginal borrowers, may contribute to the risk of eventual default. An unaffordable loan is by definition responsible for substantial injury that has no countervailing benefit. Additionally, income falsification is generally done without the borrower’s knowledge and thus is not reasonably avoidable by the borrower. Applications generally are filled out by the loan originator and the borrower simply signs a copy of it as part of the stack of papers quickly presented at closing.

Failure to properly document income allows these practices to flourish. By requiring proper income verification, the OTS would minimize opportunities for such practices. The OTS should provide the following: \textit{Documentation of income is required for all loans; when the source of income cannot verify the amount of income, bank statements, tax returns and other similarly reliable types of documentation may be used. Failure to document income in accord with this requirement is an unfair and deceptive practice.}

\textsuperscript{75} See, e.g., Howell Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums at 8 (Jan. 2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (in a survey of mortgage transactions, when yield spread premiums are not paid, brokers received on average no more than 1.5% of the loan amount); cf. Jack Guttentag, \textit{Another View of Predatory Lending} 7-12 (Wharton Financial Institutions Center Working Paper No. 01-23-B, Aug. 21, 2000) (reporting on a survey of mortgage brokers showing no correlation between effort as measured by time expended and payment; brokers largely compensated based on size of loan).
b. *Lending Without Ability to Pay - Based on the Maximum Possible Payment for the First Seven Years of the Loan - Should Be Declared Unfair and Deceptive*

Even when income and assets have not been inflated, many borrowers have received unaffordable loans. These are loans which are designed to fail - either from the outset, or as soon as the fixed rate period ends and the payment begins to adjust upward. These loans are made because the individuals and entities involved in the lending process make enough money from the loans so that it does not matter whether the borrower ultimately is forced to refinance or face foreclosure.

The extent to which making unaffordable loans has come to dominate mortgage lending is shown most tellingly by subprime lenders’ own words: “[M]ost subprime borrowers cannot afford the fully indexed rate, and . . . it will hurt liquidity for lenders and effectively force products out of the marketplace.”

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

The OTS and other federal banking agencies released the Interagency Guidance on Nontraditional Mortgage Product Risks in September 2006 and the Interagency Guidance on Subprime Mortgage Lending in July 2007. Together, these guidelines urge constituent banks to evaluate a borrower’s capacity to repay the debt by final maturity at the fully indexed rate. We believe these statements are insufficient for several reasons.

First, in determining affordability, loan originators must consider the cost of the loan and the income available to pay that loan. With regard to available income, it is essential that loan originators be required to consider residual income as well as debt-to-income ratio. Simply using a debt-to-income ratio fails to account for the low dollar amounts available to very low-income families. After making housing related monthly payments, and all other regularly scheduled debt payments due as of the date the home loan is made, sufficient residual income must be available to cover basic living necessities, including but not limited to food, utilities, clothing, transportation and known health care expenses.

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


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Second, taxes and insurance must also be taken into account in determining the affordability of a loan. If the borrower can afford the mortgage payment but not the tax and insurance payments, the loan is designed to fail just as surely as if the borrower could not afford the mortgage payment.79

Third, the fully indexed rate is a rate which in most loans will never actually be the rate that is charged to the borrower. It is a fictional rate which is based on the application of the index at or shortly prior to origination plus the margin that will apply at the end of the first (two or three year) period of fixed rates. If, as is almost certain to be the case, the index rate changes during the fixed-rate period, the rate that will apply at the end of the fixed rate period will be different from the “fully indexed rate” that was calculated when the loan was originated. Assessing the affordability of a loan based on a rate that will never actually be applied to it makes little sense.80

More importantly, assessing affordability based solely on the fully indexed rate does not protect homeowners from the risk of increasing payments when the underlying index increases.

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

The interest rates and thus the payments do rise on these loans. Almost all of the subprime loans that we see are based on the six month LIBOR index. During the past eight years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).81 The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

79 We note that the Interagency Guidance on Subprime Mortgage Lending does state that the ability to repay includes the borrower’s total monthly housing related payment (PITI), even if the “TI” is not escrowed. However, the Interagency Guidance on Nontraditional Mortgage Product Risks fails to address this issue.

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

Consider the following changes in interest based on the six month LIBOR history and the effect on the payments on a loan for $100,000 made in December 2002. Note that this example is based on a loan without a teaser rate, so the payment shock is less than many borrowers are experiencing.

<table>
<thead>
<tr>
<th>Months</th>
<th>LIBOR rate</th>
<th>LIBOR + index</th>
<th>Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-24</td>
<td>1.38% (Nov. 2004)</td>
<td>7.38%</td>
<td>$691.02</td>
</tr>
<tr>
<td>25-30</td>
<td>2.63% (May 2004)</td>
<td>8.63%</td>
<td>$774.81</td>
</tr>
<tr>
<td>31-36</td>
<td>3.51% (Nov. 2005)</td>
<td>9.51%</td>
<td>$835.51</td>
</tr>
<tr>
<td>37-42</td>
<td>4.58% (May 2006)</td>
<td>10.58%, but capped at 10.51%</td>
<td>$905.30</td>
</tr>
<tr>
<td>43-48</td>
<td>5.32% (Nov. 2006)</td>
<td>11.32%</td>
<td>$962.78</td>
</tr>
<tr>
<td>49-54</td>
<td>5.35% (May 2007)</td>
<td>11.35%</td>
<td>$964.91</td>
</tr>
</tbody>
</table>

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

A requirement that the lender ensure that the borrower can pay the fully indexed rate is akin to throwing a drowning swimmer a life preserver with a rope that only reaches halfway. In most situations, the homeowner will drown because the payments required by the adjusted rate will have increased to a point which is more than the borrower can afford. By only requiring underwriting to the fully indexed rate, and ignoring the highly likely effect of the payment increases resulting from the interest rate increases, the OTS would be placing its imprimatur on behavior that will cause homeowners to be locked into expensive adjustable rate loans that they cannot

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82 We are assuming a $100,000 principal amount in a standard subprime 2/28 adjustable loan, with an initial rate based on the LIBOR rate plus a margin of 6.
83 After the 24th payment, the new principal balance is $98,040.47 and there are 336 installments left.
84 After the 30th payment, the new principal balance is $97,614.46 and there are 330 installments left.
85 After the 36th payment, the new principal balance is $97,237.03, and there are 324 installments left.
86 After the 42nd payment, the new principal balance is $96,907.89, and there are 318 payments left.
87 After the 48th payment, the new principal balance is $96,609.23, and there are 312 payments left.
afford when those loans do what they are designed to do: adjust.

To sustain homeownership and preserve precious equity, the OTS should adopt a rule that it is an unfair and deceptive practice for a lender to make a loan without ensuring, at the time a home loan is made, that the homeowner has the capacity to pay all housing related debt, including taxes and insurance, based on the maximum possible rate and payment which could apply under the terms of the loan for the first seven years.

This standard would ensure that the borrower would have at least seven years in an affordable loan—the mean length for prime loans—and would provide an incentive to originators to create loan terms that truly reflect the amount the borrower will have to pay, and the amount the borrower will be able to afford.88

c. Failure to Require Escrowing for Taxes and Insurance is an Unfair Practice

Paradoxically, escrow is almost universal in the prime market, but is widely omitted for subprime borrowers – the very borrowers who are likely to be less sophisticated and have less financial cushion. This is because omitting the tax and insurance payment can fool either a first time homebuyer or an existing homeowner who is refinancing into thinking that the loan is affordable. Omitting the tax and insurance payment is a favorite trick of brokers and loan officers who promise lower monthly payments.

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

By and large, lenders whose primary concern is loan performance require escrows. Lenders whose primary concern is maintaining loan volume for securitization pools typically do not require escrows. Lenders should not be permitted to understate the cost of homeownership by failing to escrow payments. Underwriting that includes an assessment of the homeowner’s ability to repay PITI is helpful. However, actually mandating the TI escrow is critical to the ability of the homeowner to sustain homeownership over the long term.

88 Another approach, which has been raised by Rep. Ellison’s bill, H.R. 3018, is to qualify borrowers at the fully indexed rate plus additional basis points.
The OTS should adopt a rule that failure to require taxes and insurance to be escrowed is an unfair and deceptive practice.

d. The OTS Should Define Contracting for a Prepayment Penalty as an Unfair Practice.

The abusive practices described above - stated income loans, lending without regard to the consumer’s ability to repay the true payment, and failure to require escrow - are tactics that put borrowers into bad loans. Prepayment penalties keep them there.

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

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


92 See, e.g., Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages 15 (Sept. 2006), available at http://www.chicagofed.org/cedric/2007_res_con_papers/car_79_elliehausen_staten_steinbuks_preliminary.pdf. (finding that prepayment penalties were associated with higher interest rates unless they controlled for “borrower income, property value, loan amount, whether the loan...
Prepayment penalties harm consumers. They are associated with an elevated risk of foreclosure.\(^93\) By keeping the consumer in an unaffordable product, the *quid pro quo* between lender and broker thus contributes to the foreclosure crisis. These harms are not outweighed by benefits to consumers or to competition. Indeed, prepayment penalties reduce beneficial competition, by making it impossible for borrowers in bad loans to refinance with more responsible lenders. Finally, borrowers cannot reasonably avoid prepayment penalties. A prepayment penalty is a complex and contingent contract term that would be relatively immune to the comparison shopping even if the disclosure regime were drastically improved.

In 2002, the abuse by predatory lenders, some of which were non-depository “housing creditors,” led the OTS to remove prepayment penalties from the designated loan terms under its Alternative Mortgage Transactions Parity Act authority that state housing creditors could place in their loans notwithstanding state law.\(^94\) As of the rule’s effective date, any state law limiting prepayment penalties would apply to these creditors. We applauded this decision then. Since these “housing creditors” already operate in many states without the ability to charge prepayment penalties, and since credit unions also are prohibited from charging prepayment penalties, it is clear that the market can function without this device. We ask the OTS to take the lead and go a step further now.

The OTS should adopt a rule that *inclusion of a prepayment penalty is an unfair and deceptive practice*.

e. *The Failure to Engage in Meaningful Loss Mitigation*

was originated by a broker, and type of interest rate,” in which case the difference shrank); see also Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, Ctr. For Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages 3-4 (May 31, 2006), available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (the presence of a prepayment penalty increased the likelihood that African Americans had a higher cost subprime loan as compared to whites).


Before Initiating Foreclosure Should Be Declared an Unfair Trade Practice

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

There are significant losses when a home is sold through a foreclosure. The homeowner loses the equity built up in the home,\(^{95}\) which for many families is their chief form of wealth-building. The family suffers a disruptive move away from its support systems. Children may face academic difficulties because of changing schools. The neighborhood and the community deteriorate.\(^{96}\) “Every new home foreclosure can cost stakeholders up to $80,000, when you add up the costs to homeowners, loan servicers, lenders, neighbors, and local governments.”\(^{97}\)

As a result there should be every effort to avoid the foreclosure. Loss mitigation offers all parties the opportunity to reduce these financial losses, save homes, and maintain neighborhoods. So long as the cost of the loss mitigation effort is less than the cost of the foreclosure for the investor, the effort is sensible and cost effective. Despite the self-evident nature of these conclusions, servicers and mortgage holders typically modify less than 1% of their loans even in this time of foreclosure crisis.\(^{98}\)

Reasonable loss mitigation activities generally include a range of alternatives –

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

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\(^{95}\) According to the Center for Responsible Lending, By the end of 2006, “2.2 million households in the subprime market either have lost their homes to foreclosure or hold subprime mortgages that will fail over the next several years. These foreclosures will cost homeowners as much as $164 billion, primarily in lost home equity.” Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, Center for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, December, 2006 at 2.

\(^{96}\) A foreclosure is quite damaging to the neighborhood in which it occurs. Some examples of this include the drop in property values in low- and moderate-income neighborhoods in Chicago and Minneapolis directly resulting from home foreclosures. Crime rates increase as well when homes are abandoned. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosures: The Impact of Single-Family, Mortgage Foreclosures on Property Values* (Dec. 30, 2005), Housing Policy Debate.


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

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

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

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

6. A full modification of the loan which can include one or more of a combination of interest rate reduction, extension of the loan terms, re-amortization, and cancellation of principle. Loan modification will generally be the necessary response to the multitude of subprime, adjustable rate loans, which are currently adjusting to unaffordable payments.99

Indeed the FHA,100 as well as Fannie Mae101 and Freddie Mac,102 recognize the financial loss to their investors, as well as the devastation to homeowners from foreclosure, and specifically require loss mitigation before foreclosure should be pursued when a homeowner is in default. Most Pooling and Servicing Agreements (“PSAs”), governing the trusts in which most home mortgages are held, permit loss modification.103 The federal banking agencies have also issued encouragement for loss mitigation.104

However, for all of the mention of loss mitigation by these housing agencies, the permission included in the PSAs, or even the recommendations by the banking regulators, nothing requires that loss mitigation be pursued before foreclosure. None of these entities enforce any requirement to consider alternatives before initiating the process that will cost a family their home. Homeowners can only occasionally raise them as a defense to a foreclosure, and the investors have no institutional mechanisms to police loss mitigation efforts.

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

Indeed, there are powerful market forces that work to actively discourage meaningful loss mitigation efforts prior to foreclosure. Servicers have clear incentives to encourage default, and have strong financial disincentives to spend the extra time and expense required to engage in foreclosure avoidance techniques. Servicers receive only a small part of their income from a monthly fee they get for receiving monthly payments and forwarding appropriate portions of principal and interest to the investors. Servicers also receive income from ancillary fees. Finally, servicers must continue to pay the monthly payments to the trustee and cover property taxes and hazard insurance premiums after the homeowner has defaulted and may have to borrow the funds to make these payments until the foreclosure sale reimburses the servicer for moneys advanced. This gives the servicer an incentive to push a foreclosure through quickly.

Ancillary fees consist of late fees and other “service” fees. Such fees are a crucial part of servicers’ income. For example, one servicer’s CEO reportedly stated that extra fees, such as late fees, appeared to be paying for all of the operating costs of the company’s entire servicing department, leaving the conventional servicing fee almost completely profit. Consequently, servicers have perverse incentives to charge borrowers as much in fees, both legitimate and illegitimate, as they can. For example, just

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105 The basic fees received by servicers for processing monthly payments are based on the outstanding principal loan balance and typically range from 25 basis points (prime loans) to 50 basis points (subprime loans). For example, a securitized loan pool with an outstanding balance of $900 million and a 38 basis point servicing fee would generate yearly income of approximately $3.42 million for the servicer. Payments to servicers range from 1/4 of 1% of the note principal to 1 3/8%. See, e.g., Fannie Mae Singly Family Selling Guide, Part I: Lender Relationships, Chapter 2: Contractual Relationship (June 30, 2002), 201; Mortgage Selling and Servicing Contract (Sept. 28, 2004), 201:04: Servicing Compensation (June 30, 2002), available at www.allregs.com/efnma/. See also Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Policy Debate 753 (2004).

one improper late fee of $15 on each loan in one average size loan pool (3500 loans) would
generate an additional $52,500 in income for the servicer. The charging of these fees by
servicers makes recovery from default more difficult for homeowners, making
foreclosure more likely.

Lenders, investors and servicers for years have been publicly stating that they
dislike foreclosures, that foreclosures cost them money, and that they only engage in
them as a last resort. As advocates working with the lawyers who represent these
homeowners, we find that these statements are – unfortunately – rarely true.107
Servicers appear to pursue foreclosure at the first opportunity, and too often engage
in strategies that make it near impossible for homeowners to recover from a default.108

These negative incentives on servicers mean that servicing of a loan often
affects homeowners as much as or more than how the loan was originated.109 In other
words, the negligence or the malfeasance of mortgage servicers has directly and
considerably contributed to the rising rates of foreclosures almost as much as
problems resulting from predatory loan terms.

Even in these days of dramatically escalating foreclosures of subprime

107 We regularly work with attorneys in almost every state in the nation on their efforts to
save homes from predatory lending. We provide assistance through our books, our trainings,
regular case consultations, and our provision of expert witness services. We learn about the
problems in the marketplace from these attorneys, and in turn, help frame viable solutions
both through litigation strategies as well as policy changes, to the problems these attorneys
describe.

108 Id. There are currently hundreds of lawsuits, both individual and class actions, against
scores of servicers for – among other claims – breaching the duty of good faith and fair
dealing, for pushing homeowners into unnecessary and illegal foreclosures. Just a few
examples include, In re: Ocwen Loan Servicing, LLC Mortg. Servicing Litigation, --- F.3d ----,
2007 WL 1791004, C.A.7 (Ill.), June 22, 2007 (NO. 063132); Hauf v. Homeq Servicing Corp.,
2007 WL 486699 (M.D. Ga. Feb. 9, 2007) (wrongful foreclosure after forbearance agreement
paid in full); Hukic v. Aurora Loan Servicing, 2006 WL 1457787 (N.D. Ill. May 22, 2006)
(servicer’s clerical error in recording amount of payment left homeowner battling with
subsequent servicers and ending off foreclosure for nearly five years); Rawlings v.
months to correct account error despite borrowers’ twice sending copies of canceled checks
evidencing payments); Choi v. Chase Manhattan Mortg. Co., 63 F. Supp. 2d 874 (N.D. Ill.
1999) (home lost to tax foreclosure after servicer failed to make tax payment from borrowers
closen account and then failed to take corrective action to redeem the property); Monahan v.
GMAC Mortg. Co., 893 A.2d 298 (Vt. 2005) (affirming $43,380 jury award based on servicer’s
failure to renew flood insurance policy and subsequent uninsured property damage).

109 See, e.g. Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15
Housing Policy Debate 753 (2004); Zalenski, Walter E. 2003. Mortgage Loan Servicing: The
Rest of the Compliance Iceberg, Paper Presented at Current Issues in Mortgage Loan
Servicing at the Annual Meeting of the American Bankers Association, San Francisco, August
10.
mortgages investors are encouraging – loan modifications only with fairly loose and vague standards and only when they can be made in such a way as to reduce the losses to investors. 110 There is little clear, consistent guidance on how these loss mitigation programs should be carried out, and reports from the field are that homeowners see little, if any, difference in efforts to avoid foreclosure.

The OTS should declare that it is an unfair practice for a foreclosure to be pursued before meaningful loss mitigation alternatives have been considered with the homeowner. The key elements of a loss mitigation requirement are not complex and need not be re-invented. 111 All loss mitigation efforts should be premised on saving the home for the borrower and family – unless the homeowner indicates that is not his/her desire. A range of alternatives should be available, depending on the borrower’s circumstances. As is recognized in all of the existing loss mitigation programs, ensuring that the homeowner can afford and sustain the new terms of the mortgage is a key factor to a successful loss mitigation effort. 112 In addition to the “traditional” loss mitigation options we summarized above, we recommend a special “crisis” workout triage which we attach at Exhibit B.

B. Non-Mortgage Closed-End Credit Lending Practices

1. OTS Should Prohibit Unfair Practices in Payday and Auto Loans

Smaller loans not secured by real estate accompanied by little or no assessment of ability to repay proliferate. These products include payday and auto title loans, both which function in a similar fashion. They are small loans that sport triple-digit APRs, requiring balloon payments due in either two weeks (payday) or a month (auto title). They are not payable in installments, 113 and are secured by a live check, an electronic debit to a bank account, or title and/or keys to a car. Because of this structure, consumers typically renew or “roll over” these loans several times before they can pay in full. The renewal comes at a price—another origination fee each time. Some consumers pay more in fees than the original principal and still owe the amount borrowed. These loans have been controversial for years and their abusive natures

111 Fannie Mae and Freddie Mac have engaged in loss mitigation for years; in addition, Senator Reed has just introduced a bill to, among other things, require loss mitigation efforts before a foreclosure can be initiated. See, S.1386. Many of the proposals in these comments are spelled out in code form in Senator Reed’s bill.
112 See, e.g., Freddie Mac, Single Family Seller Servicer Guide, Volume II, Chapter B65, §
113 A handful of state laws mandate installments after several “rollovers” occur.
have been well documented.114

Last year, Congress took the extraordinary step of establishing special protection for servicemembers and their dependents in credit transactions. Lenders are required to assess ability to repay and are prohibited from using a check or other

method of access to a deposit, savings, or other financial account maintained by the borrower, or taking the title of a vehicle as security for the obligation.\textsuperscript{115} Congress also restricted the interest and the fees charged by certain lenders to 36\% APR.\textsuperscript{116} These provisions effectively ban the making of these loans to the military.

We urge the OTS to do the same for thrifts. The OTS issued guidance on payday loans in 2000 warning thrifts of the potential credit, transaction, reputation, compliance, and legal risks involved. At this time, we are not aware of any thrifts engaged in payday lending directly or through brokers. Nevertheless, we urge the OTS to adopt a rule that prohibits the use of a check or other method of access to a deposit, savings, or other financial account maintained by the borrower or taking the title of a vehicle as security for the obligation. By taking the lead, the OTS will ensure that no thrift ever makes these products available. More importantly, the agency will set the bar for the entire marketplace.

2. \textit{The OTS Should Adopt the FTC Holder Notice Rule}

When the OTS issued a credit practices rule to parallel the FTC’s rule, it did not include the FTC Rule Concerning Preservation of Consumer’s Claim and Defenses (referred to as the “FTC Holder Notice Rule.”)\textsuperscript{117} We urge the OTS to correct this oversight and apply the Holder Notice Rule to savings associations.

In consumer transactions, one of the most important issues is whether a creditor is subject to the claims and defenses that the consumer has against the seller or original creditor. There are two reasons for the importance of this issue. First, the seller or original creditor may be judgment proof, so that consumers would be left without a remedy if they had to pay the holder of the note and then recover all or some of this amount from the original seller or creditor. As the West Virginia Supreme Court stated in construing a state law that incorporated the FTC Holder Rule, without such a rule a financial institution could “run in effect a ‘laundry’ for ‘fly-by-night’ retailers.”\textsuperscript{118}

Even if the seller is solvent, it is usually impractical to expect a consumer to defend a collection action and simultaneously bring an affirmative suit against the seller or original creditor. The collection suit may be resolved years before the affirmative suit, and it is often not feasible for a consumer to bring an affirmative action for the small amount of money at stake. By far the most practical action for the consumer is to defend the collection action by raising in that case the consumer’s

\begin{itemize}
  \item \textsuperscript{115} 10 U.S.C. §§ 987(e)(5) and (6).
  \item \textsuperscript{116} 10 U.S.C. § 987(b)(APR cap).
  \item \textsuperscript{117} Compare 12 C.F.R. part 535 (OTS rule) with 16 C.F.R. §§ 433 (FTC Holder Rule), 444 (FTC Credit Practices Rule).
\end{itemize}
Making creditors liable for the acts of the original seller serves the additional goal of establishing a market-based incentive for creditors to inquire into the merchants for whom they finance sales and to refuse to deal with those merchants whose conduct would subject the creditor to potential claims and defenses.\(^{119}\) Forcing the market to police itself reduces unfair and deceptive practices.

Moreover, the creditor is in a much better position than the consumer to recover money from the seller. “Consumers are not in a position to police the market, exert leverage over sellers, or vindicate their legal rights in cases of clear abuse. . . . Redress via the legal system is seldom a viable alternative for consumers where problems occur.”\(^{120}\) On the other hand, “As a practical matter, the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party.”\(^{121}\)

The FTC Holder Notice Rule covers credit-sale obligations assigned to holders. For example, a car dealer sells a new car, finances the sale, and then sells the loan contract to a savings association. In addition, a sale of goods or services can be financed by a loan from a third party lender, where the seller has a “business arrangement,” broadly defined, with the lender. For example, a university refers students to a savings association who extends credit to finance the student’s education. The FTC Holder Notice Rule also covers these purchase-money loans.

In its current form, the Rule applies to the sellers of goods or services. It defines an unfair or deceptive act or practice to include the situation where the seller takes or receives a consumer credit contract or instrument or accepts the proceeds of any purchase money loan unless the contract includes the Notice. The Notice subjects the holder to all claims and defenses which the consumer could assert against the seller, up to the amounts paid by the consumer.

The FTC enacted this Rule in 1975, about eleven months after Congress passed the provisions creating a duty on the part of the OTS and other banking agencies to adopt mirror regulations to those promulgated by the FTC. For whatever reason, the


\(^{121}\) The FTC emphasized in its *Statement of Basis and Purpose* for the rule that the holder is in an excellent position to recover money from the seller: the holder “has recourse to contractual devices which render the routine return of seller misconduct costs to sellers relatively cheap and automatic . . . The creditor may also look to a ‘reserve’ or ‘recourse’ arrangement or account with the seller for reimbursement.” *Id.*
OTS did not adapt this rule to savings associations at that time.

The problem arises when the seller fails to ensure that the Notice is included in the loan. Until 2002, there was no clarity as to the holder’s responsibility in that situation. In that year, the National Conference of Commissioners on Uniform State Laws and the American Law Institute adopted revisions to the UCC Article 3. A relevant provision states that the FTC Holder Notice shall be implied into any promissory note whenever that notice should have been inserted into the note. ¹²² At this point in time, Arkansas, Minnesota, and Texas have adopted this provision. However, Kentucky and Nevada passed the revised Article 3 without this provision.

We urge the OTS to adapt the FTC Holder Rule by applying it to savings associations. This decision would ensure the consumer protection envisioned by the Rule in 1975 and close any loophole as to whether the Notice is operative even when excluded from the credit contract or loan note. Further, the UCC revisions will eventually make their way into the law of many or most states. By taking action now to recognize the importance of the Holder Rule and the Article 3 revisions, the OTS would show its leadership role in the area of consumer protection under its FTC authority and would create a uniform rule for savings associations wherever they do business.

C. Credit Card Issues

While we urge the OTS to adopt an approach to its UDAP regulations similar to the FTC standards, we also urge that specific credit card practices be banned or regulated. These practices are per se deceptive or unfair, for the reasons discussed below. However, banning specific practices will never adequately protect consumers, given how inventive credit card banks have become in developing new ways to extract fees and abuse consumers.

Banning unfair practices prevents deception in the credit card industry, ultimately ensuring the operation of a fair and competitive marketplace. Without substantive regulation, creditors have an incentive to create credit plans that are too complicated to explain and compare easily, and that impose costs that consumers do not focus on when shopping for cards. Creditors have shifted away from interest rates – which can easily be disclosed, understood and compared – to a myriad of flat fees precisely because those fees are not captured by the interest rate, are not aggregated, and are not easily translated into a uniform measure that can be compared across cards. The sheer number of different fees and policies makes it unlikely that a consumer will understand or focus on any of them, especially when their impact is cumulative.

Disclosure alone will never be enough to prevent deception in the credit card

¹²² Rev. UCC § 3-305(e).
market. The only way to give consumers adequate protection is to replace the state law protections that were taken away with substantive federal protections.

1. Credit Card Abuses are Drowning Americans in Debt

As the OTS is well aware, the use of open-end credit is pervasive in American society. Credit cards have become an increasingly integral part of our lives. Three-quarters of all households have at least one credit card, and over half of cardholders carry credit card debt from month to month.\(^{123}\) There are now almost 1.5 billion cards in circulation — over a dozen credit cards for every household in the country.\(^{124}\) The amount of credit card debt outstanding at the end of 2006 was nearly $880 billion,\(^ {125}\) over three times as much as in 1993.\(^ {126}\)

The explosion of credit card debt has had devastating impacts on millions of American consumers. Between 1989 and 2001 credit card debt in America almost tripled from $238 billion to $692 billion. Worse, the savings rate steadily declined and the number of personal bankruptcies filed climbed 125%.\(^ {127}\) Mounting credit card also causes consumer to spend the equity in their homes to pay off credit card debt by refinancing and putting homes at risk of foreclosure.

A significant amount of the debt load facing American households is caused not so much by consumer borrowing, but by the harsh — and exorbitantly expensive — tactics of the credit card industry. We hear frequently from attorneys representing consumers who are struggling to “do the honorable thing,” meet their obligations, and pay their creditors. Yet the creditors’ response is to use abusive tactics to keep consumers on a treadmill of debt, paying fees and charges, for as long as possible. The exorbitant interest rates and multiple fees charged to already overburdened


Comments of the National Consumer Law Center and National Association of Consumer Advocates
consumers are breaking the proverbial backs of American families, particularly the most vulnerable, financially distressed consumers.

2. An Incomplete List of Abuses

Credit card abuses are not limited to one or a handful of practices. Instead, card issuers have devised a myriad of schemes and traps to squeeze every last penny out of consumers, particularly consumers who are carrying heavy debt loads or beginning to exhibit signs of financial distress. Furthermore, it is not just one or a handful of credit card companies that engage in abusive practices, but a great number of the top ten credit card issuers. It is this pattern of heavy-handed and manipulative conduct by an entire industry that shows that credit card issuers have altered their fundamental treatment of consumers from a fair, respectful business relationship to an abusive, exploitative one.

The abusive practices by credit card lenders are well documented, including most recently by the Government Accountability Office. We discuss some of the most burdensome and egregious, but as discussed below, this is by no means a complete list of credit card abuses-- the possibility of a new abusive practice is only limited by the human imagination.

a. Junk Fees.

A significant contributor to snowballing credit card debt is the enormous increase in both the number and amount of “junk” fees, such as fees for cash advance, balance transfer, wire transfer, currency conversion, and more. Most prominent among these fees are late payment and over-limit fees.

Credit card lenders have made these fees higher in amount, imposed them more quickly, and assessed them more often. Creditors now impose these fees not as a way to curb undesirable behavior from consumers – which used to be the primary justification for imposing high penalties – but as a significant source of revenue for the creditor. In fact the European Union has taken exactly this step.

According to the GAO Credit Card Report, over one third of credit card consumers were assessed a late fee in 2005. The average late fee has soared to over

129 See GAO Credit Card Report at 13.
Over-limit fees have similarly jumped to over $30.81 in 2005. The OTS should ban fees as unfair if they are not reasonably related to the creditor’s costs.

**b. Over-limit Practices.**

The OTS has cited over-limit fees that result from the imposition of a penalty fee as potentially unfair. However, unfairness goes beyond that more narrow issue to encompass the general over-limit practices of creditors. Creditors encourage consumers to use their cards to the maximum extent and regularly approve purchases that are over the credit limit. They “pad” the nominal credit limit, approving transactions that exceed it, then charge excessive fees. For example, for a consumer with a nominal credit limit of $2,000, the creditor may increase the effective credit limit up to $2,500, but charge a substantial fee for each transaction over the nominal limit.

The original (and perhaps understandable) purpose originally was primarily to avoid customer relations problems stemming from denials for proposed charges that would have resulted in a balance exceeding the nominal credit limit only by a relatively modest amount. However, when creditors realized they could charge fees as high as $30, the primary reason to permit customers to go over their limits became the ability to generate substantial over-limit fees. The OTS should ban as unfair any over-limit fees for which the creditor has approved the transaction or has institute a “pad” in the credit limit.

**c. Penalty Rates.**

Creditors market low APRs – even to consumers chosen because they have gone through bankruptcy – but then impose sky high penalty rates if the consumer pays late even by a few hours, exceeds a credit limit, or otherwise defaults. Penalty APRs average 27.3% according to the GAO Credit Card Report, and can be as high as 30% to 40%. The new terms apply to the old balance – leaving consumers stuck paying balances at interest rates far higher than was originally agreed, with devastating consequences.

Raising an APR from the mid-teens to 27% or higher, simply on the basis of a single transgression, itself is unjustified and unfair. After all, the card issuer has already collected a one-time charge for that late payment or over-limit transaction, which probably more than covers its costs. This practice is especially outrageous when applied retroactively. There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance; the terms of a loan are being

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130 *Id.* at 20-21.
131 *Id.*
132 *Id.* at 24-25.
changed after the loan has already been made. The OTS should ban as unfair practices excessive penalty rates and penalty rates that apply retroactively.

d. Universal Default.

Even worse is universal default, in which credit card lenders impose penalty rates -- not for late payments or any behavior with respect to the consumer’s account with that particular issuer -- but for late payments to any of the consumer’s other creditors. In many cases, lenders will impose penalties simply if the card holder’s credit score drops below a certain number, whether or not the drop was due to a late payment or another factor, a practice known as “adverse action repricing.” Consumer Action’s 2005 survey of credit card lenders found that 45% of banks surveyed had a universal default policy, and that for 90% of these banks, a credit score drop could trigger a penalty rate hike.\(^{133}\) In its 2007 report, Consumer Action found that while most creditors now deny that they employ universal default, many still reserve the right to change a consumer’s interest rate for any reason, including based upon credit report information.\(^{134}\)

Among other concerns, using credit scores to trigger penalty rates is troublesome given the enormous problem of inaccuracies in credit reporting. Studies have repeatedly found credit reports to be riddled with inaccuracies.\(^{135}\) The subprime mortgage crisis makes clear that many borrowers will experience drastic declines in their credit scores simply because they were the victims of fraudulent, deceptive or unfair practices. The subprime mortgage crisis also has raised questions about the predictive value of credit scores, and has shown that imposing unfavorable terms on consumers with lower credit scores tends to cause rather than predict default. Finally, the use of credit scoring to impose penalty rates has a disparate racial impact.\(^{136}\)


\(^{136}\) Numerous studies have shown significant racial disparities in credit scoring. See, e.g., Matt Fellowes, Credit Scores, Reports, and Getting Ahead in America, Brookings Institution, May 2006; Raphael W. Bostic, Paul S. Calem, and Susan M. Wachter, Hitting the Wall: Credit as an Impediment to Homeownership, Joint Center for Housing Studies of Harvard University, February 2004; Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America’s Families, September 1996, at 27.
If a consumer is having trouble managing credit, the responsible banker approach is to restrict future credit, not to encourage continued borrowing but shove the consumer deeper in the hole with rates that make it harder to pay off the current balance. Penalty rates do far more than cover the risk to the creditor of nonpayment; defaulting consumers are the most profitable. As discussed in section II(C)(3), a rule restricting penalty rates would also encourage thrifts to assess ability to pay more responsibly at the outset before extending credit. The OTS should ban universal default and adverse action repricing as unfair practices.

e. Payment Allocation Abuse.

Many credit card companies heavily advertise low APRs in their solicitations that are only applicable to one category of transactions. They then allocate payments first to the balances with lower APRs. Payment allocation abuses are a form of bait & switch, depriving consumers of the benefit of the credit card lenders’ highly promoted “0% APR” or other teaser rates for balance transfers. Consumers find all of their payments applied to their 0% balance, eliminating that amount quickly, while purchases at higher APRs accrue significant finance charges since they are not being paid down. Permitting payment allocation abuse encourages deceptive advertising. The OTS should prohibit payment allocation abuse as an unfair practice, and dictate that payments must be first posted to the balance that carries the highest rate.

f. Late Payment Triggers.

Not only are late fees higher, credit card lenders have been quicker to impose them, often using hair trigger tactics. Previously, credit card lenders gave consumers a leniency period of a few days before imposing late fees. Now, card lenders will impose late fees if the consumer is even one day over the due date. Some lenders impose late fees for payments received on the payment due date but after a certain cut-off time, such as 1 P.M. And until consumer advocates and lawyers began to complain and file lawsuits, these lenders set ridiculously early times like 9 or 10 A.M. deliberately to result in the imposition of late-payment fees -- well before the U.S.

Postal Service delivers the mail. Furthermore, when due dates sometimes fell on a weekend or holiday, lenders considered the payment late if not received on the prior business day. The OTS should ban payment cut-off times as unfair, and require creditors to treat payments as timely if they are postmarked as of the due date.

g. Unilateral Change-in-Terms.

The nature of credit cards is that the borrower signs an agreement at one point in time, but continues to draw upon the credit line thereafter. Creditors can respond to changes in consumer circumstances by reducing the credit limit or cutting off charging privileges. The problem is that they are allowed to change any term of a credit card virtually at will.

There are two problems with these unilateral changes-in-terms. First, they deprive consumers of any “benefit of the bargain,” making a mockery of both federal disclosure laws and contract law, because the terms of the contract are illusory. A savvy consumer can select a credit card after reviewing Truth in Lending disclosures, comparing terms, reading articles about picking a credit card – in other words, be a smart shopper – but then be faced with a change-in-terms notice that totally changes all the terms of the credit card. One court has described change-in-terms provisions as “an Orwellian nightmare, trapped in agreements that can be amended unilaterally in ways they never envisioned.”

Second, the vast majority of consumers probably do not read or understand change-in-terms notices. Credit card lenders have admitted that very few consumers opt out of changes. Evidence uncovered from a case involving similar change in terms notices (albeit from cell phone contracts) found that very few customers actually read these notices.

In any case, consumers have few options to switch to other companies even if they do figure out that the terms of their card are changing. To the extent that the


Perry v. FleetBoston Financial Corp., 2004 WL 1508518 at *4 n.5 (E.D. Pa. Jul. 6, 2004). This court went on to say that it was “reminded of George Orwell’s 1946 work, Animal Farm, in which the pigs assume power and change the terms of the animals’ social contract, reducing the original Seven Commandments, which included ‘All animals are equal,’ to one—‘All animals are equal, but some animals are more equal than others.’”


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reason for the notice is a penalty rate levied based on changes in credit scores, that same credit score will be used by any other card issuer with whom the consumer makes an inquiry about a new card.

**h. Subprime credit cards.**

There are a number of credit card products targeted at the “subprime market,” which generally means consumers with lower credit scores and/or impaired credit histories. The few consumer protection actions taken by the federal banking regulators have primarily focused on subprime credit cards and have targeted unfair practices such as:

- "Downselling" consumers by prominently marketing one package of credit card terms, but then approving consumers only for accounts with less favorable terms.
- Issuing credit cards with low credit limits, then adding mandatory fees or “security deposits” resulting in little or no available credit when the consumer receives the card.
- Deceptively marketing credit “protection” products.

As documented by a new NCLC report, one segment of the subprime market consists of an even higher cost version of a credit card that features low credit limits quickly consumed by hundreds of dollars in fees at the outset -- the fee-harvester card.142 For example, one of the fee-harvester cards featured in the new NCLC report comes with a credit limit of $250, but the consumer who signs up for this card will automatically incur a $95 program fee, a $29 account set-up fee, a $6 monthly participation fee, and a $48 annual fee – an instant debt of $178 and buying power of only $72.

The OTS should ban as deceptive, i.e., not really constituting a credit offer, any credit card that offers less than $300 of available credit after initial fees are subtracted. In addition, the OTS should prohibit creditors from imposing initial fees that consume more than 10% of the overall credit line.

**i. Mandatory Arbitration Clauses.**

The use of arbitration provisions in credit card agreements has been a tremendous barrier for consumers seeking relief for credit card abuses. Consumers who complain about deceptive disclosures, late posting of payments, payment

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allocation abuses, and failure to follow federally required billing procedures have lost their day in court due to arbitration provisions (often added using change-in-terms notices). 143

Card issuers are now using arbitration provisions offensively as well, as a lopsided method to obtain judgments against unsuspecting consumers. Some of these consumers include victims of unauthorized use and identity theft. Reports issued by NCLC and Public Citizen document how creditors use arbitration proceedings to pursue consumers, including some consumers who never applied for a credit card or agreed to arbitration. 144 Shockingly, both reports show that creditors prevailed in these arbitration proceedings over 90% of the time, indicating a troubling bias against consumers. The OTS should prohibit credit card agreements that require a consumer's waiver of his or her right to a court trial and consent to binding mandatory arbitration.

In addition, the OTS should ban class action waivers as an unfair waiver of consumers' rights. Credit card agreements now routinely prohibit individuals from joining class action lawsuits. The only purpose of these clauses is to prevent consumers from redressing legal violations that are too small, on an individual basis, to attract a lawyer. Class action bans have no legitimate justification, and serve only to encourage violations on a scale of millions.

The abusive practices listed above are inherently abusive, and should be banned on that basis alone. However, they should also be banned because they permit credit card lenders to “hide the ball” on the real price of a credit card. Consumers will shop for credit cards based on sales pitches in the solicitation - points and rewards, and with respect to pricing, APR and annual fee. Consumers never shop on “what is the penalty APR or late fee” because they never expect to be that consumer who is late, or loses a job and can’t pay off the bill.


3. The Unfairness of Risky Credit Card Lending

The most important unfair practice for the OTS to tackle is the failure of credit card lenders to engage in real underwriting, i.e., to evaluate a consumer’s ability to repay a credit card debt. This failure is the reason why creditors stick so many consumers who make the smallest misstep (or even no misstep) with rates averaging 27% APR, even after the lenders have collected $25 or $30 for their troubles.

Creditors have figured out how to make money by lending to people without any determination of their ability to repay. Evaluation of ability to pay must involve not just obtaining a credit score but also determining whether the consumer can afford the credit given her income and other debts. Instead, credit card lenders engage in “back end” underwriting. After the consumer has received the credit card and run up a debt, and after facing trouble making the payments on the debt, the credit card lender hikes up the interest rate for the consumer and justifies the increase in rate based on the “newly discovered” high risk of non-payment.145

Lenders use the extension of risky credit to justify the higher penalty rates, but those high rates simply exacerbate the riskiness (or likelihood of default) of those borrowers. Enough high risk customers pay these exorbitant amounts to subsidize any losses that actually result from customers who do not repay their debt.

Thus, the industry has found a way to use risky lending to its benefit. These tactics have proven to be immensely profitable. Revolvers – those consumers who carry a credit card balance from month to month - make up most of the profits for the credit card industry, about 80%.146 And it is the revolver who makes the tiniest misstep – a day late on a minimum payment, a few dollars over the limit – who is the most profitable borrower as she is socked with penalty rates and. One of the most startling facts uncovered by the GAO Credit Card Report is that an enormous amount of credit card revenues come from financially vulnerable or distressed consumers.147

145 Sometimes this risk is NOT newly discovered but consists of negative information in a credit card that existed prior to the creditor’s initial offer of a new credit card or balance transfer. See, e.g., Order Granting in Part Defendant Motion for Summary Judgment, Hauk v. Chase, CV No. 05-00625-SVW (C.D. Cal. July 6, 2006) (creditor offered balance transfer APR of 4.99%, then hiked APR on card to 28% APR after consumer transferred $10,000 balance; penalty rate was based upon late payment to another lender that occurred three months prior to balance transfer offer)

146 GAO Credit Card Report at 69-72 (approximately 70% of revenues from interest charges, with a growing portion attributable to penalty interest, and 10% from penalty fees).

147 The GAO Credit Card Report noted that about 11% of credit card consumers are assessed an interest rate of 25% or more, which is probably a penalty rate. However, only about half of cardholders are revolvers. That means about a quarter of revolvers have a penalty rate. These penalty rate revolvers probably make up for more than 25% of profits from interest rates, since as the GAO noted they pay higher prices and also may carry larger balances.
Moreover, a recent report by Demos finds that it is low-income, minority and single female consumers who are most likely to pay these penalty rates.148 For example, the Demos report finds that revolvers whose household incomes are less than $25,000 are more than twice as likely as $50,000 households to pay over a 20% APR, and minorities are twice as likely as whites to pay those high rates.149

Once the consumer has racked up the debt, a consumer is beholden to the credit card lender, and has few choices in the marketplace. Consumers who are homeowners are often able to tap home equity, but if their credit scores are poor, they now face the risk of abusive subprime home equity lending. Otherwise, the best that a distressed consumer might be able to do is file for bankruptcy, or try to walk away (stop paying). Therein also lies part of the reason credit card lenders use such draconian tactics when a consumer stumbles even a little - lenders often can squeeze enough out of distressed consumers to make the account profitable, even if ultimately the consumer files for bankruptcy or the debt is written off.

This approach is backwards and should be stopped. The OTS should prohibit creditors from making loans to consumers who cannot repay. The industry should be required to evaluate a borrower’s ability to repay and only extend credit to those who can afford the credit provided to them.

D. Deposit Accounts

Issue 1: Should OTS consider further rulemaking on unfair or deceptive acts or practices that would cover products and services in addition to consumer credit? If so, should the rule be limited to financial products and services and how should that scope be defined?

The answer to this is “Yes.” As the OTS has recognized, deposit accounts need to be protected, especially from seizures of exempt funds pursuant to attachment and garnishment orders, or pursuant to the bankers’ exercise of the right of set-off.

1. OTS Should Prohibit the Freezing of Exempt Funds

OTS proposes in the ANPR to make it an unfair practice for savings banks to freeze accounts containing exempt benefit payments upon receipt of attachment or garnishment orders. However, this is not enough. Interest makes up about 70% of credit card lenders profits, and penalty fees account for another 10%. GAO Credit Card Report at 67-72.

149 Id. at 6.
garnishment orders. We fully support this proposal and applaud the OTS for suggesting it. The elderly and disabled who receive federal benefits have been subjected to an escalating number of illegal freezes in the past decade. These recipients suffer terribly when they lose access to their only income – they have difficulty paying for food and health care and they put their housing at risk by falling behind on rent or home mortgage payments.

In recent years the number of recipients of Social Security and other federal benefits who receive their payments electronically has risen dramatically. This is undoubtedly the result of the huge government effort to promote direct deposit fostered by the passage of EFT 99 in 1996, which requires that all federal payment (except income tax refunds) be electronically deposited. The federal government saves substantial money through direct deposit, and direct deposit of federal benefits into a bank account is often advantageous to low-income recipients.

However, there are two major and increasingly significant drawbacks to direct deposit: (1) the increase in bank accounts held by low income federal payment recipients has increased recipients’ vulnerability to illegal and improper seizure of their exempt benefits, and (2) fees charged to customers with low-balance accounts are growing at exponential rates.

We estimate that on a monthly basis thousands of low income recipients of Social Security, SSI and other federal payments whose benefits are entirely exempt from claims of judgment creditors are left temporarily destitute when banks allow attachments and garnishments to freeze their only assets. As was illustrated in a recent Wall Street Journal article (A The Debt Collector vs. The Widow B Viola Sue Kell thought her Social Security benefits were safe in the bank. She was wrong. @), when a bank applies an attachment or garnishment order to the exempt funds in a low income recipient’s bank account, the consequences are generally devastating. There is no money for food or medicine. Checks written for rent or the mortgage are bounced. People go hungry. They get sick or sicker. They suffer anxiety. They are forced to pay

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150 In 1985, 41.5% of Social Security recipients and 12.4% of SSI recipients received their payments electronically. By 2007, these percentages had risen to 84.1% and 58% respectively. [http://www.ssa.gov/dep/trendenv.shtml](http://www.ssa.gov/dep/trendenv.shtml).
152 A recent private study commissioned by the U.S. Treasury Department estimated that $100 million was saved by converting from paper checks to electronic payments. Financial Mgmt. Servs., U.S. Department of Treasury, Understanding the Dependence on Paper Checks: A Study of Federal Benefit Check Recipients and the Barriers to Boosting Direct Deposit (2004), available at [http://fms.treas.gov/eft/reports/EFTResearch7.27.04FINAL.pdf](http://fms.treas.gov/eft/reports/EFTResearch7.27.04FINAL.pdf) (study conducted by Federal Reserve Bank of St. Louis).
steep bank fees and fees to merchants because the checks they wrote when they had money in the bank now bounce.

The banks say it is not their duty to determine which accounts contain exempt funds. They say it is not their job to refuse attachment orders issued by state courts just because the accounts contain exempt funds. The banks say that it is the business of the courts to sort out which funds are exempt from attachment and which funds are available.

We disagree with this assessment as a legal matter and as a policy matter. Legally, the cases are only beginning to catch up with the technological situation that exempt funds directly deposited in bank accounts presents,154 but the case law presents no bar to such a requirement. As a policy matter, how can there be any dispute that the funds provided by American taxpayers to keep this nation’s elderly and disabled from starvation and destitution should be kept available rather than frozen for the convenience of creditors who have no right to the monies?

2. **Savings Banks Should be Required to Identify Electronically Deposited Exempt Funds and Freeze Only Non-Exempt Funds When They Receive Attachment or Garnishment Orders.**

Social Security benefits, SSI benefits, Veterans’ benefits, Railroad Retirement benefits, were all intended by Congress to be used exclusively for the benefit of recipients to ensure a minimum subsistence income to workers and the disabled.155 To

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155 **Social Security benefits:** “The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.” 42 U.S.C. § 407(a).

**Veterans benefits:** “Payments of benefits due or to become due under any law administered by the Secretary shall not be assignable except to the extent specifically authorized by law, and such payments made to, or on account of, a beneficiary shall be exempt from taxation, shall be exempt from the claim of creditors, and shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, either before or after receipt by the beneficiary.” 38 U.S.C. § 5301(a)(1).

**Railroad Retirement benefits:** “Except as provided in subsection (b) of this section and the Internal Revenue Code of 1986 [26 U.S.C.A. § 1 et seq.], notwithstanding any other law of the United States, or of any State, territory, or the District of Columbia, no annuity or supplemental annuity shall be assignable or be subject to any tax or to garnishment, attachment, or other legal process under any circumstances whatsoever, nor shall the payment thereof be anticipated.” 45 U.S.C. § 231m.
preserve these benefits for recipients, Congress provided that the benefits cannot be seized to pay pre-existing debts, as such seizures would result in the loss of subsistence funds. Each of the statutes governing the distribution of these funds specifically articulates that these funds are to be free from attachment or garnishment or other legal process.\(^6\)

The courts processing the competing interests of the creditors, debtors and banks have articulated the underlying reasons for these protections. The courts have enumerated the following purposes to exemption protections: (1) to provide the debtor with enough money to survive; (2) to protect the debtor’s dignity; (3) to afford a means of financial rehabilitation; (4) to protect the family unit from impoverishment; and (5) to spread the burden of a debtor’s support from society to his creditors.\(^{156}\)

This nation’s courts have consistently said that exemptions are to be liberally construed in favor of the debtor.\(^{157}\) The United States Supreme Court has repeatedly reiterated that the Social Security,\(^{158}\) and Veterans Benefits\(^{159}\) are protected from attachment and garnishment. The protections in these federal statutes explicitly apply to benefits that are paid and payable\(^8\) thus making the benefits exempt both before and after payment to the beneficiary,\(^{160}\) regardless of whether the creditor is a state or a private entity.\(^{161}\)

Federal Retirement program benefits: 
An amount payable under subchapter II, IV, or V of this chapter is not assignable, either in law or equity, except under the provisions of section 8465 or 8467, or subject to execution, levy, attachment, garnishment or other legal process, except as otherwise may be provided by Federal laws. 5 U.S.C. \(8470.\)

\(^{156}\) See, e.g., \textit{In re Johnson}, 880 F.2d 78, 83 (8th Cir. 1989) (Minn. law); \textit{North Side Bank v. Gentile}, 129 Wis. 2d 208, 385 N.W.2d. 133 (1986); \textit{Vukovich, Debtors Exemption Rights}, 62 Georgetown L.J. 779 (1974).

\(^{157}\) This rule is almost universally recognized. See, e.g., \textit{Wilder v. Inter-Island Stream Navigation Co.}, 211 U.S. 239 (1908); \textit{In re Perry}, 345 F.3d 303 (5th Cir. 2003) (Texas homestead law); \textit{In re Cobbins}, 227 F.3d 302 (5th Cir. 2000) (Miss. law) (liberal construction required, but mobile home not exempt unless debtor also owns land); \textit{In re Colwell}, 196 F.3d 1225 (11th Cir. 1999) (Florida law); \textit{In re Crockett}, 158 F.3d 332 (5th Cir. 1998) (Texas law); \textit{In re McDaniel}, 70 F.3d 841 (5th Cir. 1995) (Texas law); \textit{In re Johnson}, 880 F.2d 78, 83 (8th Cir. 1989) (Minn. law); \textit{Tignor v. Parkinson}, 729 F.2d 977, 981 (4th Cir. 1984) (Va. law). Many additional decisions are cited at National Consumer Law Center, Fair Debt Collection § 12.6 (5th ed. 2004 and Supp.).


\(^{159}\) \textit{Porter v. Aetna Cas. & Surety Co.}, 370 U.S. 159, 82 S. Ct. 1231, 8 L. Ed. 2d 407 (1962) (deposited VA benefits retain exempt characteristic so long as they remain subject to demand and use for needs of recipient for maintenance and support, and not converted to permanent investment).


In *Porter v. Aetna Casualty and Surety Co.*, the Supreme Court held that veterans disability benefits deposited in a bank account remain exempt so long as they are readily traceable and retain the quality as moneys, that is, they are readily available for the day-to-day needs of the recipient and have not been converted into a permanent investment. This rationale has been widely applied to other exempt benefits, to hold that exempt funds remain exempt in checking, savings, or CD accounts so long as these are usual means of safekeeping money used for daily living expenses.

These rationales have also been routinely applied to Social Security benefits, holding that those benefits are generally exempt from attachment by creditors when

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162 370 U.S. 159, 82 S. Ct. 1231, 8 L. Ed. 2d 407 (1962).
166 In re *Smith*, 242 B.R. 427 (Bankr. E.D. Tenn. 1999) (proceeds of veteran’s life insurance policy remained exempt when widow used them to purchase CD, and funds were not commingled with other funds); *Jones v. Goodson*, 772 S.W.2d 609 (Ark. 1989) (key issue was accessibility; depositor could obtain funds at will, although he would be penalized by loss of some interest); *Decker & Mattison Co. v. Wilson*, 44 P.3d 341 (Kan. 2002) (proceeds of workers’ compensation settlement, deposited in couple’s joint account, then used to purchase CD remained exempt, where funds were traceable and CD a usual means of safekeeping); *E.W. v. Hall*, 917 P.2d 854 (Kan. 1996). But see *Feliciano v. McClung*, 556 S.E.2d 807 (W.Va. 2001) (lump sum workers’ compensation award would remain exempt in ordinary bank account, but purchase of CD turns it into non-exempt investment).
167 See *Porter v. Aetna Cas. & Surety Co.*, 370 U.S. 159, 82 S. Ct. 1231, 8 L. Ed. 2d 407 (1962). See also *Jones v. Goodson*, 772 S.W.2d 609 (Ark. 1989) (certificates of deposit purchased with veterans benefits remained exempt; funds were immediately accessible even though depositor would forfeit some interest in case of early withdrawal); *Younger v. Mitchell*, 777 P.2d 789 (Kan. 1989) (veterans benefits deposited into an interest bearing savings account exempt); *United Home Foods Dist., Inc. v. Villegas*, 724 P.2d 265 (Okla. Ct. App. 1986) (veterans benefits direct deposited into a bank account and used to pay household expenses clearly exempt).
168 *Philpott v. Essex Cty. Welfare Bd.*, 409 U.S. 413, 93 S. Ct. 590, 34 L. Ed. 2d 608 (1973); S&S Diversified Servs. L.L.C. v. Taylor, 897 F. Supp. 549 (D. Wyo. 1995) (Social Security old age benefits remained exempt when commingled with other funds in joint account, so long as they are reasonably traceable; court warned creditors it may impose sanctions for attempt to...
those benefits are deposited into a bank account as long as the funds are available on demand or for the support of the beneficiary and even when they are commingled with other funds.169

Despite the explicitness of the federal law and the purpose of these benefits, banks (after receiving garnishment or attachment orders) routinely freeze accounts holding these benefits. When the account is frozen, no money is available to cover any expenses for food, rent, or medical care. Checks and debits previously drawn on the account (before the recipient learned that the account was frozen) are returned unpaid. Subsequent monthly deposits into the account will also be subject to the freeze and inaccessible to the recipient.

The funds will remain frozen for a time period determined by state law before being turned over to the creditor. In order to unfreeze the account, generally the recipient must find an attorney or go to the local courthouse on his or her own, fill out a form stating that the funds in the account are exempt, and then present the form and accompanying proof in the form of letters from Social Security and bank statements to the creditor. If the creditor voluntarily agrees to release the funds, the creditor will send a release of the attachment to the bank. At this point, it may still take several days or even weeks before the funds are actually released.

However, if the creditor does not voluntarily agree to release the funds, the only way to have the bank account unfrozen is for the recipient to request a hearing. In most cases a lawyer is necessary to help a recipient through this arcane judicial

process. Yet lawyers are hard to find in many areas of the nation. Legal aid programs are often overwhelmed with other work. Transportation to lawyers, the courthouse and the bank is often difficult and expensive for recipients, who are by definition, elderly or disabled and often impoverished. The effect of a freezing of exempt funds is thus - generally - a full taking of these funds, because rarely does the recipient have the wherewithal to pursue the process of claiming the exemptions.

Commingling of exempt funds with non-exempt funds or funds of another does raise the problem of traceability. However, the majority rule across the United States is that exempt funds will continue to be protected even when deposited into accounts with non-exempt funds,\(^{170}\) generally applying a first-in first-out accounting method.\(^{171}\) A small minority of courts have refused to require tracing, finding that the exemption was lost when the funds were commingled.\(^{172}\)

Although some banks do examine accounts to determine whether they are comprised exclusively of exempt funds\(^{173}\) in which case, the bank declines the


\(^{173}\) New York Community Bank, Astoria Federal Savings and Loan Association, Roslyn Savings Bank, and JP Morgan Chase, for example, as well as other banks in the New York area, have stated in depositions and letters that they examine bank accounts to determine whether they contain only electronically deposited federally exempt funds, and they will not honor a restraining order as long as it can be determined that the accounts contain only
attachment order the majority of banks do not. Upon receipt of a judgment creditor’s request for attachment, most banks ignore even clear evidence of exempt funds such as electronic deposit from the Social Security Administration - and simply freeze the recipient’s bank account.

Because of two significant changes in recent years - 1) the huge influx of low income recipients who receive the federal payments through direct deposit and 2) the ease with which banks can now identify these exempt amounts in the accounts because of this electronic record - it is appropriate for the banks to respond differently in the future.

As was recognized by the federal district court in the recent case of Mayers v. New York Cmty. Bancorp, Inc.,174 the traditional constitutional balancing between the competing interests of the players now dictates a different response by the banks. Some banks routinely look to see if the account is comprised of solely exempt funds. Clearly, it is neither difficult, illegal, nor expensive to perform this analysis first. The issue is whether the banks should look, not whether they can - because they clearly can. The technology is simple - every electronic deposit is denominated by the source and type of funds.

a. Exempt Funds in Commingled Accounts Should Also Be Protected

The more complex issue is what should happen if the funds are commingled - either with non-exempt funds owned by the recipient, or with funds of another person who is not a debtor on the attachment or garnishment. Here it is very important that we do not create the incentive for Social Security and other beneficiaries to have second class bank accounts - as we would if by depositing one dollar of non-exempt funds the recipient would lose any protections applied to accounts comprised purely of exempt funds. It would seem to be a backwards national policy to punish the normal use of bank accounts by recipients when they deposit other funds in their accounts, when one of the stated reasons for EFT 99 was to encourage the use of mainstream banking by low income federal recipients.175

The use of a simple accounting system - as has been required by the courts as a matter of routine when there is commingling could be easily adapted for the

exempt funds, such as SSI.


automatic use by banks for accounts with electronic deposit of exempt benefits. As is explained in the Montana Supreme Court case of *Dean v. Fred's Towing*:176

We see no reason why the tracing of funds as used here to determine what amount in an account is attributable to exempt funds should not apply with equal force to exempt Social Security funds in an account ... if sums [are] exempt at their source they remain exempt even though commingled with non-exempt funds, as long as the exempt source of the funds [are] reasonably traceable.177

In the age of sophisticated computer technology, it would be so simple for this elementary accounting principle to be applied upon the press of a button to bank accounts containing exempt funds.

If the recipient is able to object to the attachment of the bank account containing exempt funds, this accounting analysis will have to be performed in any event - because that is the traditional way to determine which funds are exempt when they have been commingled. So the proposal here would be to have the nation’s banks all use a simple accounting program, required by their regulators, which would simply be performed before the attachment, rather than after it.

If a simple accounting system is applied, we recommend it be the AFirst In Last Out system. Under this system, exempt funds are considered to be the first deposited and the last withdrawn on any given day. Of course, exempt funds are deposited electronically only once or twice a month, so the system is simple to administer, especially with modern computers.178

177. 245 Mont. at 371, 582.
178. The accounting system we recommend would be AFirst In, Last Out (aka AFILO) to be applied to all exempt funds. Under this system, all exempt funds would be considered to be deposited first on a given day, and withdrawn last i.e. first in and last out. Consider the following example of how this would work:

| Day 1 - Deposit of $700 exempt funds. | Balance $700 --- $ 700 exempt $0 non-exempt |
| Day 3 - Deposit of $200 non-exempt funds. | Balance 900 --- 700 exempt 200 non-exempt |
| Withdrawal of $50 | Balance 850 --- 700 exempt 150 non-exempt |
| Day 4 - Withdrawal of $300 | Balance 550 --- 550 exempt 0 non-exempt. |
| Day 5 - Deposit of $200 non-exempt funds. | Balance 750 --- 550 exempt 200 non-exempt |
An alternative system that would be even simpler mathematically would be to adopt - on a uniform, national basis - the method that several states use to determine which funds are exempt when there has been commingling in an account. For example, in California, a set amount is considered to be exempt from all attachments, and only the funds in the account which exceed that amount are available for attachment.179 A simple system such as this provides certainty and ease of use for the banks, as well as basic protections for the recipients.

b. Banks Have Liability Only for Not Providing these Protections to Exempt Funds

Some banks insisted that this is a complicated question involving the intersection of state and federal law, and that banks run a legal risk for not freezing an account in response to a court ordered attachment or garnishment. We disagree with this assessment.

Generally state laws require that attachment and garnishment orders apply only to non-exempt funds.180 We believe it highly unlikely, if not impossible, that banks would be exposed to any legal jeopardy for refusing an attachment when the only funds the bank is refusing to attach are exempt under federal law.181

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179 See, e.g. West's Ann.Cal.C.C.P. ' 704.080.
180 We have done a review of all state laws and it appears that in every state an attachment or garnishment order clearly only applies to non-exempt funds. In a minority of states, there is some ambiguity surrounding the issue of whether the exempt status of the funds only applies upon the debtor’s taking some action. However, that would conflict with the specific protection of the federal statutes at issue here - where the Supreme Court and others have already said that Social Security, SSI and Veterans Benefits retain their exempt status from before the time they are paid to the recipient until after they are paid to the recipient. A state procedure that purports to say that these funds are not exempt unless the recipient comes forward to claim them directly conflicts with this protection and would be clearly preempted.
181 Advocates for low-income consumers in some states have succeeded in changing the forms provided to banks with attachment or garnishment orders, prohibiting banks from applying the orders to accounts that hold only funds electronically deposited by the Social Security Administration. See, e.g., Pa. R. of Civ. Proc. Rule 3111.1. The new rules protect funds that are on deposit in a bank or other financial institution in an account in which funds are deposited electronically on a recurring basis and are identified as funds which upon deposit are exempt from attachment . . . .@ Pa. R. of Civ. Proc. Rule 3111, Note, reprinted at http://www.aopc.org/OpPosting/Supreme/out/471civ.5attach.pdf. Under the amended rules, the judgment creditor rather than the defendant has the burden of raising an issue with respect to exempt payments within the scope of new Rule 3111.1. The defendant need not file a claim for exemption as exempt funds are not attached.@@ Pa. R. of Civ. Proc. Rule, Civil Procedural Rules Committee Explanatory Note, reprinted at http://www.aopc.org/OpPosting/Supreme/out/471civ.5attach.pdf.
In fact, such a result seems potentially a violation of the Supremacy Clause. State laws are preempted if they conflict with the purposes of a federal law or regulation. Moreover, as was explained previously, the courts throughout the nation have already articulated that exemption procedures are to be liberally construed applied so as to protect debtors.

Indeed, we have never heard of any case in which a bank suffered even the burden of legal inquiry after it refused to honor an attachment or garnishment order because the only funds on deposit were exempt. In fact, this scenario seems highly unlikely, given the fact that creditors and their attorneys would face legal jeopardy of their own for pursuing funds that they have reason to know are exempt. In recent years, creditors and creditors’ attorneys who wrongfully seized exempt funds in bank accounts have been found subject to common law claims such as conversion, negligence, or intentional infliction of emotional distress and to statutory claims for violations of the Fair Debt Collection Practices Act and state unfair and deceptive practices statutes.\footnote{See Todd v. Weltman, 434 F.3d 432 (6th Cir. 2006); Rahaman v. Weber, 2005 WL 89413 (Minn. Ct. App. 2005) (procedure for claiming exemption, including damages if creditor seized exempt property, did not preclude common law causes of action for conversion against creditor and its attorneys).}

On the other hand, our advocates report numerous cases in which the banks were required to pay the recipients money because the bank failed to look or ignored clear evidence of the exempt status and applied attachment or garnishment orders to exempt funds, or refused to release funds when the bank customer brought proof of that exempt status.\footnote{Chung v. Bank of Am., 2004 WL 1938272 (Cal. Ct. App. 2004) (unpublished) (stating that bank garnishee had duty to verify whether funds were exempt, not creditor); Lukaksik v. Bank North, N.A., 2005 WL 1219755 (Conn. Super. Ct. Apr. 26, 2005) (plaintiff pleaded exceptional circumstances sufficient to maintain action for breach of fiduciary duty); Branch Banking Trust Co. v. Bartley, 2006 WL 1113632 (Ky. Ct. App. Apr. 28, 2006) (father sued bank that allowed creditor to garnish non-custodial account containing minor son’s funds; bank raised genuine issue of fact on counterclaim that father breached fiduciary duty by setting up ordinary joint account and failing to respond to creditor’s garnishment notice). But see Gorstein v. World Sav. Bank, 110 Fed. Appx. 9 (9th Cir. 2004) (bank has no duty to determine whether portion of funds in account were exempt); McCahey v. L.P. Investors, 774 F.2d 543 (2d Cir. 1985) (debtor’s interest in preserving non-exempt property for his or her own use is ... subservient to the creditor’s judgment, meaning that bank has no duty to determine exempt funds).} Finally, if banks and other financial institutions followed guidance issued by their federal regulators regarding how to treat federally exempt funds, it seems highly improbable that any state court would hold the bank liable for not applying an attachment order to federally exempt funds.
3. **Fees Charged Social Security Recipients and Others Should be Very Limited.**

The banks assess expensive fees against these frozen accounts. Although the account is frozen and inaccessible to the depositor, the bank still deducts its fees from the balance. The act of freezing the account itself generates an attachment fee generally between $100 and $150. All checks, ATM withdrawals, and preauthorized electronic transfers for rent and other purposes are returned for insufficient funds. Every time a debit request is returned unsatisfied, the bank NSF fee generally in the amount of $25 to $35 is deducted.184

These fees can eat up the precious money in an account all too quickly, and should be strictly limited, if not prohibited. Certainly they should not be a profit center for the bank.

If overdraft fees and other fees are permitted to be charged against federally exempt funds in bank accounts, at the least they should be limited to the actual cost of the expense that generated the fee. It makes no sense as a policy matter for the American taxpayer to be expending millions of dollars on a yearly basis to help recipients avoid destitution, only for substantial portions of these funds to be siphoned off by the banks that are distributing their funds.

4. **Savings Banks Should Be Prohibited from Exercising the Right of Set-Off Against Exempt Federal Benefits**

As the majority of courts have recognized, “the assertion of a bank’s right of set-off has exactly the same effect as a third party’s levy of execution on the account – it deprives the depositor of the income which [has been] provided him to meet subsistence expenses . . . .”185

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184 This practice is separate from the problems caused when banks promote overdraft protection loans to Social Security recipients and bleed the accounts through high overdraft fees. Although this practice was declared legal in *Lopez v. Washington Mut.*, 302 F.3d 900 (9th Cir. 2002), it is still very bad public policy. NCLC describes these transactions as “bounce loans” because any benefits from the program are far outweighed by the costs. However, the financial services industry generally refers to them as “bounce protection” or “courtesy overdrafts.” See Consumer Federation of America and National Consumer Law Center, *How Banks Turn Rubber Into Gold by Enticing Consumers to Write Bad Checks* (Jan. 27, 2003), available at [http://www.consumerlaw.org/action_agenda/bounce_loans/appendix.shtml](http://www.consumerlaw.org/action_agenda/bounce_loans/appendix.shtml).


Comments of the National Consumer Law Center and National Association of Consumer Advocates
The *policy* reasons to prohibit freezing exempt funds pursuant to an attachment or garnishment order equally support a prohibition against allowing the bank to set off its own debts against funds held in their bank. The benefits are intended to protect households from deprivation of the means to meet the basic necessities of living. That purpose is entirely frustrated when the exemption is not maintained for deposited funds.\footnote{186 In re Capps, 251 B.R. 73 (Bankr. D. Neb. 2000) (set-off is a “legal procedure” within the meaning of the Social Security Act’s anti-alienation provision, so contractual provision giving lender right to set off bank account did not permit set-off of account which contained only Social Security proceeds).}

OTS should prohibit set-off against exempt funds held in bank accounts. Furthermore, set off does not involve a court order – it is entirely within the bank’s control. As a result there are no preemption or court order issues that apply. This is moral, ethical and legal means to carry out the clear purposes of the protections from creditors intended in the federal benefit statutes.

5. **The OTS has the Full Authority under Current Law to Regulate on These Issues**

The federal banking agencies have provided numerous regulations and guidance preempting and interpreting state laws for the benefit of their regulated institutions. State laws protecting consumers in the areas of predatory mortgage lending, electronic deposits, even foreclosure protections, have all been preempted by the OCC and the OTS. Recently the five agencies together issued guidances on issues relating to predatory mortgage lending which were not specifically grounded in any particular federal law but just the real need to protect consumers from some of the more outrageous abuses occurring in the mortgage market.

The question is whether a bank, acting under the authority of its regulatory agency’s guidance, could face any legal jeopardy for failing to attach property which is exempt under federal law. Federal law preempts conflicting state law. Any state law that purports to hold a bank responsible for failing to follow a state law that conflicts with the federal law would be preempted under the Supremacy Clause and traditional preemption analysis.

The Supremacy Clause gives the U.S. Constitution and federal statutes preemptive force. The courts have consistently held that if the provisions of a state law are inconsistent with an act of Congress, they are void, as far as that inconsistency extends.\footnote{187 Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 31 (1824); accord Lorillard Tobacco Company v. Reilly, 533 U.S. 525, 541 (2001); Crosby v. National Foreign Trade Council, 530 U.S. 363, 373} State or local laws may not stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.\footnote{188}
Moreover, “[p]reemption may result not only from action taken by Congress itself; a federal agency acting within the scope of its congressionally delegated authority may preempt state regulation.”\(^{189}\) That is, “[f]ederal regulations have no less preemptive effect than federal statutes.”\(^{190}\) Federal agency orders similarly may preempt state or local action.\(^{191}\) Even mere letters from a federal agency interpreting an ambiguous statute may preempt state law.\(^{192}\)

Federal agency action may preempt state law even if the federal statute itself does not conflict with state law or expressly give the federal agency authority to preempt.\(^{193}\) In analyzing the preemptive effect of federal agency action, a narrow focus on Congress’ intent is misdirected because an agency’s ability to preempt does not depend on express congressional authorization to displace state law.\(^{194}\) Federal agencies have considerable authority to preempt as long as their actions are not arbitrary and capricious under the deferential Chevron standard.\(^{195}\)

The federal statutes protecting exempt funds from garnishment or other legal process already preempt any state laws that permit those funds to be frozen. To the extent there is any ambiguity, it is certainly consistent with congressional intent for the banking agencies to issue guidance or regulations to their institutions prohibiting


\(^{193}\) See City of New York v. Federal Communications Commission, 486 U.S. 57, 63 (1988); see also Watters v. Wachovia Bank, 127 S.Ct. at 1582 & n.24 (Stevens, J., dissenting) (complaining that the majority found a regulation preemptive even though Congress did not authorize the federal banking agencies to preempt state law).

\(^{194}\) Fidelity Federal, 458 U.S. at 154; accord City of New York, 486 U.S. at 63.

the freezing of funds that Congress explicitly protected to meet basic needs. On the other hand, any state law that permits such funds to be frozen or that imposes liability on banks that comply with federal law -- would conflict both with Congress’s intent and with a permissible agency directive and would be preempted.

The human cost caused by freezing of exempt funds is enormous. In the Appendices attached to our Testimony presented to the Senate Finance Company recently,196 we attached a large set of examples of individuals who were hurt by these practices. All of the banks involved knew of the exempt status of the federal funds they were freezing. All of the banks could have avoided this terrible harm to these recipients of Social Security, SSI and VA funds. Unfortunately, for every specific story included in the Appendices to the September 20, 2007 testimony, there are thousands more. The letters and stories illustrate both the depth of this problem to the low income individuals it affects, as well as the huge number of people who are suffering from these continued garnishments and attachments. It is within OTS’s authority to address this problem, and we urge it to do so.

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PROPERTY REQUIREMENTS:

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

UNDERWRITING:

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

<table>
<thead>
<tr>
<th>Employment/Income Source</th>
<th>Acceptable Verification Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaried</td>
<td>Business existence must be documented for all self-employed applicants through:</td>
</tr>
<tr>
<td></td>
<td>- evidence of a business license; and</td>
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<tr>
<td></td>
<td>- verbal confirmation of a phone directory listing.</td>
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<tr>
<td></td>
<td>A signed confirmation of the business must be obtained from the applicant’s accountant where a license is not required for the business.</td>
</tr>
<tr>
<td>Self-Employed</td>
<td></td>
</tr>
<tr>
<td>Retirement</td>
<td>- Awards Letter with income “blacked out”; or</td>
</tr>
<tr>
<td>Social Security</td>
<td>- Verify annuity funds; or</td>
</tr>
<tr>
<td>Annuity</td>
<td>- Letter from Trustee</td>
</tr>
<tr>
<td>Trust</td>
<td></td>
</tr>
<tr>
<td>Schedule B</td>
<td>- Verify assets supporting income; or</td>
</tr>
<tr>
<td>Dividend &amp; Interest Income</td>
<td>- Sch. B with income “blacked out”</td>
</tr>
</tbody>
</table>

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

Applicants without credit scores are not eligible.

Cash reserves are not required.

Non-permanent resident aliens are acceptable per Fannie Mae guidelines.

First-time homebuyers are eligible.

Non-occupant co-borrowers are not acceptable.

Second homes or investment properties – applicants may not own more than five (5) financed properties, including their primary residence.

Special Feature Code (SFC): 442
Exhibit B

CRISIS LOAN MODIFICATION AND WORKOUT TRIAGE
By National Consumer Law Center

A. LOAN MODIFICATION DECISION TREE (Step One)

Automatic: Homeowners in default (60 days) or facing reset within three months.

- Loan modification automatically offered to the homeowner without consideration of repayment ability.
- If automatic adjustment not made, a defense to the initiation of foreclosure.
- Possible modifications:197
  - Convert ARM to fixed rate loan at the teaser rate.
  - Reduce the interest on fixed rate loan to par rate.
  - Cramdown of the principal to present market value based upon a BPO.198

B. WORKOUT DECISION TREE (Step Two)

Case-by-Case Approach: Homeowners in default (60 days) or facing reset within three months—Step One not sufficient or tried but not successful due to changes in circumstances.

- Servicer/mortgage holder shall not initiate a foreclosure of a residential mortgage unless, within six months of the date of default, it has made a good faith review of the borrower’s financial situation and offered, whenever feasible, a repayment plan, forbearance, loan modification, or other option to assist the borrower in bringing the arrears current. Failure to comply to make this good faith review constitutes a defense to the initiation of a foreclosure.

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197 Some may argue that rate modifications should be temporary. However, temporary changes likely will postpone the crisis to another future date.
198 Principal cramdowns should be accompanied by a statement to homeowners that the cramdown amount may be income for tax purposes but that there are possible exclusions, they will need to file a Form 1040 and Form 982, and should seek the advice of a qualified tax professional. [NOTE: The tax issue is not insurmountable. Homeowners often can persuade the IRS that it is not income or that they meet the elements of a particular exclusion. In addition, the fear of potential tax consequences should not lead to the perverse result of favoring modifications that leave properties under water.]
Workout options are based on an analysis with repayment ability fully assessed, including:

- the scheduled monthly payments on the home loan or loans being offered, counting principal and interest (calculated in accordance with this paragraph), taxes, insurance, assessments, and private mortgage insurance premiums, combined with the scheduled payments for all other debt;
- a determination that the resulting combined debt-to-income ratio either does not exceed 40 percent of the consumer's documented and verified monthly gross income, or that the consumer has sufficient residual income as defined in the guidelines established in 38 C.F.R. 36.4337(e) and Veteran's Administration form 26-6393; and
- all sources of income are verified by tax returns, payroll receipts, bank records, or other third-party verification.

Possible options to save the home (individually or in combination):

- repayment or forbearance plan after step one automatic loan modification has occurred.
- combination of principal write-down plus rate reduction.
- FHA-like partial claim to cover arrearages.

Other requirements:

- consumers get more than one bite of the apple – can do more than one loan modification or workout.
- no general releases.
- no mandatory arbitration

Modification and other fees:

- servicers should be allowed to charge a reasonable fee (no more than FHA or Fannie Mae permits) for loan modifications or other workouts
- late and other fees should be waived where their addition makes a reasonable workout unaffordable.