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On

"Legislative Solutions to Abusive Mortgage Lending Practices"

Before the

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Subcommittees on Housing and Community Opportunity &
Financial Institutions and Consumer Credit
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Introduction & Overview

The Coalition for Fair and Affordable Lending[1] ("CFAL") appreciates the opportunity for me to testify on its behalf at today's hearing. I am Steve Nadon, CFAL's Chairman, and Chief Operating Officer of Option One Mortgage, which is a subsidiary of H&R Block, and which is one of the nation's largest nonprime mortgage lenders.

At the outset, I want to commend Chairman Ney and Chairman Bachus for scheduling today's hearing so that the Committee Members can hear suggestions on how to best refine pending legislation to prevent abusive lending practices without limiting borrowers' access to affordable mortgage credit and their ability to choose flexible mortgage financing options.

Much of my testimony will focus on provisions in Title I of H.R. 1295, the Ney-Kanjorski bill, and on H.R. 1182, the Miller-Watt bill, amending HOEPA's points and fees trigger, prepayment penalties, discount points, lender-paid broker compensation and the financing of loan closing costs. These issues, which greatly impact loan affordability, are at the heart of much of the debate surrounding these two bills. I believe it is essential for Committee Members to understand the practical----and potentially very harmful----effects for borrowers if some of the proposed restrictions are adopted. Appendix "A" to this testimony provides a much more detailed analysis and commentary on most of the

[1] The Coalition for Fair and Affordable Lending (CFAL) was established in 2002 to advocate national uniform fair legislative standards for nonprime mortgage lending. CFAL's members include many of the nation's leading nonprime lenders.

provisions in both bills. In addition, CFAL subsequently will be providing the Subcommittees with specific suggested legislative language for amendments in areas where CFAL believes this is needed and where we think the two bills can be brought together.

CFAL appreciates all Members' interest and involvement in this important legislative issue. We especially commend and thank the lead sponsors of H.R. 1295 and H.R. 1182, and their staffs, for the thought and hard work they have put into these bills. Both bills are well-intended and have a number of good concepts, but both have some problematic provisions. Having reviewed both bills, CFAL favors H.R. 1295 and believes that the Committee should use it as the base legislative vehicle for reporting out a Committee-approved measure, but should further refine it, including where appropriate, incorporating certain of the Miller-Watt bill's concepts.

- H.R. 1295, the Ney-Kanjorski bill, has broad bipartisan support. It significantly enhances current federal law, covering more loans, improving existing provisions and adding effective and workable new safeguards on other specific lending practices. Most of these provisions equal or exceed those of most state laws.
- Unlike the Miller-Watt bill, Ney-Kanjorski provides for uniform national mortgage lending standards, which CFAL strongly supports, and which is vitally important to ensuring both that all borrowers in this country, wherever they live, enjoy a high level of protection and that all communities have mortgage capital available on fair and affordable terms.
- H.R. 1295 also has very important additional provisions to greatly enhance financial counseling and education programs that are based on legislation developed earlier by Rep. David Scott, who we commend for making such a vital contribution to this comprehensive bill.
- Ney-Kanjorski has titles that would improve mortgage broker regulation, prevent appraisal fraud and help control "property flipping," and address mortgage servicing concerns.

However, H.R. 1295 is not perfect, and it needs a number of further technical and substantive refinements. For example, while we strongly support preemption, the provisions in Ney-Kanjorski need to be scaled back so that they do not sweep in almost all mortgage-related laws (e.g., foreclosure laws) and are instead targeted primarily to state and local laws aimed at regulating mortgage lending practices whether based on a "loan trigger rate" or some other mechanism. It also needs to be clarified to ensure that the Federal Reserve Board has authority to define and prohibit other abuses that may arise subsequently. Likewise, a number of more technical corrections are needed, such as making it clear, as we understand the lead sponsors intended, that the sale of single premium credit insurance and comparable products are prohibited in connection with all mortgage loans. Also, while CFAL believes that some of the Miller-Watt bill's provisions would adversely affect many borrowers, other concepts from that bill might be worked into H.R. 1295. We look forward to working with Committee Members and other interested parties to help ensure that the final Committee product will be the best bill possible for borrowers and will have strong bipartisan support.

Before moving to a discussion of how the two bills deal with key issues, I want to briefly comment on the importance of nonprime mortgage lending and the need for uniform national mortgage lending standards.

Nonprime Mortgage Lending & Uniform National Lending Standards

Nonprime Lending Is Critically Important For Homeownership - As Committee members know, housing is critically important to our nation. Not only is home ownership "the American dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. CFAL's members and other nonprime lenders play an increasingly vital role in meeting the housing credit needs of millions of Americans. In 2004, nonprime mortgage lending accounted for over 20% of the overall market and amounted to over $600 billion. Nonprime lending is especially important in helping people who have higher risk profiles, due to credit impairments or other factors, to purchase a home or to refinance an existing mortgage and obtain access to some of their equity to meet important personal financial needs.[2] Congress clearly must ensure that nonprime borrowers are not abused in the mortgage lending process, but you also must make certain that "protective" measures do not unintentionally and unnecessarily harm them by limiting their access to needed affordable mortgages and flexible financing choices.

Uniform Federal Standards Will Benefit Borrowers - Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. New federal statutory requirements are needed to remove gaps or weaknesses in HOEPA (the "Home Ownership and Equity Protection Act of 1994"), which is the primary federal law regulating mortgage lending practices with regard to high-cost loans. Moreover, legislation is needed to provide uniform national lending standards so that all mortgage lenders are governed by them and that every American borrower receives the same equal and effective protections regardless of which lender they choose or where they may live. CFAL believes that both federal and state regulators should actively enforce these nationwide standards.

The growing patchwork of arbitrary and confusing state and local laws intended to prevent mortgage lending abuses makes compliance burdensome, costly, and in some instances has disrupted local mortgage markets and reduced credit availability. More importantly, this hodgepodge of state regulation provides very unequal levels of

[2] More detailed general information on nonprime lending is contained in the following earlier CFAL testimony before these Subcommittees at: http://financialservices.house.gov/media/pdf/110503sn.pdf (November 2003); and http://financialservices.house.gov/media/pdf/033004st.pdf (March 2004). In addition, considerable detail regarding the lending practices of my own company, Option One Mortgage, is attached as Appendix "B."

protection for borrowers. About half of the states have passed special anti-predatory lending statutes. None of these laws is the same. Some have provisions that go too far, while others do not provide adequate protections. The other states have not passed such comprehensive laws, and their residents for the most part must rely primarily on only the relatively weak current federal law. Furthermore, many borrowers in all states, including those that have special anti-predatory lending laws, can only rely on current HOEPA provisions because their lender is a depository institution that is exempted from compliance with stronger state lending laws. We believe that the states and even local governments have created this confusing patchwork of laws because Congress has not updated HOEPA. It is time for Congress to ensure that all Americans enjoy the same level of protection.

HOEPA and Proposed Amendments

In 1994, Congress recognized that the highest risk mortgage borrowers may be more likely to be subject to coercive or inappropriate lending practices. Accordingly, it passed HOEPA[3] to provide additional disclosures and some substantive protections for certain of the highest cost mortgage loans.[4] HOEPA applies only to "closed-end" refinance home loans (i.e., that amortize with set monthly payments over a specific time period) that "trigger" its provisions by having annual percentage rates ("APRs") above a set level or "points and fees" in excess of a specified percentage of the loan amount.[5] HOEPA currently does not apply to loans made to purchase a home, or to loans that are structured on an "open-end" basis (e.g., a typical home equity line-of-credit).[6]

Although HOEPA does provide some limited safeguards, it now is widely accepted that this federal law has serious defects in terms of coverage, how some of its provisions are either too weak or in some instances go too far, and how it fails to address some potentially abusive practices.

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[3] 15 U.S.C. §§ 1602(aa), 1639. Implementing HOEPA regulations issued by the Federal Reserve Board can be found at 12 C.F.R. § 226.32.

[4] In addition to special warning disclosures, loans subject to HOEPA and its implementing regulations have certain limitations or prohibitions on contract terms or sales practices, such as prohibiting the following: negative amortization which occurs when the payments made the principal balance; increased interest rates upon default; balloon payments on loans less than 5 years; payments made only to a home improvement contractor from loan proceeds; refinancing within 12 months unless it is in the borrower's "interest"; and making loans without regard to ability to repay on a "pattern and practice" basis. HOEPA also applies expanded assignee liability on covered loans for essentially ALL claims and defenses that the borrower could have raised against the loan originator, including those arising under other statutes and common law.

[5] HOEPA's APR triggers are 8% for first liens and 10% for junior liens over a comparable maturity Treasury rate. The law's points and fees trigger covers loans when the total points and fees (counting only certain specified items) exceeds the greater of 8% of the total loan amount, or an indexed base amount, which is $510 for 2005.

[6] Both the Ney-Kanjorski and Miller-Watt bills expand HOEPA's coverage to include purchase money loans and open-end loans, and CFAL supports this expanded coverage.

HOEPA's Practical Effect – Loans today are generally extended using risk-based pricing, with the highest-risk borrowers having the highest prices. In a number of cases, the borrowers' risks and reasonable costs associated with making the loans when fairly priced will cross one or both of HOEPA's high-cost trigger thresholds.

It is widely recognized that HOEPA has the practical effect in most cases of prohibiting the highest-risk borrowers from being able to obtain legitimate nonprime loans instead of simply, restricting inappropriate practices. Few lenders make loans that are subject to this statute and there are no secondary market purchasers of the relatively few that are made.[7] The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price *due not to the borrower's credit, but to the higher legal and reputational risks and reduced competition caused by the law itself*. Moreover, under even more restrictive state laws (e.g. North Carolina, Georgia, New Mexico, New Jersey), which all purport to "regulate" practices, virtually no legitimate lenders are making high-cost loans because key provisions in those laws have been crafted so as to have the practical effect of preventing any responsible lender from being able to offer loans above the high-cost thresholds. In reality, what we now have in many cases is a series of overly-restrictive provisions that are masquerading as regulations when they in fact are designed and function as usury limitations and prohibitions on making high-cost loans.

We believe that borrowers in all risk grades should be able to secure loans if they have adequate repayment ability with proper literacy programs, and that federal and state laws should be designed to impose reasonable regulation and not be crafted to unnecessarily deny credit to the highest-risk borrowers under the guise of "protecting" them. Therefore, as a threshold issue, we urge the Committee to consider first whether it believes that high-cost loans should be made with effective regulation, <u>or</u> whether high-cost loans should not be made but instead prohibited. The latter option is typically favored by parties who want to "protect borrowers from themselves" and think that many Americans should only rent and not own a home. We seriously question whether Congress intended to impose price controls or a *de facto* prohibition on most high-cost lending, and we recommend that, as the Committee restructures HOEPA, you do so in a

[7] HOEPA poses two types of risk for legitimate lenders. The first is *reputational* (i.e., concerns whereby companies do not want to have their reputations hurt by being associated with loans that may be perceived as "high cost"). More frequently, however, the concern has to do with the *legal* risk that arises from HOEPA's provisions. The primary problem is that lenders sometimes inadvertently miscalculate whether or not certain loans cross HOEPA's thresholds. This puts them in a "got you" situation as they will not have given the required special HOEPA disclosure notice which has to be given before the loan is made. There is an inadequate provision for correction of this error or for most other mistakes. This means that the lender has violated the law. Penalties include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Lenders understandably consider this an extremely severe penalty, and many do not think it is worth the risk of making loans in these circumstances. Moreover, HOEPA's sweeping assignee liability provisions mean that secondary market purchasers would likewise be liable for such a miscalculation or other unintended violation about which they neither knew nor reasonably could have known. Not surprisingly, therefore, there is virtually no secondary market and no securitization of HOEPA loans.

way that reasonably regulates high-cost loans, but allows qualifying borrowers to obtain them and lenders to make and securitize them if they choose to do so.

Preserving Loan Affordability

Nonprime lenders offer their borrowers a wide array of loan products, most of which have certain basic flexible loan financing options that borrowers can choose from in order to make their loans more affordable. These financing options include:

- Accepting a prepayment penalty provision in exchange for a lower interest rate[8] (or in some cases, lower closing costs);
- Having the lender pay all or a part of the broker's compensation for them in exchange for a slightly higher interest rate[9];
- Allowing borrowers to "buy down" their interest rate by paying discount points at closing in exchange for a lower interest rate; and
- Voluntarily choosing to finance their closing costs as a part of the loan (i.e., they borrow enough to cover those costs) as this allows them to deploy their available cash resources elsewhere, or if they are cash-short, to avoid having to borrow elsewhere, often at more expensive rates, or in some cases not be able to get a loan.

The overwhelming majority of nonprime borrowers (like many prime borrowers) now voluntarily elect to use one or more of these financing options to make their loans more affordable by lowering their monthly payments or lowering their loan closing costs.

CFAL recognizes that unscrupulous lenders or brokers can apply any of these financing options in an abusive manner. Therefore, we support having reasonable safeguards to prevent abuse, while also preserving these important options for borrowers. In that regard, Ney-Kanjorski includes the following provisions:

- Prepayment Penalty Provisions - Substantially reduces HOEPA's current 5-year time limit on prepayment penalty provisions to 3 years, follows California's law limiting the maximum penalty to 6 months interest on 80% of the outstanding loan balance, and, perhaps most importantly, requires lenders to give borrowers a choice of a loan without a prepayment penalty as well as an explanation of the potential benefits and detriments of accepting a penalty, but appropriately does

[8] The Center for Responsible Lending (CRL) has issued a report that essentially claims borrowers generally not only do not get a lower rate in exchange for a prepay penalty but that they actually often pay a higher rate. http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf .
Others have pointed out that this CRL study is fatally flawed:
http://www.msb.edu/prog/crc/Publications%20PDF%20files/Review%20of%20CRL%20Prepayment%20Penalty%20Studies.pdf . CFAL also considers this report to be very inaccurate. Our company data shows just the opposite of CRL's claims. CFAL is having an independent analysis done of available data to help demonstrate how prepayment penalty options do give borrowers lower rates.

[9] Some borrowers also elect to not pay any broker or lender points and fees and pay a higher interest rate instead, but most do not choose this option because the rate is generally much higher and makes their monthly payments higher.

not include the potential maximum prepay penalty (which may never be accessed) in the points and fees trigger calculation;[10]

- Lender-Paid Broker Compensation – Allows lenders to continue the widespread and accepted practice in both the prime and nonprime markets of paying all or a part of the broker's compensation for the borrower when the borrower elects to reduce his or her closing costs in exchange for a slightly higher rate, does not include such indirect broker compensation (e.g., yield spread premiums (YSP)) in the points and fees trigger calculation;
- Discount Points – Enables most nonprime borrowers (but not those with the most expensive high-cost loans) to use up to 2 bona fide discount points to buy down their interest rate without counting these in the points and fees trigger calculation provided several requirements are met (e.g., each point paid must result in at least ¼ % lower interest rate); and
- Financing of Points and Fees – Follows Massachusetts' law allowing high-cost loan borrowers to continue financing such closing costs, but caps this at a reasonable level of no more than 5% of the loan amount (6% if the loan is $40,000 or less).

We believe that the Ney-Kanjorski bill for the most part[11] strikes a good balance between adding protections against abuse of these financing options and allowing lenders

[10] Critics often forget, or do not mention, the ongoing benefit and the potential longer term benefit that borrowers receive when they elect a prepayment penalty option. For example, assume a $150,000 loan with an 8% interest rate and a 1% savings on the rate by choosing the penalty option (i.e., otherwise the rate would be 9%). Under the California rule contained in Ney-Kanjorski, the maximum amount of the penalty would be 6 months' interest on 80% of the amount prepaid, which would be $4,800 ($150,000 x .8 = $120,000 subject to the penalty. 6 months' interest on that amount would be $120,000 x .08 divided by 2 = $4,800). The 1% reduction in rate would amount to a savings of $106.25 per month on the monthly payment. If a borrower decided to refinance after 26 months, the borrower would have to pay $4,800, but at that point would have received $2,763.28 in benefit by having the lower rate, so the net cost would really only be $2,036.72 ($4,800 - $2,763.28 = $2,036.72). On the other hand, if the borrower waited 4 years to refinance (which for many is increasingly likely in today's rising rate environment), the borrower would have saved $5,101.44 in mortgage payments, and not have to pay a penalty.

[11] CFAL believes that it would be appropriate to refine some of the Ney-Kanjorski provisions.

- For example, while we think that a 3-year prepayment penalty time limit is generally appropriate for a fixed rate loan, many loans today are adjustable rate mortgages (ARMs) with the interest rate adjusting after 2 years. We believe that it would be appropriate to strengthen Ney-Kanjorski by adding a provision that in the case of ARMs, the penalty period would terminate at the first rate adjustment date.
- Also, we recognize that some parties are concerned that there is no limitation on yield spread premiums (YSP) paid to brokers since YSP is not included in the points and fees trigger calculation as is done in the Miller-Watt bill. Concerns have also been raised as to whether there is always adequate up-front disclosure or transparency regarding the fact that a broker is receiving a YSP. This is another area where the Committee might consider refining Ney-Kanjorski so that it further addresses concerns covered by Miller-Watt by, for example, allowing 2 YSP points to be excluded (like 2 bona fide discount points) but including any over that level. Likewise, the Committee might consider requiring a clear early disclosure of the YSP payment. At Option One, we require the broker to obtain a signed acknowledgment from the borrower that the loan will have a specific interest rate and further that the broker will receive a specific amount of compensation as YSP from Option One. A copy of this disclosure form is attached as Appendix "C."

to continue offering these choices to borrowers so they can make their loans more affordable.

The Miller-Watt bill takes a fundamentally different approach on each of these issues, which has substantially negative impacts on loan affordability:

- Prepayment Penalty Provisions – Miller-Watt has several different restrictions on prepayment penalty provisions, including adding a new high-cost trigger that would make any loan (including a prime loan) with a penalty provision that is longer than 30 months or greater than 2% of the amount prepaid a high-cost loan; prohibiting prepayment penalties entirely on high-cost loans unless the amount of the loan exceeded the FHA insurance limits (which normally does not happen), and requiring the potential maximum amount of an otherwise allowable penalty to be counted in the points and fees trigger calculation---the net practical effect of these restrictions is that prepayment penalties, which allow borrowers the option of lowering their rates, simply could no longer be offered on virtually any nonprime loans, and this in turn would likely increase the interest rates for all nonprime borrowers by around 1%[12] (i.e., ALL nonprime borrowers monthly mortgage payments would increase significantly);
- Lender-Paid Broker Compensation – Miller-Watt includes indirect broker compensation (i.e., YSPs) in the points and fees trigger calculation, which, together with the inclusion of other items, would have the practical effect of pushing most into loans over the points and fees threshold into the highest cost category thereby forcing lenders to shift all or most costs into the interest rate, so rates will go up significantly, as will monthly payments;
- Discount Points – Miller-Watt on the one hand provides for the exclusion of 1 or 2 bona fide discount points, but on the other makes the exclusion apply only to loans that are close to the prime rate and then only if there was no exclusion of any prepayment penalty---here again the practical effect being that discount points could rarely be used on nonprime loans, thereby denying borrowers the option of lowering their monthly mortgage payments; and
- Financing Points and Fees – Miller-Watt imposes a total prohibition on any financing of points and fees on high-cost loans, which together with the *de facto* prohibition on prepayment penalties would essentially mean that few, if any, high-cost loans could even be made.[13]

[12] The Pentalpha Group study on prepayment penalties attached as Appendix "D" explains this marketplace impact.
[13] If the lender assumed that the average high-cost loan would refinance after 24 months, the interest rate in most cases probably would have to be set at a prohibitively high level to be able to recoup the closing costs before a refinancing occurred. For example, assume refinancing after 24 months on a $150,000 high-cost loan with 6% in points and fees amounting to $9,000. Shifting these costs into the loan rate would raise a borrower's monthly payment by another $375 in order for the lender to recoup these costs ($9,000 divided by 24 months = $375). Thus, in this type situation, the entire loan model basically falls apart and the loan probably would not be offered as the borrower could not afford the payments.

As explained earlier, virtually no reputable lenders are making high-cost loans under restrictive state statutes, like North Carolina's, and we do not believe that they could do so under the Miller-Watt bill. **However, the far greater problem Miller-Watt poses is the adverse impact it would have on many nonprime borrowers who would be seeking to obtain a loan below the new HOEPA trigger thresholds.** Let me explain this problem.

Under current HOEPA, the 8% points and fees trigger does not include either the potential maximum prepayment penalty or yield spread premiums. It does include discount points, but this typically has not presented a problem for borrowers as there has been ample room under the 8% trigger to accommodate several discount points without crossing the high-cost threshold.

Both Ney-Kanjorski and Miller-Watt lower the 8% trigger to 5%, but they take very different approaches in dealing with prepayment penalties, YSPs and discount points. As noted above, Miller-Watt includes both YSP and the potential maximum prepayment penalty in the calculation of points and fees and its exclusion of discount points essentially does not apply with respect to most nonprime loans. The result of this is that in real terms the 5% trigger is more like 2% or less. **This forces the lender to put more costs into the rate, significantly raising the rate, and therefore raising the borrower's monthly payment.** The borrower also is generally no longer able to use discount points to buy down his or her rate or a prepayment penalty to lower the rate, and the *de facto* prohibition on the use of prepayment penalties would further cause all nonprime loans to go up about 1%.

The bottom line here is unmistakable and inescapable: Most nonprime borrowers would have no flexible loan financing options that are so essential to meeting their needs and circumstances, and would find that loans would be much less affordable. Moreover, many borrowers who want to purchase homes would find that, with the much higher rates and monthly payments they could no longer qualify for a large enough loan so they would have to shift to a less expensive home and a smaller loan.

For example, under current federal law and under Ney-Kanjorski, a borrower who qualifies for a 30-year, $160,000 fixed rate loan at an annual interest rate of 8%, and who elects to use a prepayment penalty to lower the rate to 7% and to pay 2 discount points to lower the rate further to 6 ½%, and who elects to finance the points and fees, can lower his or her monthly principal and interest payment from $1,174.02 to $1051.76 a difference of $122.26 per month. On the other hand, under Miller-Watt, not only would this borrower not be able to choose the prepayment and discount point terms to make the loan more affordable, but mortgage rates generally for all nonprime borrowers would be raised around 1% (because prepay penalties are essentially prohibited), so the borrower would be paying a 9% rate, instead of a 6½% rate, making this monthly payment $1313.14 instead of $1051.76 as under Ney-Kanjorski, or 25% more per month.

Ney-Kanjorski vs. Miller-Watt Loan Affordability Comparison				
NEY-KANJORSKI			MILLER-WATT	
Home Price	$200,000		Home Price	$200,000
Mortgage Loan	$160,000		Mortgage Loan	$160,000
Mortgage Terms			Mortgage Terms	
	30 years			30 years
	8% Fixed Interest Rate			8% Fixed Interest Rate
	1% Broker's Fee			1% Broker's Fee
	2% Discount Points			No Discount Points
	1% Lender's Fee			1% Lender's Fee
	2 year Prepayment Provision			No Prepayment Provision
Payment Calculation			Payment Calculation	
Total Loan Amount (finance points & fees)	$166,400		Total Loan Amount (finance points & fees)	$163,200
Interest Rate	6 ½ % (8% - 1% for prepay provision – ½ % for 2 discount points = 6 ½ %		Interest Rate	9% *(Miller-Watt essentially prevents nonprime loans from offering prepayment provisions; this is projected to raise ALL nonprime borrowers' rates approximately 1%; so instead of being able to reduce an 8% rate to 7% with a 2 year prepay provision, the 8% rate would increase to 9% and the bill also essentially prohibits discount points)*
Monthly Payment	$1051.76 (= 25% Less than Miller-Watt)		Monthly Payment	$1313.14 (= 25% More than Ney-Kanjorski)

Mr. Chairman, I suspect this is a classic case of unintended consequences and I do not believe that the Miller-Watt bill's sponsors ever intended such adverse consequences for borrowers. In any case, I sincerely hope that the Committee will not adopt the overly restrictive approach on these flexible loan financing options that is proposed in the Miller-Watt bill. CFAL believes that Ney-Kanjorski's provisions here generally provide reasonable protections that preserve borrowers' choices and their options for making their loans much more affordable than under Miller-Watt. As I noted earlier, some of these Ney-Kanjorski provisions can be tweaked or tightened somewhat, but they are basically sound and should be retained.

Other Provisions in Miller-Watt and Title I of Ney-Kanjorski

The remainder of my testimony will highlight CFAL's views on a number of other significant provisions in these bills.[14]

Preventing "Loan Flipping" – Both bills apply similarly-worded tangible benefit tests, and both require that violations be knowing or intentional. Miller-Watt includes the word "net" presumably to require overall netting of the possible benefits and detriments. CFAL does not favor adding this term as it only makes even more unclear what is required for compliance. Frankly, unless one is intimately familiar with all the personal financial circumstances facing a borrower and his or her family and their own personal values and aspirations, how can anyone make a judgment about what is best for them? Miller-Watt also would apply this benefit test to all loans, not just high-cost mortgages. Only five states apply the test to all home loans as Miller-Watt proposes.[15] The Ney-Kanjorski bill, like most states, does not apply the test to all loans. Instead, it applies the anti-flipping test only if a borrower is refinanced to a high-cost loan from either a non-high-cost loan or from another high-cost loan. CFAL supports the Ney-Kanjorski approach.[16] The bill's 2-year time limit is a reasonable compromise given the varying limits in the states that have such provisions.[17]

Miller-Watt fails to give any definition or guidance as to what is deemed to be a tangible net benefit, but at least gives the Federal Reserve Board discretion to define this critical term if it elects to do so. Ney-Kanjorski seeks to provide more guidance on what Congress intends to be considered an adequate benefit by drawing on the concept in South Carolina's law of providing a list of safe harbor situations where a lender could safely assume a benefit existed. While we strongly favor having safe harbors, we believe that several of the Ney-Kanjorski provisions can be tightened further to prevent abuse, and we will be submitting suggested language subsequently for doing so. One option that the Committee should consider would be to combine having certain specified safe harbors while requiring the Federal Reserve Board to issue regulations to further define what the tangible benefit requirement means similar to what Miller-Watt proposes.

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[14] More detailed comments on various issues in both bills are contained in Appendix "A."

[15] Due to market disruptions caused in substantial part by the vagueness of their anti-flipping tests, two states (Georgia and New Jersey) that initially applied this restriction to more than high-cost loans subsequently amended their laws to limit restrictions to just high-cost loans. Georgia's flipping prohibition now applies to high-cost loans only. New Jersey no longer even has a tangible benefit anti-flipping test.

[16] Ney-Kanjorski also includes a provision modeled on the Massachusetts law, allowing a court the discretion to deny attorney's fees in flipping cases where a reasonable settlement offer is rejected. We support this provision as it will encourage reasonable settlements instead of costly and slow litigation.

[17] In five states the limit is 1 year (as is in current federal law) and in one state the limit is 18 months. Limits ranging from 42 to 60 months apply in three other states, while six states have no time limit on their flipping test. Four states restrict points and fees or prepayment penalties charged on refinancings.

Ensuring Repayment Ability - Current federal law provides that a "pattern or practice" of disregarding repayment ability must be shown for a violation to occur. Federal Reserve Board (FRB) regulations also provide that if the lender engages in a pattern or practice of making loans without verifying and documenting the borrower's repayment ability there is a presumption of such a violation having occurred. Both Miller-Watt and Ney-Kanjorski would provide for violations on a case-by-case basis instead of having to show a pattern or practice, which has proven very difficult to do. Thus, both bills substantially tighten the current federal standard. It is unclear why Miller-Watt also retains the pattern or practice restriction as a separate prohibition. Advocacy groups have long argued that the pattern or practice requirement is too difficult to prove and that the repayment ability test should apply on an individual case basis.

Both bills use a 50% debt-to-income (DTI) repayment ability test in order for a presumption of repayment ability to apply. The Ney-Kanjorski bill also requires borrowers to meet a separate residual income test, the precise requirements of which would be set by FRB regulations.

As to verification, Miller-Watt would require income verification "by tax returns, payroll receipts, or other third-party income verification." The precise meaning of what is considered third-party income verification is unclear. In any case, this provision goes well beyond what is required in the North Carolina statute upon which the bill is generally based.[18]

CFAL favors the Ney-Kanjorski verification provisions which follow a more balanced multi-tiered verification approach. First, the lender could not benefit from a repayment ability presumption if the lender knew or "has reason to know otherwise" that the borrower did not meet either the DTI or residual income test. Next, it requires verification "by the credit application, the borrower's financial statement, a credit report or any other reasonable means," similar to the North Carolina law's requirement. Then, because greater protections may be needed for persons living on fixed incomes (e.g., seniors on Social Security), Ney-Kanjorski also requires "reasonable documentation of such fixed income, in addition to any statement by the consumer" in order for the repayment ability presumption to apply.

Because many people, including small business owners and a great many recent immigrants, do not have earned income from regular wages that is easily verified, Ney-Kanjorski provides for verification by a signed financial statement or other documentation that shows the borrower's income and obligations, <u>but only if</u> the lender also "has a reasonable basis for believing that the income exists and will support

[18] The North Carolina statute provides: *"An obligor shall be presumed to be able to make the scheduled payments to repay the obligation if, at the time the loan is consummated, the obligor's total monthly debts, including amounts owed under the loan, do not exceed fifty percent (50%) of the obligor's monthly gross income <u>as verified by the credit application, the obligor's financial statement, a credit report, financial information provided to the lender by or on behalf of the obligor, or any other reasonable means</u>."*

repayment of the transaction." Lenders can evaluate repayment ability and confirm the borrower has adequate income by reviewing credit reports, mortgage payment history, and other data without always having to have "third-party income verification" (whatever that means) as Miller-Watt would require.

Preventing "Steering" – Steering unknowing borrowers to more expensive loans than they otherwise qualify for is perceived to be a significant problem by many parties. However, only one state, California, has a provision that prohibits steering. The Miller-Watt bill does not address this issue. Ney-Kanjorski includes an anti-steering provision based largely on the California statute. It essentially requires that: (1) lenders may not steer a borrower to a product not based on the lender's best credit grade that the borrower qualifies for; and (2) brokers may not steer customers to less favorable products than those offered by lenders with whom the broker regularly does business. This steering prohibition includes a safe harbor provision that allows borrowers to voluntarily choose to accept a somewhat more costly loan for their own personal reasons, even if they may be able to obtain a less expensive loan. For example, many borrowers have immediate needs for funds and voluntarily select the loan that closes fastest even if it is a bit more expensive.

CFAL supports prohibiting improper steering, but this is a very complex issue and it is important that the steering language be workable and that it accomplish its legitimate objective. We support the Ney-Kanjorski provision's concept, but are still reviewing the technical wording to determine if it needs further refinement.

Limiting Mandatory Arbitration – Miller-Watt would ban mandatory arbitration on all home loans, whereas Ney-Kanjorski prohibits it only on high-cost loans. Not a single state prohibits mandatory arbitration on all loans as Miller-Watt proposes. Arbitration is strictly prohibited on "high-cost" loans in only 8 states.[19]

Arbitration can often be an effective, quicker and less expensive dispute resolution process for the borrower.[20] Some mortgage lenders use it, others do not. Arbitration also is used in many other types of consumer credit, securities and employment cases. However, because high-cost mortgage loan borrowers may be more vulnerable and need extra protections, the Ney-Kanjorski bill, like all states that impose arbitration restrictions, prohibits mandatory arbitration only on high-cost loans. We support the targeted approach taken by Ney-Kanjorski and all states.[21]

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[19] Five other states with arbitration limitations allow an arbitration clause if it complies with certain requirements (e.g., if it meets the standards of a nationally recognized arbitration association).
[20] The Committee may wish to review an informative study done on arbitration by Ernst & Young entitled "Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases."
[21] Both bills also contain similar provisions allowing for non-binding post controversy agreements that essentially amount to mediation, but Ney-Kanjorski adds several additional safeguards as to how such voluntary dispute resolution processes are to be conducted.

Meaningful Right to Cure - The federal statute's cure provisions have long been found to be inadequate by the mortgage lending industry, and lenders view enacting a workable cure procedure to be a critical part of reforming lending requirements. Borrowers, as well as lenders, will benefit from having a quick and inexpensive error resolution process instead of having to engage in lengthy and costly litigation.

Both bills have a two-track cure provision, but Miller-Watt proposes a more limited provision than Ney-Kanjorski.

- Essentially, Miller-Watt would first allow the lender to cure any violation, intentional or otherwise, within 30 days of loan closing provided the borrower had not filed suit over the violation. Miller-Watt also would allow a lender to correct an error within 60 days of learning of the error provided the borrower has not notified the lender of the violation or initiated a lawsuit and the lender could prove the violation was unintentional or a bona fide error.
- Ney-Kanjorski would allow 45 days after closing for the error to be corrected, and correction could be made even if a suit had been instituted. It also would allow a correction within 60 days of discovery, provided the lender not only made full restitution but also paid the borrower a $2,000 error penalty and the borrower's reasonable attorney's fees, if any.

The Ney-Kanjorski approach, which we strongly favor, would provide for borrowers to have errors corrected quickly, without slow and costly litigation, and the lender penalty would give lenders incentive to avoid errors. However, the Committee may wish to consider whether clarifications or modifications may be needed to address borrowers' rescission rights in connection with a new error correction procedure. Currently, a borrower has an extended 3-year right of rescission, in addition to TILA's basic 3-day rescission right, for material breaches of HOEPA. Consideration should be given as to how rescission should interface with the new cure provisions.

Limited Assignee Liability – Strict assignee liability generally does not apply with respect to prime loans or to nonprime loans, with the exception of high-cost loans under HOEPA and under the laws of around a dozen states. Miller-Watt makes no change in the current HOEPA assignee liability provisions.

Most legislators have rejected applying such strict liability for assignees because it is not fair to hold innocent purchasers strictly liable for violations that they had no reasonable way of knowing had occurred. Legislators also have recognized that assignee liability can easily upset the secondary market.[22] If assignee liability is extended beyond

[22] Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Securitization has let us bring in vast amounts of capital from the national and global markets. This has both enabled the nonprime lending industry to make far more credit available and to

high-cost loans as some advocates want, there is a real danger that mortgage capital for all covered loans could dry up in many markets. For example, broad assignee liability was one of the key reasons the nonprime market literally shut down in Georgia and legislators were forced to make significant changes to the law. A similar situation occurred in New Jersey.

The fact is that high-cost loans to which overreaching assignee liability restrictions in HOEPA and certain states' laws apply are virtually never sold in the secondary market. Because there is no secondary market for high-cost loans, and competition is therefore limited as the major wholesale lenders that sell all their loans into the secondary market do not offer such loans, borrowers who can only qualify for a high-cost loan have to obtain them from a lender that retains the loan in its own portfolio. The common result for the borrower is that the loan is priced significantly higher than it otherwise would be if there was a competitive secondary market for these loans. Alternatively, if they can not obtain a high-cost mortgage loan, they may go to more expensive sources of capital, such as credit card advances.

The Ney-Kanjorski bill therefore seeks to refine HOEPA's excessive and unworkable liability on assignees by substituting more balanced language so that high-cost loans could be sold in the secondary market, and so the thousands of borrowers in every state who only qualify for such loans would have far more opportunity to obtain them at less cost. It draws upon several states' language relating to due diligence requirements to avoid liability. The bill basically seeks to apply assignee liability only when the purchaser knew or reasonably should have known that violations of the statute had occurred in originating the loans. This approach would shift from having a *de facto* prohibition on selling HOEPA loans in the secondary market to letting such loans be securitized, provided the applicable special substantive safeguards are met. CFAL supports the Ney-Kanjorski provisions.[23]

Borrowers in foreclosure who claim to be victims of abusive practices can and do sue both the originating lender and broker. The mortgage servicer also is typically sued and borrowers raise lending violations---even technical, unintentional and immaterial ones----as foreclosure defenses. Generally, the originator is required by the purchaser to buy back the loan from the secondary market purchaser (in practice, it's usually sold back as soon as the allegations are raised by the borrower) and if liability attaches, it normally is satisfied by the lender, broker, and/or servicer.

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dramatically decrease the rates we charge borrowers. However, overreaching assignee liability provisions, regardless of how well-intended, can easily disrupt our capital markets, and have a horrendous adverse impact on both credit availability and borrowers' credit costs. Unbalanced legislation can also hurt not only those who it is primarily intended to protect (e.g., those perceived as being most vulnerable), but it can also injure the many other people who make up the larger part of the overall nonprime market.

[23] CFAL's views on assignee liability are discussed further in earlier testimony given to these Subcommittees at: http://financialservices.house.gov/media/pdf/062304cfal.pdf (June 2004).

Other Titles in Ney-Kanjorski

In closing, I want to note that we also want to work with Committee members and other interested parties on the issues covered by the other titles in Ney-Kanjorski concerning consumer financial education and counseling opportunities; mortgage broker licensing requirements; loan servicing; and preventing appraisal abuses and "property flipping."

In particular, CFAL is especially interested in the provisions in Title II relating to housing counseling and borrower financial education that were developed under Rep. David Scott's leadership. We share Rep. Scott's confidence that provisions in the bill that mandate establishing and widely publicizing the existence of both a toll-free telephone number and an internet website that the public can use for information about reputable credit counselors to assist them in making mortgage decisions will be practical, important tools for helping consumers navigate the mortgage process intelligently. We want to stress the significance of the toll-free number as it provides a human touch connecting consumers to a live certified advisor who can provide assistance. In addition, we support Rep. Scott's concept of having the 800-number program develop data that may provide an early warning system regarding problem areas based on the call volume and questions asked.

We strongly believe that enhanced borrower educational opportunities are critical for empowering people to make more informed financial choices and to avoid abusive practices. The ultimate answer to many of these problems is education as Rep. Scott has recognized, not restrictive legislation. We think that the Committee also should consider having lenders pay a modest $2 fee when loans are recorded after closing to help support state and community based education and counseling programs. A portion of this fee also could be used as a funding mechanism for enhanced state enforcement efforts.

* * * *

CFAL is confident that the Financial Services Committee can work together on a bipartisan basis to fairly resolve the various issues addressed in these legislative proposals, and can report out a balanced bill that provides effective national standards for fair lending that protect nonprime borrowers without unduly limiting their financing options and access to affordable mortgage credit. We look forward to continuing to work constructively with Committee members and all other interested parties to help enact such legislation.[24]

[24] Please contact CFAL's Executive Director, Wright Andrews (202-742-4245, *wandrews@butera-andrews.com*), if you have questions or would like further information about CFAL's positions or have technical issues.

APPENDIX “A”

CFAL
Coalition for Fair and Affordable Lending

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
DEFINITIONS			
Applicable Loan Types	• Higher-Cost Mortgage defined to include consumer credit transactions secured by the borrower’s principal dwelling. • Refinance, purchase money, closed-end and open-end loans are included, but reverse mortgages are excluded.	• High-Cost Mortgage defined to include consumer credit transactions secured by the borrower’s principal dwelling. • Refinance, purchase money, closed-end and open-end loans are included, but reverse mortgages are excluded.	• Both Ney-Kanjorski and Miller-Watt significantly expand HOEPA’s coverage by including loans made for the purchase of a home and mortgages that are structured as open-end loans (e.g., home equity lines-of-credit).
Points and Fees Defined	• All finance charges as defined in TILA, except interest and the time-price differential; • All compensation paid directly to the mortgage broker by or on behalf of the borrower (excluding borrower credits); • All third party fees listed in section 106(e), except for escrow for future payments of taxes or insurance, unless: • The charge is bona fide, competitive, and reasonable; • The lender receives no direct compensation; and • The charge is paid to a 3rd party whether or not affiliated; • All prepayment fees or penalties incurred by the borrower if the loan refinances a previous loan currently held by the same lender or its affiliate; and	• All finance charges as defined in TILA, except interest and the time-price differential; • All compensation paid directly or indirectly to the mortgage broker; • All third party fees listed in section 106(e), except for escrow for future payments of taxes or insurance, unless: • The charge is reasonable; • The lender receives no direct compensation; and • The charge is paid to an unaffiliated 3rd party; • Premiums or other charges for single premium credit insurance (excluding fees or premiums paid on a monthly basis); • The maximum prepayment fees and penalties which may be charged or collected under the terms of the loan document (does	• As noted below, for most loans, both bills significantly lower current law’s 8% points and fees trigger to 5%, thereby including potentially many more loans. However, the two bills take fundamentally different approaches in defining what charges are to be included in the definition of “points and fees” for purposes of calculating this trigger percentage. It is critical to understand the radically different marketplace effects that would result. o Miller-Watt dramatically further increases the potential coverage by counting both the potential maximum prepayment that might be charged on the new loan (*even if never accessed*) (the limited exception for “conventional” prepayment fees is drafted so that essentially no nonprime loans could qualify) penalty and lender-paid indirect broker compensation (i.e., yield spread premiums that allow borrowers to have part of their costs paid by the lender in exchange for a slightly higher rate). And, while Miller-Watt allows for the exclusion of up to 2 bona fide discount points, this exclusion is limited so that in reality relatively few no nonprime borrowers could use discount points to “buy down” their rate to obtain a lower monthly payment. o Ney-Kanjorski follows current law, and the law in most states, and does not include potential maximum prepayment fees and lender-paid broker compensation. Including these items would in effect be “double counting” because both of these items are already reflected in the loan interest rate, which is subject to a separate APR (annual percentage rate) trigger. Ney-Kanjorski also allows for the exclusion of up to 2 bona fide discount points

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	• Excludes 2 bona fide discount points if the undiscounted interest rate is not more than 4% above Treasury securities with comparable maturity (i.e., essentially the conventional or prime mortgage rate)	not apply to conventional prepay fee); and • All prepayment fees and penalties if the loan refinances a previous loan made or held by the same lender or its affiliate. • Excludes 2 bona fide discount points if undiscounted interest rate does not exceed more than 1% above Fannie/Freddie 90-day standard net yield; or one bona fide discount point if within 2%.	that are used by many nonprime borrowers to "buy down" their rate. (It does limit the use of discount points by the highest-risk borrowers whose loans are more than 4% above the conventional loan rate). • The key point to understand here is the practical effect of these different approaches. The Miller-Watt bill's inclusion in the points and fees trigger calculation on most loans of potential maximum prepayment penalties, discount points and lender-paid broker compensation, which in reality in most nonprime loan transactions would have the actual effect of further lowering the trigger percentage not just 3% (from 8% to 5%), but another 2%-6%, means almost all nonprime loans as currently structured would be deemed "high-cost". o Most lenders currently refuse to make high-cost loans because of the high legal and reputational risks, there is no secondary market for them, and even fewer would likely make them under the proposed additional restrictions in the Miller-Watt bill. o Lenders would be forced to restructure loan pricing so that the lender paid all, or at least a large part, of the loan closing costs, thereby avoiding crossing the "points and fees" trigger. (This would pose a problem for some loans as this could cause the rate to exceed the separate APR trigger, and lenders generally would not make those loans.) o This in turn would mean that in order to recover these costs, lenders would have to charge much higher loan rates, meaning much higher monthly payments, which would make loans much less affordable for nonprime borrowers. Many borrowers also could not even qualify for a loan as the new higher monthly payment would prevent them from meeting debt-to-income repayment ability tests. In order to qualify under the debt-to-income test many borrowers would have to purchase a less expensive home. • As explained further below, the Ney-Kanjorski bill would allow borrowers the choice of "loan affordability" financing options like: (1) accepting a prepayment penalty in exchange for a lower rate; or (2) having some of the compensation they would have to pay the broker paid by the lender in exchange for a slightly higher rate; or (3) using discount points to 'buy down" their rate so they can

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			have more affordable monthly payments. Miller-Watt's various direct and indirect limitations on such items have the opposite effect and make loans less affordable for many borrowers. • Both bills would require that the prepayment penalty on the prior loan be counted in the trigger calculation if the lender or its affiliate holds the prior loan. However, Miller-Watt would also require that the prepayment penalty on the prior loan be counted even if the lender or its affiliate no longer was the holder of the prior loan. • Ney-Kanjorski refines current law with respect to the treatment of fees paid to affiliates. o Current law generally excludes fees paid to third parties (e.g., appraisal fees, title search fees, etc.), but requires that lenders include these fees if paid to an affiliate. o Thus, even if an affiliate can provide a better service at a less expensive price, the lender must include it in the trigger calculation. o Recognizing the anti-competitive effect of an affiliate fee restriction in today's marketplace, and the fact that potential abuses can be controlled by adding other safeguards, Ney-Kanjorski allows affiliate fees to be excluded, provided certain requirements are met. o It provides that the fee can only be excluded like other third party fees if it actually is paid to the affiliated third party, if the lender receives no direct compensation for the service, and most importantly, if the fee paid for services to the affiliate is reasonable and competitive with prices offered by other non-affiliated service providers. • We understand that the intent of Ney-Kanjorski is to continue to exclude lender-paid broker compensation from the points and fees trigger calculation as HOEPA does currently. o Technical clarification should be made in the bill's language to clarify the sponsors' intent. o On the other hand, if the Committee ultimately determines that there should be a limit on such indirect compensation, we urge that it allow for

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			at least 2% yield spread premium. • We also understand that the sponsors intend to correct a drafting error and include single premium credit insurance and comparable products in the trigger calculation. Lenders generally no longer offer such products in connection with mortgage loans. CFAL supports making this technical correction to in essence prohibit offering such products in connection with mortgage transactions.
Bona Fide Discount Points	• Must be knowingly paid by the borrower for the express purpose of lowering the interest rate (IR); must reduce the loan IR from an IR which does not exceed the benchmark rate which is 4% over comparable Treasury securities; and must reduce the IR by a minimum of 25 basis points per discount point so long as other terms of the loan remain the same.	• Must be knowingly paid by the borrower for the purpose of reducing, and which in fact results in a bona fide reduction of, the interest rate or time-price differential applicable to the mortgage; the reduction must be reasonably consistent with established industry norms and practices for secondary market transactions.	• Both bills contain similar definitions of bona fide discount points. Ney-Kanjorski's approach is arguably more restrictive as it requires at least ¼ % discount per point paid. • Miller-Watt's "industry norms" approach may be more flexible as in reality industry norms and practices vary considerably and lenders in many cases might be reasonably consistent even if they gave less than ¼% discount. • Committee Members should keep in mind that while HOEPA's current points and fees trigger has included discount points in the trigger calculation, that has not presented a problem with respect to borrowers using them to buy down their rates as the 8% trigger level is high enough to accommodate up to 2 discount points in most cases if borrowers choose this option for lowering their monthly payments. • Under the new much lower 5% trigger level proposed in Ney-Kanjorski and Miller-Watt, it would be much more difficult to use discount points without crossing the higher-cost loan threshold unless the bills provide for some workable limited exception. • To deal with this concern, Ney-Kanjorski allows for the exclusion of up to 2 bona fide discount points, but only if (1) the specified safeguards---such as providing a minimum of ¼ % discount per point---are met; and (2) the loan's interest rate is within 4% of a comparable Treasury security. This would allow a limited use of discount points on most nonprime loans, but not on the more expensive loans with rates exceeding the 4% over Treasury level. • Miller-Watt provides for a far more restrictive exclusion for discount points, and its practical effect is to prevent any exclusion for most nonprime loans. Under Miller-Watt, if the loan rate is within 1%, or in some cases 2%, of the "required

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			net yield on a 90-day standard mandatory delivery commitment for a reasonably comparable loan" (i.e., basically a conventional, or 'prime' loan rate) from Fannie or Freddie (whichever is greater), 1 or 2 discount points could be excluded, provided there was no exclusion for prepayment penalties. In practice, this would prevent discount points from being used on most nonprime loans because their rates exceed these percentages due to the borrowers' higher risks.
THRESHOLDS (Triggers)			
APR Thresholds - High-Cost Loans	• Cannot exceed 8% over comparable T-Bill; 10% over comparable T-Bill for a junior lien.	• Cannot exceed 8% over comparable T-Bill; 10% over comparable T-Bill for a junior lien.	• Both bills retain the current APR triggers. • Retaining these trigger levels is important because lowering the points and fees trigger as is done elsewhere in both bills leads to shifting more fees into the rate which means that many more loans may come near or exceed the APR trigger.
Points and Fees Threshold – High-Cost Loans	• Higher-cost loan if points and fees as defined in the bill exceed 5% of the total loan amount, if the loan amount is greater than $40,000, or exceed 6% if the loan amount is less than or equal to $40,000.	• High-cost loan if points and fees as defined in the bill exceed 5% of the total loan amount, if the loan amount is greater than $20,000 (to be adjusted annually by FRB, but must stay within 6-10%), or the lesser of 8% or $1,000, if the loan amount is less than or equal to $20,000 (to be adjusted annually by FRB, but must stay within 8-12%).	• Both bills lower the HOEPA points and fees trigger percentage from 8% to 5%, but Ney-Kanjorski applies it to loans over $40,000 while Miller-Watt would apply it to loans starting at $20,000. • Ney-Kanjorski would use a 6% trigger for smaller loans of $40,000 or less, whereas Miller-Watt would use the lesser of 8% or $1,000 on loans of $20,000 or less. • Miller-Watt would allow for annual adjustment by the Federal Reserve Board, but limit the range to 6%-10% for loans over $20,000, and to 8%-12% for loans of $20,000 or less. • The Committee should consider whether either bill provides an adequate trigger level for smaller loans. For example, it typically takes about the same amount of work to do a smaller $50,000 second mortgage as a $150,000 first mortgage, yet the trigger amount may be very different----5% x $50,000 = $2,500 vs. 5% x $150,000 = $7,500. That being the case, it probably would be reasonable to have a somewhat higher % for smaller loans than either bill provides and to raise the amount to at least $50,000. • Having an unrealistically low trigger for smaller loans can be disadvantageous to the borrower. For example, if a broker can not make a reasonable commission on a small second mortgage, the loan might not be offered and the borrower would

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			have to obtain needed funds by refinancing the first mortgage, paying even higher costs.
Prepayment Penalties Threshold – High-Cost Loans		• Adds a new trigger making a loan high-cost if: (1) the loan documents permit the lender to charge or collect a prepayment penalty of more than 30 months after the loan closing, or (2) which exceeds, in the aggregate, 2% of the amount prepaid.	• If this new trigger provision applied, a substantial portion of today's nonprime loans---as well as many prime loans----would become "high cost" loans. • The effect of this Miller-Watt provision would be to force lenders to limit the few prepayment penalties that would be otherwise allowed to at most 30 months and 2% of the amount prepaid. • As will be discussed subsequently, other provisions in Miller-Watt have the effect of preventing prepayment penalties from even being offered on most nonprime loans, and further limiting prepayment penalties as here can only have adverse impacts on loan affordability.
PROHIBITED PRACTICES			
Financing Points and Fees	• Prohibited in excess of 5% of the total loan amount (or 6% for loans that do not exceed $40,000). • If any portion of the points and fees are financed, disclosure is required with a statement that such treatment of any such point, fee, or charge is not legally required.	• No financing of any points and fees on a high-cost loan. • Prohibits financing of any prepayment penalty payable by the borrower in a refinancing transaction if the lender or its affiliate is the holder of the note being refinanced.	• Only North Carolina and Indiana prohibit financing of points and fees as is done in Miller-Watt. Four other states limit financing to 3% or less of the loan amount, and four others impose financing limitations ranging from 5% to 8%.[1] The Ney-Kanjorski bill would establish a reasonable uniform standard, which is more restrictive than most states, at 5% (like Massachusetts) over which points and fees cannot be financed. • Ney-Kanjorski imposes a 5% financing limit on higher-cost loans instead of prohibiting the financing of points and fees on such loans as Miller-Watt does because Ney-Kanjorski seeks to follow the approach of reasonable and balanced regulation and offers borrowers pricing choices instead of imposing prohibitions that make loans far less affordable for them. • Current federal law imposes no limitation on financing closing costs and, as noted above, only two states prohibit financing such costs on higher-cost loans. This is not surprising because typically higher-cost loan borrowers, just like many prime borrowers, lack the cash to pay closing costs out-of-pocket. Most such borrowers, and in fact many prime borrowers, will voluntarily select the option of

[1] One state, Kentucky, has a 4% limitation on financing of prepayment charges and certain points and fees in cases where a lender is refinancing its own loan or that of an affiliate.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			financing the costs as a part of the loan because this makes the loan much more affordable for them----in many cases it will mean the difference between fulfilling their dreams of home ownership or not being able to afford a home of their own. • Higher-cost borrowers, because of the increased risks they pose, already have to pay higher rates, and if they lack the available cash and can not finance a reasonable amount of closing costs, their options become much more limited or disappear. o In some cases they may be able to borrow to pay the costs from even more expensive sources, such as a credit card cash advance, or an unsecured personal loan that may be undocumented (and its costs may not be taken into account when calculating repayment ability), or a pawnshop loan. o Another approach would be for the lender to pay the costs and try to recoup them by charging an even higher interest rate. Obviously, a higher rate would mean higher monthly payments and would make the loan much less affordable as has been explained earlier. • However, the Miller-Watt prohibitions against both financing points and fees and having prepayment penalty options actually make it questionable whether in most cases higher-cost loans could even be offered at all. o If the lender assumed that the average higher-cost loan with a high interest rate would refinance after 24 months, the rate in most cases probably would have to be set at a prohibitively high level to be able to recoup the closing costs before a refinancing occurred. For example, assume refinancing after 24 months on a $150,000 higher-cost loan with 6% in points and fees amounting to $9,000. Shifting these costs into the loan rate would raise a borrower's monthly payment by another $375 ($9,000 ÷24 = $375) in order for the lender to recoup these costs. Thus, in this type situation, the entire loan model basically falls apart and the loan probably would not be offered as the borrower could not afford the payments.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			• Miller-Watt also prohibits the financing of any prepayment penalty on a loan that is refinancing a loan made by the loan holder or an affiliate. (Elsewhere, Miller-Watt also requires that any such prepayment penalty, or one on a loan currently held by the lender or its affiliate, even if not made originally by the holder or its affiliate, must be counted in the points and fees when calculating the 5% trigger.)
Counseling	• When making a higher-cost loan, a lender must provide (as specified by regulation issued by the Federal Reserve Board) a written statement recommending counseling and a list containing the names, addresses, and phone numbers of HUD- or state-approved counselors. • Failure to provide a complete and updated list as reasonably possible constitutes a violation of this section. • The bill includes separate provisions expanding housing counseling and educational programs and related activities. Among other things, it would create a new HUD office to better administer such programs and improve program standards. The legislation authorizes additional funding through 2009 for such counseling. In addition, other provisions would allow borrowers to opt-in at the time of	• Before making a loan a lender must receive a certification from a HUD- or state housing authority-approved counselor. The counselor may not be employed by the lender or its affiliate. • The counselor must verify that the borrower has received all the disclosures as required by RESPA and Section 129 of HOEPA, prior to issuing a certification. • The FRB may prescribe regulations "requiring or encouraging" lenders to provide consumer mortgage education to prospective customers or to direct them to qualified education or counseling programs in there area. However, no FRB requirement is to be construed as affecting or superseding any state requirement regarding consumer mortgage counseling or education.	• Miller-Watt takes the approach of requiring mandatory counseling on higher-cost loans. • However, most state anti-predatory lending laws, which according to Ney-Kanjorski opponents are so effective, have no such counseling requirement. And, in North Carolina and the six other states that do require mandatory counseling on higher-cost loans, almost no such counseling occurs. Why? Because virtually no high-cost loans are being made under most such states' overly restrictive laws. No counseling is done when loans are not offered. • Ney-Kanjorski takes the approach of the large majority of states and does not force borrowers to undergo mandatory counseling. What it does require, however, is that lenders always recommend that borrowers who are getting higher-cost loans should consider having counseling and that lenders provide timely information to the borrowers on how to obtain such counseling. • Miller-Watt's provision granting the Federal Reserve Board unfettered discretion to require lenders to provide mortgage education to customers causes lenders concern as burdensome and costly requirements might be imposed. • Ney-Kanjorski's provisions reorganizing HUD's counseling and educational programs may provide more effective and efficient borrower education, but these provisions also merit further scrutiny by the Committee to determine if they offer the optimum approach for improving HUD's operations. • Enhancing counseling and educational programs and expanding the availability of such programs should be viewed as a priority issue as almost all parties agree that consumer financial education is critically important to empowering borrowers and helping prevent abusive lending practices. • Among other things, the Committee may want to give further consideration to what more might be done to ensure non-English speaking borrowers' special

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	loan closing to special foreclosure prevention counseling assistance, which would be available to them if they later have difficulty repaying their mortgage loans.		educational and counseling needs are adequately addressed.
Flipping	• Prohibited from knowingly or intentionally engaging in the unfair act or practice of loan flipping. • "Flipping" is defined as refinancing a home loan with a higher-cost mortgage within the next 24 months after closing without a "reasonable tangible benefit" considering all material circumstances known to the lender. • Ney-Kanjorski would provide guidance as to what would be considered an acceptable benefit by listing a number of safe harbors whereby the loan would be presumed to provide a benefit if the criteria listed in any of the safe harbors applies.[2]	• Prohibited from knowingly or intentionally engaging in the unfair act or practice of flipping. • "Flipping" is defined as refinancing an existing mortgage without a "reasonable tangible net benefit." • Benefit would be determined by "considering all of the circumstances, including the terms of both the new and the refinanced loans or credit, the cost of the new loan or credit, and the borrower's circumstances." • The net benefit test does not have a time limitation and it would apply to ALL loans, not just high-cost loans. • The Federal Reserve Board would	• Both bills apply relatively similarly worded tangible benefit tests, and both require that violations be knowing or intentional. Miller-Watt includes the word "net" presumably to require some degree of overall netting of the possible benefits and detriments. CFAL does not favor adding this term as it only makes even more unclear what is required for compliance. • Only five states apply the test to all home loans as Miller-Watt proposes.[4] • The Ney-Kanjorski bill, like most states, does not apply the test to all loans. Instead, it targets the anti-flipping test to apply if a borrower is refinanced to a higher-cost loan from either a non-higher-cost loan or from another higher-cost loan. The bill's 2-year time limit is a reasonable compromise given the varying limits in the states that have such provisions.[5] • Miller-Watt fails to give any definition or guidance as to what is deemed to be a tangible benefit, but at least gives the Federal Reserve Board discretion to define this critical term if it elects to do so. • Ney-Kanjorski seeks to provide more guidance on what Congress intends to be considered an adequate benefit by drawing on the concept in South Carolina's law of providing a list of safe harbor situations where a lender could know a benefit existed. • CFAL believes that several of the bill's safe harbor provisions should be

[2] The Ney-Kanjorski safe harbors are: (A) the purpose of the higher-cost mortgage is to finance a personal investment or a purchase or acquisition of real property that is not the principal dwelling of the borrower; (B) the interest rate on the new fixed-rate higher-cost mortgage is lower than the interest rate on the fixed-rate refinanced loan and it will take 4 years or less for the borrower to recoup the costs of the points and fees, and other closing costs that are required to be paid by the borrower on the new higher-cost mortgage through savings resulting from the lower interest rate; (C) the lender makes a good-faith determination that the borrower's monthly payment to pay the higher-cost mortgage is a minimum of 15 percent less than the total of all minimum monthly payments on the obligations being financed, based on a borrower credit report or other reasonable documentation utilized by the lender; (D) any cash

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	• If no safe harbor applies, “factors to be considered may include the terms and conditions of both the new and refinanced loan, the borrower’s known economic and non-economic circumstances, the purpose of the loan, and the cost of the new loan.” • Prohibits refinancing a special mortgage[3] (e.g., below-market interest rate or subsidized loan) made by any government agency, government-sponsored enterprise, or nonprofit corporation if it is apparent on the face of the security instrument for the existing loan that it is a special mortgage and if the borrower would lose one or more of the benefits of the	be allowed, but not required, to define the meaning of the term “tangible net benefit”.	tightened and/or refined and we will be submitting technical language subsequently to the Committee suggesting how this can be done. • One option that the Committee might want to consider would be to agree upon having certain specified safe harbors, while requiring the Federal Reserve Board to issue regulations to further define what the tangible benefit requirement means similar to Miller-Watt would do. • Miller-Watt does not include a special provision relating to refinancing below-market type loans, such as a Habitat for Humanity loan, as is contained in Ney-Kanjorski and some state laws. Ney-Kanjorski addresses a serious concern lenders have raised to such provisions regarding knowing what loans are “special mortgages” by requiring that it must be apparent on the face of the security instrument that the existing loan is in fact a special mortgage. • Ney-Kanjorski also includes a provision modeled on the Massachusetts law, allowing a court the discretion to deny attorney’s fees in flipping cases where a reasonable settlement offer is rejected.

proceeds paid either to the borrower, or on behalf of the borrower, above the payoff of the refinanced loan are in excess of twice the amount of total points and fees and closing costs that are required to be paid by the borrower; (E) the refinanced loan is changed from a loan that is not a fixed-rate fully-amortizing loan to a fixed-rate fully-amortizing loan; (F) the terms of repayment of the refinanced loan are changed from a longer full amortization term to a shorter full amortization term by at least 5 years; (G) the borrower presents a certificate, dated not more than 90 days prior to the date of the application for the new higher-cost mortgage, from an independent housing or credit counselor approved by the United States Department of Housing and Urban Development, or by any State regulatory agency, which states that the borrower has received counseling with regard to refinancing the existing loan; (H) the borrower provides the lender with a written, signed statement not prepared by the lender, at or before the consummation of the new higher-cost mortgage, that the new loan is needed to meet a bona fide personal or family financial, health or medical emergency, or to avoid a filed foreclosure action; or (I) the refinancing is necessary under, or in response to, any order or judgment of a court of competent jurisdiction.

[3] The loan would have to have, by at least 2 percentage points, a below-market interest rate as of the date of its consummation; or non-standard payment terms beneficial to the borrower, such as payments that vary with income or are limited to a percentage of income, or terms that permit the borrower to make no payments under specified conditions.

[4] Due to market disruptions caused in substantial part by the vagueness of their anti-flipping tests, two states (Georgia and New Jersey) that initially applied this restriction to more than high-cost loans subsequently amended their laws to limit restrictions to high-cost loans. Georgia’s flipping prohibition now applies to high-cost loans only. New Jersey no longer even has a tangible benefit anti-flipping test.

[5] In five states the limit is 1 year (as is in current federal law) and in one state the limit is 18 months. Limits ranging from 36 to 60 months apply in four other states, while five states have no time limit on their flipping test.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	special mortgage, without either express written consent of the holder of the loan or certification from a person or organization certified by HUD that the borrower obtained credit counseling. • A borrower may not recover the costs of the action and attorney's fees for violations of this section if the court determines that the borrower turned down a reasonable offer of remedy and compensation.		
Ability to Repay	• Deletes HOEPA's requirement that a "pattern or practice" of failure to consider repayment ability must be shown before a violation can be established and allows a violation to be shown on an individual case basis. • A lender may not extend credit without considering a borrower's ability to repay including his or her current and expected income, current obligations, and employment. • Presumption of ability to repay if (1) total monthly debt payments do not exceed 50% of the	• Retains HOEPA's pattern or practice prohibition as a separate violation, adding that a violation is presumed if the lender engages in a pattern or practice of making high-cost loans without verification. • Adds an additional violation for individual cases, providing that a lender may not make a high-cost loan if the lender does not reasonably believe that the borrower will be able to make the scheduled payments, based upon a consideration of current and expected income, current	• Current federal law provides that a "pattern or practice" of disregarding repayment ability must be shown for a violation to occur. Federal Reserve Board (FRB) regulations also provide that if the lender engages in a pattern or practice of making loans without verifying and documenting the borrower's repayment ability there is a presumption of such a violation having occurred. • Both Miller-Watt and Ney-Kanjorski would provide for violations on a case-by-case basis instead of having to prove a pattern or practice, which has proven very difficult to do. Thus, both bills substantially tighten the current federal standard. It is unclear why Miller-Watt also seems to retain the pattern or practice restriction as a separate prohibition. Advocacy groups have long argued that the pattern or practice requirement is too difficult to prove and that the repayment ability test should apply on an individual case basis. • Both bills use a 50% debt-to-income (DTI) repayment ability test in order for a presumption of repayment ability to apply. • The Ney-Kanjorski bill also requires borrowers to meet a separate residual income test, the precise requirements of which would be set by FRB regulations.

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	monthly gross income, as verified by the credit application, the borrower’s financial statement, a credit report, or any other reasonable means; and (2) the borrower has sufficient residual income to pay essential monthly expenses (as defined by FRB regulation). • If repayment ability is based primarily on fixed income (from a public or private source), then income verification must include reasonable documentation of such fixed income, in addition to any statement by the borrower. • In the case of a borrower without regular earned or fixed income, the borrower must sign a financial statement or provide other documentation showing the borrower’s income and debt obligations, and the lender must have a reasonable basis to believe that the income exists and will support the repayment. • The absence of any means of verification does not create a presumption of a violation.	obligations, employment status, and other financial resources, other than equity in the residence. • A borrower is presumed to be able to repay if the borrower’s total monthly debts (including the amount owed under the loan) do not exceed 50% of the borrower’s monthly gross income, as verified by tax returns, payroll receipts, or other third-party income verification.	The Committee should give consideration to making the residual income test an alternative, instead of a second test. • As to verification, Miller-Watt would require verification “by tax returns, payroll receipts, or other third-party income verification.” The precise meaning of what is considered third-party income verification is unclear. In any case, Miller-Watt goes beyond what the North Carolina law which provides: “*An obligor shall be presumed to be able to make the scheduled payments to repay the obligation if, at the time the loan is consummated, the obligor's total monthly debts, including amounts owed under the loan, do not exceed fifty percent (50%) of the obligor's monthly gross income <u>as verified by the credit application, the obligor's financial statement, a credit report, financial information provided to the lender by or on behalf of the obligor, or any other reasonable means</u>.*” • Ney-Kanjorski adopts a multi-tiered verification approach. o First, the lender would not benefit from a repayment ability presumption if the lender knew or “has reason to know otherwise” that the borrower did not meet either the DTI or residual income test. o Next, it requires verification “by the credit application, the borrower’s financial statement, a credit report or any other reasonable means.” o Then, because greater protections may be needed for persons living on fixed incomes (e.g., seniors on Social Security), Ney-Kanjorski also requires “reasonable documentation of such fixed income, in addition to any statement by the consumer” in order for the repayment ability presumption to apply. o Also, because many people, including business owners and a great many recent immigrants, do not have earned income from regular wages that is easily verified, it provides for verification by a signed financial statement or other documentation that shows the borrower’s income and obligations, but only if the lender also “has a reasonable basis for believing that the income exists and will support repayment of the transaction.” Lenders can evaluate repayment ability and confirm the borrower has adequate

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			income by reviewing credit reports, mortgage payment history, and other data without always having to have "third-party income verification" as Miller-Watt would require.
Prepayment Penalties	• Prepayment penalties are allowed on all loans, not just higher-cost, but only if (1) the penalty cannot be imposed due to debt acceleration from default or breach of loan terms; (2) the penalty period is limited to 36 months; (3) the borrower is given a choice of a similar loan without a penalty and informed of potential benefits and detriments of the penalty; and (4) the amount is limited to 6 months' interest on the amount prepaid in any 12 month period in excess of 20% of the original principal balance (i.e., 80% of 6 months' interest). • The Federal Reserve Board must prescribe regulations as needed to enforce this section's requirements.	• Prepayment penalties are allowed for high-cost loans only if: (1) the borrower's monthly debts do not exceed 50% of his or her monthly gross income; (2) the penalty applies only to prepayment made with funds obtained by other means than refinancing by a lender or its affiliate; (3) the penalty does not apply after the end of a 30-month period beginning at consummation and does not exceed 2% of the loan amount; (4) the principal of the mortgage exceeds the maximum under section 203(b)(2) of the National Housing Act for the same area; and (5) the penalty is not prohibited under other applicable law. • Also, any method of computing a refund of unearned scheduled interest is deemed to be a prepayment penalty if it is less favorable to the borrower than the actuarial method.	• Miller-Watt contains a series of restrictions on prepayment penalties that have the collective practical effect of prohibiting the use of such penalties on almost all nonprime loans. • If borrowers are in effect denied the choice of having a prepayment penalty clause in exchange for a lower interest rate, the interest rates on all nonprime loans would have to be significantly higher in order to recoup costs, resulting in a much higher monthly payment. This would mean that loans would become much less affordable for many borrowers, and many would not even be able to qualify for a loan because they would fail the debt-to-income test when the higher monthly payments were factored into the calculation. If they do not have this option, not only can they not lower their rate ½ % to 1%, but it is likely that rates on all borrower' loans would have to be increased by around 1% according to current economic analysis. • The Miller-Watt bill's limitation that a penalty could not be longer than 30 months or over 2% of the loan amount without the loan being deemed a high-cost loan also would mean in the relatively few cases where a penalty option could be offered that the value of the penalty in terms of reducing the borrower's rate (or in some cases, closing costs) would be relatively limited. • Ney-Kanjorski takes a fundamentally different approach of adopting reasonable and effective regulations regarding prepay penalties instead of restrictions that in effect prohibit penalties. o The Ney-Kanjorski 3-year limit, which is consistent with Freddie Mac's limitation, is quite reasonable as a maximum time period for all types of nonprime loan products. It is 2 years less than the current 5-year limit that applies under HOEPA and some state laws. o A 3-year limit is generally recognized as the industry best practices standard for fixed rate loan products. Lenders also limit penalties further on certain products. For example, one of today's popular products is the

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
			so-called "2/28" 30-year adjustable rate mortgage (ARM) where the rate can adjust upward after an initial fixed rate period of 2 years. On this type product, lenders generally offer a 2-year prepayment penalty option so the borrower can more easily refinance if the rate adjustment turns out to be substantial. A shorter prepayment period, however, also typically means less of a rate reduction. o Quite importantly, <u>Ney-Kanjorski requires that the borrower be given a choice of a loan without the penalty option and an explanation of the possible benefits and detriments of choosing a loan with the penalty option</u>. o It also limits the amount of the penalty based on California's "6 months' interest" rule, under which borrowers may annually prepay up to 20% of the loan balance without penalty. • Critics often forget, or do not mention, the ongoing benefit and the potential longer term benefit that borrowers receive when they elect a prepayment penalty option. For example, assume a $150,000 loan with an 8% interest rate and a 1% savings on the rate by choosing the penalty option (i.e., otherwise the rate would be 9%). Under the California rule contained in Ney-Kanjorski, the maximum amount of the penalty would be 6 months' interest on 80% of the amount prepaid, which would be $4,800 ($150,000 x .8 = $120,000 subject to the penalty. 6 months' interest on that amount would be $120,000 x .08 divided by 2 = $4,800). The 1% reduction in rate would amount to a savings of $106.25 per month on the monthly payment. If a borrower decided to refinance after 26 months, the borrower would have to pay $4,800, but at that point would have received $2,763.28 in benefit by having the lower rate, so the net cost would really only be $2,036.72 ($4,800 - $2,763.28 = $2,036.72). On the other hand, if the borrower waited 4 years to refinance (which for many is increasingly likely in today's rising rate environment), the borrower would have saved $5,101.44 in mortgage payments, and not have to pay a penalty.
Single Premium Credit Insurance	• Prohibited from offering or selling of single premium credit	• No financing of any single premium credit life, credit	• Miller-Watt prohibits the financing of single premium credit insurance and comparable products on all loans and in another provision requires the cost of

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Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	insurance or any analogous non-insurance product. Expressly applies prohibition to debt cancellation or suspension agreements. • Exception for such products paid on a monthly basis.	disability, credit unemployment or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract. • Restriction applies to all home loans, not just higher-cost. • Exception for such products paid on a monthly basis.	such products to be included in the points and fees trigger calculation. The practical effect of these provisions is to prohibit the sale of such products. • Ney-Kanjorski takes the direct approach of prohibiting such products in connection with higher-cost loans. We understand that due to a drafting oversight, that bill failed to include the cost of such products in the trigger calculation as is currently done pursuant to HOEPA regulations, and that the sponsors intend to correct this during Committee consideration. • Lenders generally no longer even offer such products, and we support prohibiting the sale of such products in connection with all mortgage loans.
No Lending Without Specific Disclosures	• Adds 4 new disclosures: (1) "The interest rate and the amount of fees you pay on this loan are higher than most people pay for conventional or 'prime' rate loans. As a result, your monthly interest payments are higher than those on a comparable loan with a lower interest rate." (2) "The rate of interest and the amount of fees you pay on a loan may vary depending on which lender or broker you select. You may be able to get a loan with a lower interest rate. Your credit score can provide an indication of whether you may qualify for a lower-cost prime loan. If you have a relatively good credit risk score, such as a		• Ney-Kanjorski's addition disclosure provisions appear to be reasonable and may help borrowers better understand the loan transaction. • The bill also provides that the FRB can determine what is considered a prime rate loan for purposes of the disclosure statement.

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	FICO score in excess of 660, you may qualify for a ‘prime’ loan. In that event, you should consider shopping more for a lower-cost loan instead of simply accepting the higher-cost loan that has been offered to you.” (3) “If you are taking out this loan to repay other loans, look to see how many months it will take to pay for this loan and what the total amount is that you will have to pay each month before this loan is repaid. Even though the total amount you will have to pay each month for this loan may be less than the total amount you are paying each month for those other loans, you may have to pay on this loan for a longer period than those other loans and that may cost you more overall.” (4) “You may get into serious financial difficulties if you use this loan to pay off old debts and then replace them with other new debts.” • Regulations for disclosures - The FRB may amend the definition and determination of a prime rate loan.		

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
Late Fees	• Prohibits late charges for all consumer credit transactions secured by a house occupied as a principal dwelling (not just higher-cost) in excess of 5% of the amount of scheduled past due payments and requires that late fees may not be charged more than once with respect to single late payments and may only be assessed on payments past due for 15 days or more. • The Federal Reserve Board must prescribe regulations as needed to enforce this section’s requirements.	• No late payment charge: (1) greater than 4% of the amount past due, (2) unless authorized by the loan documents; (3) before the end of the 15-day period beginning on the date when the payment is due (of the 30-day period in the case of a loan on which interest on each installment is paid in advance); or (4) more than once with respect to a single payment. • A provision also is included to require in essence that if a payment is paid in full within the allowed time, a late fee cannot be imposed on it relating to an earlier unpaid late fee.	• Both bills contain relatively similar late charge provisions, with Ney-Kanjorski using a 5% maximum and Miller-Watt using a 4% maximum, but Ney-Kanjorski applies the restriction to all loans, not just higher-cost loans.
Payoff Statement	• A payoff statement must be delivered within 7 business days of request and a payoff/demand fee is prohibited. • No fee is allowed for the first 2 payoff requests in any continuous 6-month period. After that, a fee must be reasonable. • Also, the lender may charge a “processing” fee for faxing or courier service delivering the payoff/demand statement. The	• A payoff statement must be delivered within 5 business days of request and a payoff/demand fee is prohibited. • The lender may charge a reasonable fee after 4 requests in any calendar year. • Also, the lender may charge a “processing” fee for faxing the payoff/demand statement. The fee must be comparable to other similar services. • The lender must disclose that	• Both bills contain relatively similar provisions. • Miller-Watt requires that 4 payoff balance statements be available without cost per year, whereas Ney-Kanjorski allows 2 no-cost statements within any continuous 6-month period. • Miller-Watt requires the payoff statement within 5 business days, whereas Ney-Kanjorski allows 7 business days.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	fee must be comparable to that for other similar services.	payoff balances are available for free.	
Credit Reporting	• Lenders must furnish to a nationwide credit reporting agency on a monthly basis the complete payment history, favorable and unfavorable, of the obligor with respect to all higher-cost mortgages held or serviced by such lender, successor, assignee, or servicer. • Exception for those persons holding the loan for less than 90 days. • Exception for loan forbearances, work-outs, dispute or consumer complaint settlements.		• Most, but not all, lenders now report mortgage payment data to credit bureaus so that a more accurate credit history is available when credit inquiries are made. • Ney-Kanjorski adds a provision requiring reporting to credit bureaus on a monthly basis with regard to payment history on higher-cost mortgages. • The Committee should consider expanding this requirement to all home mortgages.
Arbitration	• Mandatory arbitration is prohibited for higher-cost loans. • Post-controversy voluntary arbitration is allowed as a method for resolving any controversy at any time after a dispute or claim arises, but cannot be interpreted as barring a borrower from subsequently bringing an action in court.	• No consumer credit transaction secured by the borrower's principal dwelling, not just high-cost loans, may include terms requiring arbitration or any other nonjudicial procedure. • A borrower and lender may agree to arbitration or any other non-judicial procedure at any time after a dispute or claim arises, but the	• Unlike any state or federal law, Miller-Watt would ban mandatory arbitration on all home loans, whereas Ney-Kanjorski applies the restriction only to higher-cost loans. • Arbitration is strictly prohibited on "high-cost" loans in only 9 states.[6] Arbitration can often be an effective, quicker and less expensive dispute resolution process for the borrower. Some mortgage lenders use it, others do not. Arbitration also is used in many other types of consumer credit, securities and employment cases. However, because higher-cost mortgage loan borrowers may be more vulnerable and need extra protections, the Ney-Kanjorski bill, like all states that impose arbitration restrictions, prohibits mandatory arbitration only on

[6] Five other states with arbitration limitations allow an arbitration clause if it complies with certain requirements (e.g., if it meets the standards of a nationally recognized arbitration association).

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Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	• A post-controversy voluntary arbitration agreement must: (1) establish the venue for the arbitration in the Federal judicial district or division in which the real property is located; (2) comply with the standards set forth by a nationally recognized arbitration organization; and (3) require the lender to bear the reasonable costs of all parties to the arbitration, including the production of witnesses and documents, during the first 2 days of such arbitration.	agreement cannot be interpreted as barring a borrower from bringing an action in court.	higher-cost loans. • Both bills contain similar provisions allowing for non-binding post controversy agreements that essentially amount to mediation, but Ney-Kanjorski adds several additional safeguards as to how such voluntary arbitrations are to be conducted.
Periodic Payments	• No higher-cost mortgage may include terms under which more than 2 scheduled payments of interest or principal may be paid in advance or otherwise deducted from the loan proceeds.		• Ney-Kanjorski seeks to clarify the current HOEPA restriction that no more than 2 scheduled mortgage payments may be paid in advance or otherwise deducted from the loan proceeds.
Modification and Deferral Fees	• Lenders are prohibited from charging modification or deferral fees in excess of the lesser of the amount of 1 monthly loan payment or $300. • This prohibition does not apply to loans in default or at least 60 days delinquent and part of a	• No fee is allowed to modify, renew, extend, or amend a high-cost loan, or to defer any payment due under the terms of a high-cost loan. • An exception is provided for such fees if the modification, renewal, extension or amendment results in	• Ney-Kanjorski allows for a limited fee for modifying a loan or deferring payment, whereas Miller-Watt allows for no such fee in most cases. • The Committee should consider how the two bills address this issue and determine the degree to which, if any, a limited fee might be allowed. • It would seem to be reasonable to allow lenders to charge a modest fee for their work when the borrower wants to modify a loan or defer a loan payment.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	work-out process.	a lower APR and the amount of the fee is comparable to fees imposed on similar transactions that are not high-cost loans.	
No Call Provision	• Call provisions under which the indebtedness may be accelerated by the lender, in the lender's sole discretion, are prohibited. • This prohibition does not apply if the acceleration is due to: o A default or pursuant to a due-on-sale provision, or some other provision of the loan documents unrelated to the payment schedule; o Due to any action or omission by the borrower that adversely affects the lender's security interest in the house or any rights of the lender in such security.	• Call provisions under which the indebtedness may be accelerated by the lender, in the lender's sole discretion, are prohibited. • This prohibition does not apply if the acceleration is due to: o A default or pursuant to a due-on-sale provision, or some other provision of the loan documents unrelated to the payment schedule.	• Both bills contain relatively similar limitations on call provisions. • Ney-Kanjorski includes language based on the FRB regulations allowing an exception for acts of omissions by the borrower that adversely affects the lender's security for the loan or any right in the security.
Balloon Payments	• Balloon payments are prohibited. • An exception is provided for seasonal or irregular income or for a bridge loan (defined as having a maturity not to exceed 18 months and made in connection with the acquisition or construction of a home).	• Balloon payments are prohibited. • Exception for seasonal or irregular income.	• Both bills strengthen current law, which only prohibits balloon payment provisions of less than 5 years, by generally prohibiting balloon payment terms on higher-cost loans. • Both make exceptions for seasonal or irregular income. • Ney-Kanjorski also adds an exception for bridge loans not exceeding 18 months (6 months more than allowed under current FRB regulations), and requires an additional disclosure requirement when this exception applies.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	• When the exception applies specific disclosure of the balloon payment term is required.		
Negative Amortization	• Prohibited, except to allow for temporary forbearance plans.		• Ney-Kanjorski adds a technical amendment to address the fact that negative amortization might occur if the lender allowed a borrower the benefit of a temporary forbearance plan.
No Encouraging Default	• Prohibited.	• Prohibited.	• Both bills prohibit encouraging default.
Home Improvements	• Cannot use proceeds of a higher-cost mortgage to make the final payment or payment in full to a home improvement contractor without an independent inspection of any home improvement exceeding $10,000, and without proof the contractor has fully performed the obligation. • A completion certificate in compliance with state law or a signed statement from the borrower and home improvement contractor shall satisfy this requirement. • The lender must also provide certain disclosures to the borrower before making a final payment.		• Ney-Kanjorski would add new protections aimed at further limiting home improvement scams. It would prevent lenders from making a final payment or payment in full on larger home improvement contracts which exceed $10,000 without an independent inspection and without proof that the contractor has fully performed the contract obligation. • The basic concept of this provision seems sound and should reduce contractor fraud. However, the Committee should consider defining or requiring the Federal Reserve Board to define by regulation what is considered to be a final payment or payment in full. This provision should not be construed so that, for example, a final payment of only $1 could be withheld and no inspection certificate or proof of compliance would be required.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
Increased Interest Rate Upon Default	• Current law's prohibition on increasing the interest rate on default would be retained but a narrow exception would be added providing the prohibition does not apply to changes in a variable interest rate based on an index due solely to a change in the index rate.	• Prohibited. • Exception when repayment has been accelerated by default, pursuant to a due-on-sale provision, or pursuant to a material violation of some other provision of the loan documents unrelated to the payment schedule.	• The Committee should consider adopting the limited exceptions contained in both bills.
Steering	• No lender shall knowingly or intentionally steer a borrower into a loan product not based on the lender's best credit grade that the borrower would qualify for. • No broker shall knowingly or intentionally steer a borrower to a less favorable product than one offered by lenders with whom the broker regularly does business and for which a borrower qualifies. • The lender must provide the borrower's credit score within 3 days of the later of the receipt of a higher-cost mortgage loan application, or the making of a determination that the borrower qualifies for a higher-cost mortgage. • If steering occurs, the loan must		• Although steering is perceived to be a problem by many parties, only one state, California, has a prohibition against steering borrowers to more expensive loans. • The newly available 2004 HMDA data is likely to increase concerns over steering. This data shows significant disparities in some cases between various racial and ethnic groups but does not and can not show the causes of such disparities, especially as it does not contain the basic risk-related factors lenders use to price loans. • Miller-Watt does not attempt to address the steering issue. • Ney-Kanjorski includes an anti-steering provision based largely on the California statute. • Ney-Kanjorski tackles this issue by essentially requiring that: (1) lenders may not steer a borrower to a product not based on the lender's best credit grade that the borrower qualifies for; and (2) brokers may not steer customers to less favorable products than those offered by lenders with whom the broker regularly does business. • This steering prohibition includes a safe harbor provision that allows borrowers to voluntarily choose to accept a somewhat more costly loan for their own personal reasons, even if they may be able to obtain a less expensive loan. For example, many borrowers have immediate needs for funds and want the loan that closes fastest even if it is a bit more expensive. • This is a very complex issue. It is very difficult in many cases, given the large

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	be, at the borrower’s option, either rescinded or rewritten, and appropriate restitution made. o Restitution by the lender must include giving the borrower all fees, interest, or other charges paid by the borrower above those that would have been paid had the loan not been originated at the less favorable credit grade. • Penalty for knowing and intentional violation by a broker: $4,000 and the borrower’s actual financial damages and reasonable attorney’s fees and court costs. • SAFE HARBOR (for lender): lender must have a reasonable basis to believe that the credit grade determined by the lender’s then-current underwriting guidelines and applied to the borrower was appropriate, based on the information available, including information provided by the borrower, or the borrower voluntarily, on an informed basis, agrees to a loan with a higher rate than that for which		variety of mortgage products available and the many differing considerations that may apply with respect to a particular borrower’s personal circumstances, to determine what loan product is really “the best deal” for the borrower. • All interested parties should carefully study the Ney-Kanjorski prohibition on steering and recommend any needed refinements to the Committee so that the final version is workable and will accomplish its legitimate objective.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	the borrower would otherwise qualify. • SAFE HARBOR (for broker): broker must have a reasonable basis to believe that the applied risk grade was appropriate, based on the information available, including information provided by the borrower, or the borrower voluntarily, on an informed basis, agrees to a loan with a higher rate than that for which the borrower would otherwise qualify.		
No Bad Faith Avoidance of Restrictions	• Prohibited from seeking to evade the law's requirements by entering into a reciprocal arrangement, dividing any loan transaction into separate parts, or structuring or restructuring a loan as another form of loan. • Reciprocal arrangements are defined to essentially cover agreements or understandings where a lender or its affiliate agrees to engage in a transaction with or on behalf of another lender or its affiliate in exchange for the second lender or its affiliate agreeing to engage in a	• Prohibited from taking any action to structure a loan as an open-end credit plan or another form of loan, or to divide any loan into separate parts in order to evade the law's protections. • Does not specifically prohibit or define reciprocal arrangements.	• Lenders should not be allowed to avoid the statutory safeguards by dividing or restructuring the loan transaction. Therefore, it is appropriate to have a prohibition on bad faith avoidance of such restrictions. • Miller-Watt does not expressly prohibit or define reciprocal arrangements. • The Committee should review both bills' provisions on this issue and develop final language as it deems appropriate. In that regard, consideration should be given as to whether the non-attribution rule should be limited to purchase money transactions or might need further refinements to prevent possible abuse.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	transaction with, or on behalf of, the first creditor or its affiliate for the purpose of evading any requirement or prohibition or other provision of federal law or regulation relating to higher-cost mortgages. • Non-attribution rule - If there are 2 contemporaneous credit transactions secured by the same property and the loan-to value ratio of one equals or exceeds 80%, the points and fees payable on this transaction may not be attributed to the other transaction.		
ENFORCEMENT, PENALTIES, ASSIGNEES, CURE, NATIONAL UNIFORMITY			
Right to Cure	• Allows a lender or assignee who fails to comply with the law’s requirements to avoid liability: (1) within 45 days of loan closing, by notifying the borrower of the error and making appropriate restitution and necessary adjustments; or (2) within 60 days of discovering	• Allows a lender who fails to comply with the law’s requirements to avoid liability: (1) within 30 days of loan closing and prior to the institution of any action, by notifying the borrower of the violation and making appropriate restitution and adjustment to the loan to make the	• The federal statute’s cure provisions have long been found to be inadequate by the mortgage lending industry, and lenders view enacting a workable cure procedure to be a very important part of reforming lending requirements. • Borrowers, as well as lenders, will benefit from having a quick and inexpensive error resolution process instead of having to engage in lengthy and costly litigation. • Both bills have a two-track cure provision, but Miller-Watt proposes a more limited provision than Ney-Kanjorski. o Essentially, Miller-Watt would first allow the lender to cure any violation

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)	HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)	Commentary & Analysis
	an error, by notifying the borrower of the error and making appropriate restitution and necessary adjustments, and by paying the borrower an error penalty of $2,000 (if a lender or assignee did not discover the error through its own procedures) and reasonable attorney’s fees. • Appropriate restitution may include modifying the transaction terms so it is no longer a higher-cost mortgage. • If a lender or assignee does not correct the error as provided for above, the borrower may file an action or proceed with an action already filed. • Document revisions made pursuant to this provision are deemed legally effective as of original date of the document that was revised.	loan satisfy the requirements or change the terms of the loan in a beneficial manner so that the loan is no longer a higher-cost loan; (2) within 60 days of the lender’s discovery or receipt of notification of an unintentional violation or bona fide error and prior to institution of an action, by notifying the borrower of the compliance failure and making appropriate restitution and adjustment to the loan to make the loan satisfy the requirements or to change the terms of the loan in a beneficial manner so that the loan is no longer a high-cost loan.	within 30 days of loan closing provided the borrower had not filed suit over the violation. Miller-Watt also would allow a lender to correct an error within 60 days of learning of the error provided the lender has not notified the lender or initiated a lawsuit and the lender could prove the violation was unintentional or a bona fide error. o Ney-Kanjorski would allow 45 days after closing for the error to be corrected, and correction could be made even if a suit had been instituted. It also would allow a correction within 60 days of discovery, provided it not only made full restitution but also paid the borrower a $2,000 error penalty and the borrower’s reasonable attorney’s fees if any. o The Ney-Kanjorski approach, which we strongly favor, would provide for borrowers to have errors corrected quickly, without slow and costly litigation, and the lender penalty would give lenders further incentive to avoid errors. o The Committee may wish to consider whether clarifications or modifications may be needed to address borrowers’ rescission rights in connection with any new error correction procedure. • Currently, a borrower has an extended 3-year right of rescission, in addition to TILA’s basic 3-day rescission right, for material breaches of HOEPA. • Consideration should be given as to how this extended rescission right should interface with the new cure provisions.
Statute of Limitations	• 2 years from the date of the occurrence of the violation. • Appears to retain 1 year statute of limitations for steering violations.	• 3 years from the date of the occurrence of the violation.	• The general statute of limitations applicable here under current federal law is 1 year. Ney-Kanjorski would double the time, whereas Miller-Watt would triple it. • Lenders believe that it is quite adequate to double the period to 2 years. • CFAL believes the 2 year statute should include steering violations.

Comparison & Analysis of H.R. 1295 and H.R. 1182

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
Right of Rescission	• Prohibits waiver of the borrower's rescission rights if a waiver was required by lender as condition of the loan or the lender advised or encouraged the borrower to waive this right.	• Can be asserted by a person in an action to collect the debt or as a defense to a judicial or nonjudicial foreclosure after the expiration of the 3-year time periods for affirmative actions.	• Ney-Kanjorski adds a reasonable safeguard prohibiting lenders from requiring the waiver of the borrower's rescission rights in order to obtain the loan or from encouraging the borrower to waive such rights. • Miller-Watt's provision allowing a borrower to assert a timeless right of rescission in debt collection or foreclosure proceedings appears to be unreasonably long and inconsistent with the concept of a statute of limitations and would encourage higher-cost borrowers who are in foreclosure to assert unmerited rescission claims.
Penalties	• Doubles the existing TILA/HOEPA maximum statutory civil penalty from \$2,000 to \$4,000 per violation and doubles maximum class action damages from \$500,000 to \$1,000,000. • Requires coordination of class action general damages with actual damages so general damages are reduced by aggregate amount of actual damages. • The court must consider whether a pattern or practice of violations existed and whether violations were willful.	• Doubles existing amount of total damages to twice the sum of actual damages, statutory damages, attorney's fees, and costs.	• Both bills increase penalties for violations. • Miller-Watt would double the sum of all damages, including actual damages. • Ney-Kanjorski, which we favor, would double the range of statutory damages.
Assignee Liability	• Allows limited liability for assignees of higher-cost mortgages. • A borrower may assert all affirmative claims and defenses		• Assignee liability generally does not apply with respect to prime loans or to nonprime loans, with the exception of higher-cost loans under HOEPA and under the laws of around a dozen states. • Most legislators have rejected applying such strict liability because it is not fair to hold innocent purchasers strictly liable for violations that they had no reasonable

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	against a purchaser or assignee that he/she could assert against the lender either: (1) as a defense to the enforcement of such mortgage based on a default if it is reasonably related to a violation of this section by a lender, unless the borrower demonstrates that the purchaser or assignee had actual knowledge of or reckless indifference to a violation (in which case a defensive claim may be raised without regard to whether such violation was related to the borrower's default); or (2) as an affirmative claim, unless the purchaser or assignee demonstrates by a preponderance of evidence that a reasonable person exercising ordinary due diligence could not determine based on required loan documentation, the itemization of the amount financed and other disclosure of disbursements that a violation had occurred. • This section does not apply if purchaser or assignee has exercised such due diligence by demonstrating that such		way of knowing had occurred. Legislators also have recognized that assignee liability can easily upset the secondary market. • If assignee liability is extended beyond higher-cost loans as some advocates want, there is a real danger that mortgage capital for all covered loans could dry up in many markets. For example, broad assignee liability was one of the key reasons the nonprime market literally shut down in Georgia and legislators were forced to make significant changes to the law. A similar situation occurred in New Jersey. • The fact is that higher-cost loans to which overreaching assignee liability restrictions in HOEPA and certain states' laws apply are virtually never sold in the secondary market. Because there is no secondary market for higher-cost loans, and competition is therefore limited as the major wholesale lenders that sell all their loans into the secondary market do not offer such loans, borrowers who can only qualify for a higher-cost loan have to obtain them from a lender that retains the loan in its own portfolio. The common result for the borrower is that the loan is priced significantly higher than it otherwise would be if there was a competitive secondary market for these loans. • The Ney-Kanjorski bill therefore seeks to refine HOEPA's excessive and unworkable liability on assignees by substituting more balanced language so that higher-cost loans could be sold in the secondary market and the thousands of borrowers in every state who only qualify for such loans would have far more opportunity to obtain less expensive loans. It draws upon several states' language relating to due diligence requirements to avoid liability. The bill basically seeks to apply assignee liability only when the purchaser knew or reasonably should have known that abuses actually had occurred. This approach would shift from having a *de facto* prohibition on selling HOEPA loans in the secondary market to letting such loans be securitized, provided the many applicable special substantive safeguards are met. • Borrowers in foreclosure who claim to be victims of abusive practices can and do sue both the originating lender and broker. The mortgage servicer also is typically sued and borrowers raise lending abuses as foreclosure defenses. Generally, the originator is required by the purchaser to buy back the loan from

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	purchaser or assignee (1) has policies in place expressly prohibiting the purchase or acceptance of assignment of higher-cost mortgages or such mortgages containing violations; (2) requires by contract that the seller or assignor represent and warrant that either (a) they would not sell or assign such mortgages; or (b) they had such a representation or warranty from a previous seller or assignor; and (3) exercises reasonable due diligence (may be met by employing a statistically robust sampling methodology – no loan-by-loan review is required) intended to prevent the purchase or assignment of such loans. • Damages for violations of TILA are limited to the amount specified in TILA/HOEPA civil liability section and for violations of other requirements to (1) the amount of all remaining indebtedness; and (2) the total amount the borrower paid. • In awarding damages, the court		the secondary market purchaser (in practice, it's usually sold back as soon as the allegations are raised by the borrower) and if liability attaches, it normally is satisfied by the lender, broker, and/or servicer and not the secondary market purchaser.

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	must consider (1) the amount of actual economic damages and the extent to which the non-economic harm suffered should be compensable by general damages; (2) the lack of the purchaser or assignee's knowledge of or participation in the facts giving rise to the violations; (3) the materiality of the violation; and (4) the relative harm to the borrower. • Damages are limited to the amounts specified in TILA/HOEPA civil liability section, unless the borrower demonstrates that the purchaser or assignee had actual knowledge of or exhibited reckless indifference to a violation. • Clarification is added to indicate that purchasers and assignees do not include certain parties such as passive investors in securities based on a pool of mortgage loans.		

Comparison & Analysis of H.R. 1295 and H.R. 1182

<table>
<tr><th>Concept</th><th>HR 1295 – Ney-Kanjorski (“Responsible Lending Act”)</th><th>HR 1182 – Miller-Watt (“Prohibit Predatory Lending Act”)</th><th>Commentary & Analysis</th></tr>
<tr><td>Coordination with State Laws (Preemption)</td><td>• Ney-Kanjorski preempts any law of any State or political subdivision to the extent that such law attempts, directly or indirectly, to regulate mortgage lending activities by or through imposition of a high-cost limitation or any requirement, limitation, or prohibition without regard to whether the provisions are consistent with section 129 or 129A or whether the consumer credit transaction is a higher-cost mortgage.
• The section provides definitions of mortgage lending activities, law of any State and high-cost limitations, and clarifies the scope of preemption.
• Preemption is self-executing, but the Federal Reserve Board also is required upon request to promptly publish in the Federal Register notice of whether and the extent to which it determines that preemption applies.
• Clarification is provided also that provisions of this title do not affect a State’s authority to enforce this Act as the primary enforcement authority with</td><td></td><td>• The mortgage market is increasingly a nationwide market dominated by larger lenders who operate throughout the country, and even many “small” lenders offer products in several states.
• A broad preemption is clearly needed to address the confusing patchwork of existing state and local laws that are intended to stop abusive lending practices.
• However, the scope of some of the preemption provisions in Ney-Kanjorski need to be refined so that state laws that are mortgage related but not related to so-called predatory lending legislation are not affected. This is an issue, however, that can be addressed during Committee consideration after interested parties suggest appropriate modifications.</td></tr>
</table>

Concept	HR 1295 – Ney-Kanjorski ("Responsible Lending Act")	HR 1182 – Miller-Watt ("Prohibit Predatory Lending Act")	Commentary & Analysis
	regard to persons licensed in or chartered by such State.		
State Enforcement Authority	• Status quo maintained regarding States' enforcement authority against federal or state entities with respect to federal law. • Act also does not affect a State's authority to enforce this statute as the primary enforcement authority with regard to persons licensed in or chartered by such State.	• Status quo maintained regarding States' enforcement authority against federal or state entities with respect to federal law.	• HOEPA contains a special provision that allows the Attorney General of any state to sue any party, including otherwise exempt depository institutions, for violations. • Both bills retain the status quo regarding this provision and other enforcement authority available to state officials. • CFAL favors active state enforcement of any new federal law establishing uniform national standards for mortgage lenders.
Regulations	• The Federal Reserve Board is required to publish regulations implementing the Act and amendments in final form within 6 months of enactment.	• The Federal Reserve Board is required to publish regulations implementing the Act and amendments in final form within 6 months of enactment.	• Both bills have comparable provisions requiring the Federal Reserve Board to publish final regulations within 6 months of enactment.

Comparison & Analysis of H.R. 1295 and H.R. 1182

OTHER TITLES	Please note the summary above includes provisions of H.R.1295 and H.R. 1182 related to prohibited mortgage lending practices with respect to higher-cost mortgages, but the summary below includes only selected provisions of separate titles of H.R. 1295 (not contained in H.R. 1182) related to mortgage brokers, appraisals, education and counseling.	
TITLE II	Education and Counseling	
Borrower Education and Counseling Opportunities	• Includes a separate title, based on earlier legislative initiatives by Rep. Scott and others expanding housing counseling and education programs and related activities. • Among other things, these education provisions would create a new HUD office to better administer such programs and improve program standards. • The bill also authorizes $75 million for each of fiscal years 2006-2009 for such activities.	• Miller-Watt has no comparable title dealing with borrower education and counseling; however, it does give the Federal Reserve Board discretion to prescribe regulations requiring or encouraging lenders to provide consumer mortgage education to prospective customers or to direct them to such programs in the vicinity of their residences. • During the last Congress, CFAL suggested that consideration be given to having a small fee on all mortgages (e.g., $2), half of which could be allocated to borrower financial education and counseling programs and half of which could be used for state enforcement programs. We again suggest that this education and enforcement fee approach be considered.
Title III	Servicing	
Mortgage Servicing Abuses	• Updates the Real Estate Settlement Procedures Act (RESPA) with regard to mortgage servicing practices. • Mortgage servicers are prohibited from: (1) force placing insurance unless there is a reasonable basis to believe that the borrower has failed to comply with the requirement to maintain property insurance, and from charging fees for responding to qualified written requests by the borrower; (2) failing to take timely action to respond to a borrower's requests to correct errors relating to the allocation of payments, final balances for purposes of paying off the loan or avoiding foreclosure, or other standard servicer duties; and (3) failing to respond within 10 days to a request from a borrower to provide the identity of and contact information for the owner assignee of the loan; and failing to comply with any other obligation to protect borrowers established by the HUD Secretary.	• The bill's servicing provisions in this Title, and provisions in the subsequent titles raise issues that CFAL's members are still evaluating. Only limited comments will be made at this time, but we will provide additional comments after the hearing if we deem it appropriate. • Mortgage servicing has definitely presented certain problems, and it is commendable that Ney-Kanjorski seeks to address a number of them (e.g., force placing insurance).

	• RESPA penalties would be increased by doubling existing monetary levels. • Mandates decreases in response times to certain borrower inquiries, establishes response times for obtaining pay-off amounts, and requires the prompt refund of escrow accounts upon the payoff of a loan. • HUD also would be required to prepare two studies relating to mortgage servicing fraud.	
Escrow and Impound Accounts	• Applies to all consumer credit transactions secured by the principal dwelling. • A lender must establish (at the time of consummation) an escrow or impound account (to remain in existence for a minimum of 5 years unless the underlying mortgage is terminated) for the payment of taxes and hazard insurance. o Such account may not be required as a condition of a sales contract or a loan, unless (1) it is required by federal laws; (2) a loan is guaranteed by a governmental lending or insurance agency; (3) the borrower's DTI exceeds 45%; (4) a borrower obtains a higher-cost mortgage; (5) the original principal amount of such loan is 90% or more of the sale price (in case of a sold property) or appraised value; (6) the combined principal amount of all loans securing the property exceeds 95% of the appraised value; or (7) it is required by the Federal Reserve Board pursuant to regulation. • A lender must make certain written disclosures to the borrower about the account within 3 business days before consummation. • Amounts paid for escrow or impound accounts are not included in points and fees.	• Many nonprime loans do not have escrow accounts for the payment of taxes and insurance. This means that nonprime borrowers, who often lack substantial cash reserves, frequently find it difficult to come up with the significant lump sum amounts needed when these expenses become due. • Requiring the establishment of escrow accounts for many nonprime loans would appear to be reasonable and beneficial to borrowers. • Further consideration should be given concerning whether these Ney-Kanjorski requirements are adequate and whether the group of borrowers for whom lenders would have to establish accounts should be adjusted to cover other borrowers. Also, clarification may be needed regarding under what conditions borrowers could terminate escrow accounts.
Title IV	**Appraisals**	
"Property Flipping" and Appraisals	• No higher-cost lending without a written appraisal of the property (the borrower is entitled to one free copy) performed by a qualified appraiser who conducts a physical inspection. • If the seller purchased or acquired the property within 180 days of the current transaction at a lower price, the lender must obtain a second qualified appraisal that supports the current sale price at no cost to the	• "Property flipping" has been a serious problem in a number of areas and has often involved a conspiracy between a number of parties, including for example, sellers, appraisers, brokers and real estate agents. One of the key elements has often been appraisal fraud. Therefore, Ney-Kanjorski seeks to strengthen the appraisal process and adds new appraisal requirements with respect to higher-cost loans.

	borrower. • If the lender willfully fails to obtain an appraisal, it is liable to the borrower for $2,000. • To enhance the independence of appraisers and help to ensure that they serve as an unbiased arbiter of a property's value, the bill prohibits the parties interested in a real estate transaction involving an appraisal from improperly influencing or attempting to improperly influence, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal. • Streamlines the process for obtaining appraisal practice permits, provides for reciprocity in State appraiser licensing, makes certain other changes relating to the appraisal process and requires the Comptroller General to conduct a comprehensive study within 18 months of enactment on possible improvements in the appraisal process and how to improve appraisals.	• Further consideration should be given to whether a second full physical inspection appraisal, which is relatively expensive, is needed or whether automated appraisals might be adequate. Also, the Committee might want to consider allowing for some price increase before the second appraisal is required because homes in so many areas are appreciating significantly every few months.
Title V	Mortgage Brokers	
New Mortgage Broker Licensing Standards & A National Broker Registry	• The bill would establish minimum uniform state broker licensing standards and create a national broker registry to help police rogue brokers.	• Brokers originate the majority of all mortgages and are play a vital role in delivering nonprime mortgage products to borrowers on a cost efficient basis. Most brokers are ethical and treat borrowers fairly, but a minority is not and those "bad apples" perpetrate many of the most serious lending abuses. • State licensing requirements vary widely and unethical brokers often will move to another state when they are sanctioned for improper actions. • State licensing requirements in some states need strengthening, and Ney-Kanjorski's broker licensing provisions appear to address many broker-related concerns. • Further input may be needed from state officials who regulate brokers with regard to how this Title could be refined and strengthened. • The concept of having some form of national broker registry has been discussed for several years, and this appears to be something that might be helpful in controlling bad actors.

APPENDIX “B”

Option One Mortgage Corporation

How We Make Homeownership Dreams Reality

May 2005

Homeownership in the United States is at an historic level. In 2004, the percentage of the population owning a home climbed to 69 percent. One of the important factors contributing to this expansion of homeownership is the growth of the nonprime (sometimes referred to as "subprime") mortgage market. By 2004, approximately 20 percent of the home mortgage lending in this country was nonprime. In essence, nonprime mortgage lending has created the opportunity for millions of Americans who do not qualify for prime loans to still have the ability to buy or refinance a home.

As one of the nation's largest nonprime home mortgage lenders, Option One Mortgage Corporation has been a leader in "doing nonprime right," with consumer-centric loan products and loan origination and servicing best practices that set the gold standard for the industry. While our goal has never been to be the biggest lender, our growth has been strong since we started our business a little over a decade ago. We believe our growth is a measure of having the right focus on quality and by being faithful to our values and culture. This is the starting point for all we do, and it has resulted in a work force of approximately 5,500 men and women across the country who are overwhelmingly proud to be part of our company and proud of how we help all kinds of Americans fulfill their homeownership dreams.

We want to share some information about the philosophy that guides us, as well as an overview of our business, including our commitments to lending in a nondiscriminatory, responsible manner; embracing diversity; supporting financial literacy; and giving back to society as a whole and the communities in which we do business, by improving housing, education, health, and human services. We have organized overviews of this information, as well as hard data and statistics to help dispel some of the misconceptions about the nonprime mortgage industry, including such hot-button issues as prepayment penalties, foreclosures, demographics, benefits-to-the-borrower, pricing, and fraud prevention. Also included in data summaries is important information about the profile of Option One's borrowers and the loans we make, including our underwriting philosophy, as well as information about how we service mortgage loans.

We hope this information will provide useful insight into the positive contributions our company is making to help people buy and retain their homes, increase their wealth and strengthen their communities through homeownership, and solve at least some of their financial challenges and goals.

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Appendices

COMPANY OVERVIEW

What We Do:	We are in the business of making, selling, and servicing nonprime residential mortgage loans.
Founded:	1992 – to increase opportunities for more Americans to realize the dream of homeownership, focusing on those borrowers who were not served by traditional mortgage lenders. Option One is a pioneer in the nonprime industry. Few companies have more experience in responsible nonprime lending.
Ownership:	Subsidiary of Block Financial, a subsidiary of H&R Block, Inc.
Lending channels:	Option One Mortgage – wholesale through brokers and other financial institutions
	H&R Block Mortgage Corporation – retail through mortgage offices
Industry Position:	Option One is consistently one of the nation's top 10 nonprime home loan originators based on volume
	Option One is consistently one of the nation's top 10 nonprime home loan servicers based on total servicing volume
Special programs:	Diversity Council dedicated to helping our company and associates embrace diversity in all forms
	Fraud Detection and Prevention Program considered a model for the mortgage industry (see Appendix D)
	Lending Hands community outreach program
	Option One University dedicated to broker training on fair, nondiscriminatory, responsible lending and other aspects of the mortgage industry
	TeamOne Associate Training Programs on ethics, fair lending, fraud detection as well as best practices and core processes
Awards:	Irvine Chamber of Commerce Business of the Year 2003
	OC Metro Best Places to Work 2004
	City of Irvine Family Friendly Award 2005

Reputation:	Option One is known for its unique culture of empowerment, generous benefits, and profit-sharing programs, and its commitment to uphold our ethical values. This translates into a committed and engaged associate workforce that provides our customers with a high level of service and satisfaction.
Geographic reach:	National (see Appendix H)
Headquarters:	Irvine, Orange County, California
Employees:	Approximately 5,500

COMPANY CULTURE

Option One's founders recognized the importance of developing and nurturing the right culture. That's why, before starting our company, they determined what kind of organization Option One would be. The foundation of the company's unique culture – its mission, vision and values – foster an environment of responsible lending.

Vision

To be widely recognized as the premier provider of innovative financial products and services.

Mission

To provide quality financial products and services that create value by achieving superior customer satisfaction and sustainable financial returns in a challenging and rewarding environment for our associates.

Values

- Do what is ethical, fair and makes good business sense.
- Do our best.
- Treat others as we want to be treated.
- Stimulate, anticipate and embrace change.

The key elements of this culture, in addition to the values above, are as follows:

- Recognizing that people are our most valuable asset.

- Empowering our associates to make decisions and recommendations that positively impact their jobs and our customers.

- Embracing change.

- Embracing diversity.

- Committing to continuous improvement of our products and services, with our focus on quality, not quantity.

- Basing our business on a customer-managed relationship; i.e., customizing our services to enable customers to have options on how, when, and where they conduct business with us.

The results of this commitment to the right culture are significant. Option One is widely recognized in the residential mortgage industry for its unique culture – a culture that sets it apart from other companies. According to research conducted by Mercer, 93 percent of associates say they are proud to work for Option One. And, of equal or even greater importance, Option One has built a high level of trust with our customers through our open and transparent communication with them. We continue to learn from them so we can serve their needs with the right products and practices.

OUR COMMITMENT TO BEING A GOOD CORPORATE CITIZEN

Commitment to Living Our Values

Each year Option One associates recommit to the company's values by signing the company's Code of Business Ethics & Conduct, which covers everything from privacy of customer information to abiding by all laws and regulations.

Training

The company has an extensive training program that includes online and classroom study in specific job skills by discipline as well as:

- Fair, nondiscriminatory lending
- Responsible (non-predatory) lending
- Fraud prevention and detection
- Professional conduct

Associate Compensation

Associates, with the exception of sales associates, participate in profit sharing, thus motivating everyone to serve their customers, internal or external, in the interest of continuing to generate a high-quality loan portfolio. Associates involved in loan sales receive commissions. Significantly, <u>no overages are paid to either account executives (wholesale) or loan officers (retail) for originating loans that have a higher-than-par yield,</u>

nor is additional compensation paid to them for originating loans that have prepayment charge provisions.

Commitment to Responsible, Nondiscriminatory Lending

An inherent, well-engrained part of Option One's values and culture is doing what is right and ethical, and treating others how we want to be treated. As a result, fair and responsible lending comes naturally to Option One. But we don't just let our intuition guide us. Option One has fair lending training for all associates so people understand where inadvertent pitfalls may lie. We also have processes in place described in more detail in our Fair Lending Best Practices (see Appendix B) to reinforce responsible lending throughout our company.

Option One's commitment to fair lending includes, among other things, the following practices:

- We make loans only when there is a benefit to the borrower.

- We lend on a nondiscriminatory basis. We comply fully with the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, and the Equal Credit Opportunity Act.

- We offer customers the lowest interest rate and best product they qualify for in the channel in which they apply.

- We do not offer loans that contain mandatory arbitration, single premium credit insurance, or loans defined as high cost mortgages under applicable federal, state or local laws.

- We don't solicit customers in our servicing portfolio for refinances.

- We allow borrowers the choice of a loan with or without a prepayment penalty. Loans with prepayment penalties come with a lower rate or lower fees.

- We encourage our customers to apply for escrow accounts.

- We make every attempt to keep customers in their homes. Foreclosure is a last option when other alternatives have been exhausted.

Loans Option One Does Not Make

- Loans considered high-cost under federal, state or local law
- Stated income loans to fixed income borrowers
- Loans where the borrower does not have the ability to repay
- Loans with increasing interest rates after default

In addition, Option One does not disburse funds to contractors for home improvement loans. All funds are given directly to the homeowner.

Commitment to Embracing Diversity

The company formalized its long-standing commitment to diversity in 2003 by forming a Diversity Council, which has the goal of embracing diversity in all aspects of our business. At Option One diversity means inclusion – accepting and appreciating differences, while identifying those ways in which each of us is similar.

Not only is fostering diversity the right thing to do, it is also key to remaining competitive and making our organization an even more successful business. Embracing diversity:

- Helps attract and retain the most talented people.
- Enables better decisions and provides fresh perspectives for solving problems and responding creatively to customers' changing needs.
- Increases our ability to relate to, understand and, therefore, better serve our diverse borrowers.

Acting on our values impels us to appreciate diversity in its many forms, including differences in race, color, religion, national origin or ancestry, gender, marital status, sexual orientation, handicap status, familial status or age. Our appreciation of diversity guides how we recruit and develop associates, and how we work together to serve the needs of our customers for mortgage products and services.

Diversity Scholarships

The company's Diversity Council recently awarded 12 associates with diversity scholarships to MBA's School of Mortgage Banking to help them further their careers. Scholarships were awarded based on essays in which associates described their personal and professional commitment to fostering diversity. A similar program is in development for Option One's independent mortgage brokers.

Option One diversity scholar accepts congratulations from other associates.

Commitment to Supporting Financial Literacy

Option One wants customers to understand the loan process because it is in everyone's best interest that borrowers make informed decisions. That's why the company supports organizations that promote financial literacy, from kids in Junior Achievement programs to non-profits that help adults improve their credit scores. These include:

BorrowSmart

The BorrowSmart Education Foundation (www.borrowsmart.org) is a non-profit organization with particular focus on helping both consumers and credit counselors understand the risks, rights, and responsibilities involved in borrowing against the equity in one's home.

Jump$tart

The Jump$tart Coalition for Personal Financial Literacy (www.jumpstart.org) advocates on behalf of educating young adults about financial matters. The Jump$tart Coalition believes that all young adults need to have the financial literacy necessary to make informed financial decisions and urges the inclusion of such information in school curricula.

Don't Borrow Trouble

This Freddie Mac-sponsored program (www.dontborrowtrouble.com) teaches homeowners how to avoid predatory lending practices. At the invitation of Freddie Mac, Option One participates in forums throughout the country on the panel "The ABC's of Subprime Lending."

Stop Mortgage Fraud

Through its involvement with the Mortgage Banker's Association (MBA), Option One also supports Stop Mortgage Fraud (www.stopmortgagefraud.com), an educational Web site where borrowers can learn their rights and how to report abusive lending practices.

Commitment to Giving Back to Society

Lending Hands is the company's non-profit giving and volunteer program. It is a tangible expression of the company's culture and values. As a residential mortgage lender, Option One helps strengthen communities through homeownership. We view community involvement as another important way we can make a difference where we live and work. We do this by supporting local civic organizations, including fire and police, and through our work with non-profit organizations.

Empowerment is a core value of Option One, so we work with partners in our primary focus areas of housing, education, and health and human services that share our desire to strengthen the community by empowering others. These partners are:

Habitat for Humanity – where we continue our mission of helping hard-working, deserving people acquire homes of their own. We have built homes in communities across America including:

Huntington Beach, California
Stanton, California
Santa Ana, California
Fairfax, Virginia
Orlando, Florida
Westminster, California
Columbus, Ohio
Detroit, Michigan
Costa Mesa, California
Boston, Massachusetts
Charlotte, North Carolina
Jacksonville, Florida
Bellevue, Washington
Philadelphia, Pennsylvania
Dallas, Texas
Nashville, Tennessee
Cypress, California (building begins summer 2005)

We have also participated in and supported MBA builds of Habitat homes in San Diego and Daly City, California.

Option One associates and friends prepare to build a Habitat house.

Junior Achievement – where we help train America's future business leaders including early financial literacy education. Our activities include the following:

- Bowl-a-thon – In 2003, associates raised enough money at this annual event to support the participation of more than 1,700 students in JA for one year.
- Pinnacle Award – For three years in a row, Option One has received this JA award for the most funds raised in its business category.
- Job Shadow Day – Option One hosts students at the corporate office for this annual event in which kids learn about future career opportunities.
- JA in a Day – Option One associates provide financial sponsorship and staffing for this classroom-teaching day at a local school. Option One associates instruct students using JA's curriculum, which covers topics such as financial literacy, good citizenship, and business economics.

Volunteer Center of Orange County (California) **–** where we have a variety of opportunities for our associates to find causes that match their personal passions. Option One associates' participation in Health and Human Services endeavors includes, but is not limited to:

- The American Cancer Society's Daffodil Days campaign
- Susan G. Komen Breast Cancer Foundation
- United Way
- Red Cross
- Mentors for Youth
- AIDS Walk Washington, D.C.
- The Orange County Rescue Mission

- National Multiple Sclerosis Society
- Give Kids the World
- Orangewood Children's Foundation
- March of Dimes

HOW WE DO BUSINESS

Option One is in the business of making, servicing, and selling nonprime loans.

Nonprime Defined

Option One considers a residential mortgage loan to be nonprime if it does not meet the guidelines of a conforming lender – in essence, the guidelines of Fannie Mae and Freddie Mac for what constitutes a prime loan.

Making Loans

Option One's open and fair approach to lending helps people achieve homeownership or use their home equity to improve their lives.

Option One originates loans on a wholesale and correspondent[1] basis through a network of 34,000 approved brokers and through relationships with national financial institutions. The company originates retail loans through its subsidiary H&R Block Mortgage Corporation.

Loans funded since inception:	$96 billion as of April 30, 2005
Borrowers since inception:	706,000 as of April 30, 2005

Servicing Loans

Option One's expertise in servicing nonprime loans is one of its strengths. The company services its own loans as well as those of other national lenders.

Current Servicing Portfolio:	Approximately $67.7 billion assets under management comprised of more than 420,000 customers as of April 30, 2005 (including sub-served loans)
Ratings:	Highest rated nonprime loan servicer – Fitch's, Moody's and Standard & Poor's
Servicing offices:	Irvine, California, and Jacksonville, Florida

[1] A correspondent is a lender who closes loans with their own funding sources and sells the loan to Option One.

Selling Loans

Option One has a consistently strong portfolio of loans that has earned the trust of institutional and individual investors. With loan data going back to 1994, Option One continually improves its processes and is able to anticipate how its loans will perform over time. Selling loans provides additional capital to fund more loans, thus providing opportunities for more borrowers.

Loans are sold through:

- Securitizations, in which Option One retains a percentage of the ownership
- Whole loan sales

Servicing options on sold loans:

- Option One retains the servicing
- Servicing is released to the purchaser

Loans Originated by Option One in 2004

The following chart summarizes Option One's loan characteristics:

OPTION ONE'S 2004 LOAN PRODUCTION (Calendar Year)				
Loans Originated			**Average Loan Size**	
Number of Loans	159,949		First Mortgage	$169,867
Dollar Value of Loans	$24,735,094,529.86		Second Mortgage	$40,030
Product Types			**Averages for First Mortgages**	
Fixed Rate	34,945			
6-Mo. Adjustable*	124			
2-Yr. Adjustable**	99,398		Debt-to-Income Ratio	39.12%
3-Yr. Adjustable***	6,727		Loan to Value Ratio	77.85%
Seconds	18,755		FICO Score	608.73

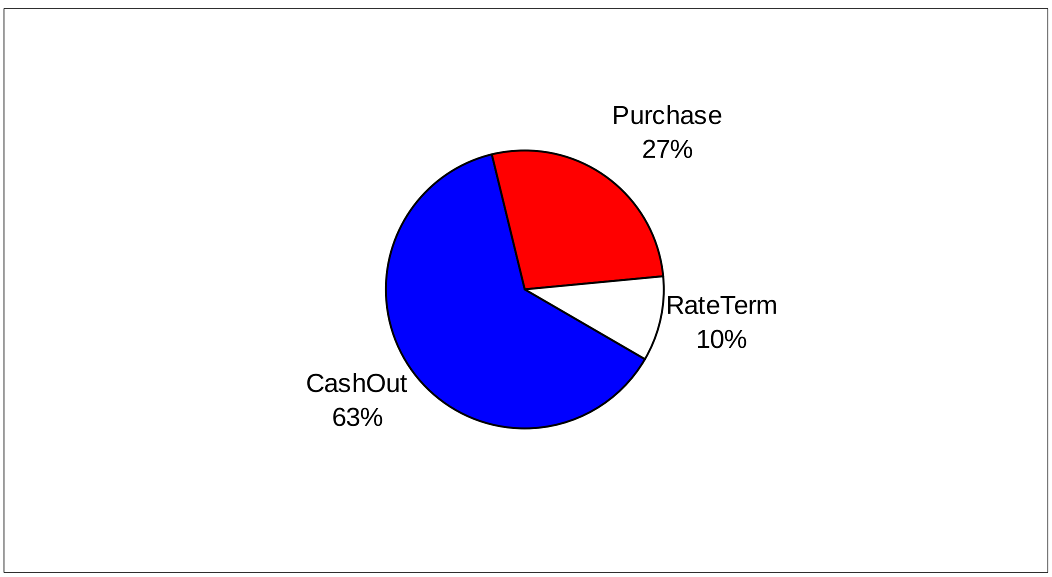
* fixed for 6 months then adjustable for the remaining 354 months
** fixed for 2 years then adjustable for the remaining 28 years
***fixed for 3 years then adjustable for the remaining 27 years

Purposes of Loans Made

Nonprime credit has helped many first-time home buyers take advantage of the burgeoning real estate market to begin building their wealth. More than one quarter of all Option One loans made in 2004 were for home purchase.

As in the prime market, 73 percent of Option One's borrowers have refinanced to take advantage of lower interest rates and to tap into some of the financial wealth in their homes.

PURPOSE OF LOAN
STATED BY OPTION ONE BORROWERS
IN 2004



Common reasons for nonprime borrowers to obtain cash out of their home include:

- Property improvements such as repairs and remodeling
- Sending their children to college
- Paying off higher-interest consumer debt
- Investing in a business
- Paying healthcare costs
- Buying a car
- Lifestyle purchases

Profile of Our Borrowers

Option One has made more than 706,000 loans since its founding in 1992. Our borrowers look much like your neighbors:

	2002 Fundings	2004 Fundings	Since Inception
Average Age	43.17	43.02	43.21
Annual Income	$60,999	$64,459	$60,591
Years in Home	6.34	6.59	6.19
Years in Job	7.48	7.27	7.32
Years in Profession	11.14	10.78	11.00
Property Type (SFR and PUD)*	85%	85%	85%
Year Home Built	1959	1963	1970
Average Square Feet	1693	1679	1679
Average Number of Bedrooms	3.3	3.3	3.3
Average Number of Bathrooms	1.8	1.9	1.8

* SFR = single family residence and PUD = planned unit development

Demographics

Our borrowers are diverse and have diversity characteristics similar to the general population as shown in the chart below. (For information about the general population, see Appendix A under Nonprime Borrower Demographic Profile.)

Option One Borrower Race & Ethnicity Statistics for 2004

Race	2004
American Indian or Alaskan Native	0.85%
Asian or Pacific Islander	2.00%
Black	14.20%
Native Hawaiian or Other Pacific Islander	0.52%
White	65.15%
Other	0.18%
Information Not Provided by Applicant	17.09%

Ethnicity	2004
Hispanic or Latino	12.80%
Not Hispanic or Latino	65.76%
Ethnicity Not Available/Not Provided	22.10%

Option One Borrower Age Statistics for 2004 Fundings

Age Range	% of Option One Borrowers
NA	1%
<20	0%
20-30	13%
31-40	31%
41-50	31%
51-60	17%
61+	7%

Our Lending Philosophy

Option One's overall lending philosophy is quality over quantity. This ranges from our underwriting and pricing policies to our customer service and loan servicing.

Conservative Underwriting

Our goal is to help people achieve the dreams made possible through homeownership. A borrower's ability to afford to pay back their loan is a key element of achieving this dream. To help facilitate this, Option One employs a conservative approach in our underwriting standards. In fact, 29.3 percent (based on 2004 submissions) of those who apply do not qualify for an Option One loan.

Underwriting considerations include:

- Credit – Option One offers the borrower the best loan program available in the loan channel in which they apply

- Capacity

    - The borrower must have the ability to repay
    - Fixed income borrowers are qualified at the fully indexed rate (The index plus the margin, rounded to the next highest eighth, equals the fully indexed rate.)

- Collateral – Determination if the collateral is accurately valued through appraisals

- Benefit – Determination that the loan will benefit the borrower

Borrower Benefit

All loans must benefit the borrower. There are a variety of factors that determine borrower benefit, but the most important is that we scrutinize loans carefully if there have been multiple refinances in the last 24 months to ensure the borrower is not eroding their equity.

To ensure our underwriters make decisions that are in the borrower's best interest, we have established a mandatory training on borrower benefit for all of our underwriters. While benefit is determined on a case-by-case basis, factors considered in determining benefit include:

- Rate
- Loan type
- Cash received
- Eliminating a financial hardship
- Net costs of the new loan recouped in 48 months
- Meaningful reduction in overall payment savings
- Multiple refinances in the last 24 months
- Amortization period
- Refinancing a land contract and putting the property in the borrowers' name

Also, Option One does not refinance special mortgages (usually a subordinate lien that has a provision where after a certain period of time the balance may be forgiven or there is a subsidized loan rate) unless there is a demonstrated overwhelming benefit to the borrower.

Decentralization

Option One has a unique position with respect to underwriting practices; it is largely decentralized. Regional underwriters report directly to corporate Lending Operations, so there is no untoward influence from branch managers or other local associates on underwriting decisions.

This has the following advantages:

- Provides better customer service because the underwriter is closer to the borrower
- Provides deeper knowledge of the local market to help facilitate decision making
- Enables decisions to be made at the local, customer level

Risk-Based Pricing

Risk

Option One categorizes prospective borrowers into risk grades based on several factors including the following:

- Credit score
- Mortgage or rental payment history
- Income documentation
- Loan-to-value ratio
- Debt-to-income ratio

The following chart shows 2004 mortgage loans originated by credit scores:

2004 Calendar Year Option One Mortgage Origination by Credit Score	
Credit Range	
No Score	1.39%
<500	0.06%
500-539	14.63%
540-579	16.17%
580-619	24.66%
620-659	24.44%
660-699	11.84%
700+	6.81%
Total	100.00%

More than 61 percent of Option One's borrowers rank in the least risky grades, AA+ and AA. Those in the top category are close to prime but they have other considerations that preclude them from getting a prime loan such as debt ratios, income documentation issues, or they request a higher loan-to-value than is allowed by prime lenders.

Borrowers in the lower grades such as C and CC typically have credit issues such as late mortgage or credit card payments. Many borrowers are able to use their Option One loan to improve their credit records and eventually move on to a prime loan. For this reason, Option One reports to all three credit bureaus monthly to help borrowers bolster their credit ratings.

The following chart provides a breakdown of Option One's 2004 borrowers by risk grade.

2004 Calendar Year Option One Mortgage Originations by Risk Grade	
Risk Grade	
AA+/AA	61.32%
A	25.92%
B	8.47%
C	2.84%
CC	1.45%
Total	100.00%

Pricing Considerations

Pricing, based on the risk categories above, is also influenced by a variety of other factors including the following:

Credit scores – used as a factor to determine the risk grade; however, there can be significant variability of credit scores within the risk grade. A borrower categorized as AA with a high credit score could receive a rate as low as 5.05 percent (as of May 2005).

Income documentation – AA borrowers who are able and willing to provide full documentation of their income can receive an interest rate as low as 5.05 percent (as of May 2005). Borrowers in limited or stated income documentation programs may pay rates that are 40 to 100 basis points higher, depending on their credit score and the loan-to-value ratio.

Loan program – Option One offers the borrower the best loan program available for their credit rating. Our most common product is a 2/28 adjustable rate mortgage (two years fixed, adjustable thereafter). The lowest rate for this loan is 5.05 percent. However, if a borrower prefers a 30-year fixed loan, the rate is 6.05 percent. (Rates cited as of May 2005.)

Loan size – Origination costs are fixed regardless of the size of the loan, however in some cases, Option One is able to offer a lower rate on larger loans.

Loan-to-value (LTV) ratio – The higher the LTV, the greater the risk; therefore, loans with lower LTVs are priced at lower rates.

Property type (single-family home, condominium, other) – Single-family homes and owner-occupied properties present lower risks; therefore, Option One rates may increase 0.4 to 1 percent if a property is not owner occupied, is a condominium, a rural property, or a three-to-four unit property.

Points – To help borrowers who do not have a lot of cash, Option One offers the option to pay a higher interest rate in exchange for lower points. When a broker offers this option to a borrower, it results in Option One paying the broker a yield-spread premium (see more about this on page 26 and in Appendix D).

Prepayment penalty – As described previously in this document, borrowers who agree to accept a prepayment penalty (no more than three years with the most common term being two years) may receive a lower interest rate. Also, we do not have prepay periods extend into the adjustment period on 2/28 adjustable rate mortgages.

The following chart summarizes Option One 2004 originations pricing by credit risk grade. More than 61 percent of Option One's borrowers rank in the highest two categories of AA+ and AA.

Option One 2004 Calendar Year Originations
Pricing by Risk Grade

Risk Grade	% of Originations	Weighted Avg Interest Rate	Weighted Avg APR	Weighted Avg FICO	Weighted Avg Points & Fees*
AA+/AA	61.32%	6.93	7.44	625.39	2.59%
A	34.29%	7.11	7.49	598.63	2.99%
B	8.47%	7.93	8.43	547.54	3.14%
C	2.84%	8.68	9.30	545.71	3.22%
CC	1.45%	9.72	10.37	549.57	3.32%

* Includes both Option One and broker points and fees paid by the borrower, but excludes third-party pass- through fees, such as appraisal, title insurance, and public official fees.

Having the Right Relationship with Reputable Mortgage Brokers

Option One works with more than 34,000 approved mortgage brokers. We expect the same values and ethical standards of these mortgage brokers as we do our own associates. We have several programs to maintain awareness of our standards and educate brokers about nondiscriminatory, responsible lending activities.

Broker Screening

Option One initially obtains a copy of the broker's license and verifies its validity. Licenses are again verified at the time of license renewal. Additionally, our Broker Approval Department runs background reports on all new broker applicants and their principals. We will not do business with a broker unless he or she has a valid license and passes our background check.

Although we believe that the vast majority of brokers are ethical, Option One maintains a strong fraud prevention and detection program to protect borrowers, as well as our company, against fraud. (For more information, see Appendix E)

Mortgage Broker's Pledge to Option One

Option One requires brokers to sign the *Broker's Commitment to Responsible Lending* (Appendix C). Some of the key commitments our brokers must make are as follows:

- *We affirm that our primary obligation is to act in the best interest of the borrower.*
- *We will always carefully analyze the Borrower's financial situation and true ability and willingness to repay the loan.*
- *We will not knowingly submit an application for a nonprime loan for a borrower who is eligible for, and whose needs are best met by, a prime loan.*
- *We will always operate in full compliance with all federal and state lending requirements – including disclosing all fees on the GFE and HUD-1.*
- *We will always comply with state and federal fair lending and non-discrimination laws. (We acknowledge and share Option One's commitment to abiding by both the spirit and letter of all fair lending laws and practices.)*
- *We will always, to the very best of our ability, ensure that each and every loan submission contains NO false or misleading information.*
- *We acknowledge and agree with Option One's Best Practices*.

Broker Watch List

All new brokers are automatically placed on a watch list for at least their first five loan submissions, ensuring their loans will be underwritten by a senior underwriter and specially scrutinized. In addition, established brokers who are suspected of fraud or whose loans are not performing as expected (e.g., high rate of default) are placed on a watch list and their loan applications are likewise scrutinized.

Fair Lending Education

Option One University is dedicated to training brokers in fair lending, fraud prevention and best practices in the mortgage industry. Courses are offered online and in person at locations throughout the nation. Some courses are certified for continuing education credit.

In addition, Option One partners with Campus MBA, part of the Mortgage Bankers Association, to sponsor additional ongoing educational opportunities for brokers. For example, last year Option One worked with the MBA on the "Creating New Customers" program, which provided brokers with a financial literacy education toolkit to host seminars in their communities. Broker training sessions and materials were offered in both English and Spanish.

Option One's *IQ Report* is a quarterly publication distributed to all of the company's brokers. Its mission is to educate brokers about fair lending practices as well as other industry issues.

Credit counselors and students attend an Option One-sponsored BorrowSmart program.

Broker Compensation

Option One's goal in broker compensation, as in all aspects of the loan transaction, is to make the process as transparent and understandable as possible to the borrower. Like the rest of the mortgage industry, one of the ways brokers doing business with Option One may be paid for the service they provide to borrowers is through yield spread premiums (YSP).

Option One makes YSPs available in a way that is faithful to our commitment to making the transaction transparent to the borrower. To educate our borrowers about all aspects of their loan, including YSPs, we have added full, plain-language, consumer-friendly disclosures about YSPs to our existing, strong initial disclosure process. We encourage borrowers to ask their broker or lender to show them how different combinations of rates and points might work in their favor. And the disclosure for loans that include a YSP clearly indicates the interest rate and the dollar amount paid to the broker for compensation. (See Appendix D for more information.)

Detecting and Preventing Fraud

Option One takes fraud prevention and detection very seriously and has a fraud program that is considered a model in the industry. Details of this program are in Appendix E, but highlights of the company's accomplishments are as follows:

- Created a Barred Individuals List to track individuals with whom Option One will no longer do business. This provides a control in case a bad loan officer moves to another company.
- Established a senior level Fraud Committee to provide oversight into fraud prevention and detection and also established a working committee to assist in operational issues pertaining to fraud management.
- Enhanced our broker approval process to include Lexis-Nexis reports on new brokers and their principals.
- Significantly increased staffing in Risk Mitigation, Option One's fraud investigation unit.
- Hired an Assistant Vice President, Portfolio Risk, who has a background in law enforcement and fraud investigations. The AVP has responsibility for the Risk Mitigation department and reports directly to the Chief Risk Officer.
- Instituted a corporate audit process whereby corporate auditors review files from brokers with high delinquency characteristics.
- Tested several front-end fraud detection systems and made a vendor selection (roll out will likely be mid-2005).

- Enhanced “red flags” training of branch and servicing associates.

- Enhanced the quality control program to incorporate lessons learned from fraud trends.

- Hired a Fraud Reporting Specialist to report fraud cases to state regulators and law enforcement agencies.

- Educate outside parties on fraud. For example, we are working with state regulators and law enforcement agencies to educate them on fraudulent schemes and methods of detecting fraud. Also, we have spoken at various industry conferences on fraud. And, we are in the process of developing a broker ethics course which will be offered through Option One University.

Servicing Loans with Borrower-Friendly Best Practices

Servicing Philosophy

As a residential mortgage servicer, we know that homeownership is the cornerstone of the American dream and we recognize its importance in building wealth and improving the lifestyles of families throughout our nation.

Option One plays a significant role in the housing market and we understand our obligation to make our services as easy to understand as possible for the consumer. Further, as an equal opportunity lender and servicer, we know how much our customers rely on us for honesty, fairness and a dedication to serving their best interests. We have made a commitment to serve our customers well.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive servicing practices, which harm not only consumers but also affect the reputations of all servicers. As responsible mortgage bankers, we comply fully with all mortgage-lending laws. These include the Fair Debt Practices Collection Act, the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, and the Equal Credit Opportunity Act.

When we created our Best Practices in Servicing (Appendix F), we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time and work to advance their understanding of the mortgage lending process.

As a top-rated residential mortgage servicer of non-prime loans, our role is to provide a high level of support and service offerings to our customers. All of our services are designed to service our customers when and how they need it. We offer a full array of services including a call center operation that is open 7 days a week, 24 hours a day; telephone automated services; and Internet self service. And, we take great care to work with customers who experience a challenge or are in trouble in meeting their mortgage financial obligations. To this end, we offer many options for borrowers including extended repayment plans, loan modifications, and reduced payoffs.

Reaching Out to Borrowers

Option One also invests in various outreach programs. For example, Option One is involved with the Home Ownership Preservation Initiative (HOPI) program in Chicago. This public-private partnership between lenders, the City of Chicago, and non-profit Neighborhood Housing Services of Chicago, Inc. (NHS) is destined to become a model of best practices throughout the nation. Among the program's activities is a direct mail campaign that targets high-foreclosure areas of the city for outreach about the city's 311 non-emergency hotline that will connect borrowers with free counseling services. Option One is involved in similar programs in Detroit and Dallas and is looking to bring such programs to Ohio and Philadelphia.

Recently Option One representatives went to Ohio to meet with troubled borrowers in person. This resulted in beneficial outcomes for both parties involved. In addition, Option One is working with Loan Cure, an organization that serves as a third-party to reach out to delinquent borrowers to bridge communication between the borrower and lender.

When all remedies to the customer have been exhausted, a foreclosure action may occur. A foreclosure typically results in a significant financial loss for both the customer and Option One.. For Option One loans, our experience is that the loss is over 40 cents on the dollar of the remaining principal amount of the loan when a foreclosure occurs.

In a recent benchmarking scorecard using January 2005 data, our foreclosure cure rate (comparing Option One results to multiple non-prime servicing competitors) was the top ranked. This means that Option One had more loans successfully cure than our peer's. The benchmark scorecard was completed by an independent third party (Loan Performance) and measured securitized loans.

Positive Recognition from the Rating Agencies and National Leaders

Our servicing platform is highly rated by all three major financial rating agencies and holds a reputation in the marketplace of being the best. Our success is driven by our strong commitment to doing it right. We track and measure a multitude of key performance metrics and benchmark our performance with the industry to strive for even better results and services for our customers.

In response to publishing our updated best practices last year, Option One received positive feedback from national leaders:

"We appreciate the steps Option One has taken to affirmatively prevent unfair lending practices and its commitment to ensuring its broadest possible compliance with local, state, and federal laws. The company's best practices for both the origination and servicing of loans set an example we hope the rest of the mortgage lending industry will follow."

– Shanna Smith, President and CEO of the National Fair Housing Alliance

"Option One's best practices policy is clear, concise, and most importantly, consumer friendly. We are especially pleased with the company's significant emphasis on the importance of escrow accounts. Sub-prime borrowers need escrow accounts as much as, if not more than, any other borrower."

– Ricardo Byrd, Executive Director, National Association of Neighborhoods.

"Option One's enhanced set of best practices is a commendable step forward in fair lending and responsible servicing. In particular, the prohibition on mandatory arbitration serves as a model for where the whole industry needs to go. Regarding servicing practices, Option One's commitment to support post origination loan counseling and to use escrow accounts should be applauded. Escrow accounts help prevent loan delinquency for cash-strapped borrowers and avoid sometimes very expensive force-placed insurance."

– *John Taylor, President and CEO of the National Community Reinvestment Coalition*

Our commitment is to continuously improve how we make and service home loans.

APPENDIX A

A NONPRIME LENDING PRIMER DISPELLING SOME COMMON MYTHS

Option One helps Americans achieve the dreams made possible through homeownership. This includes owning a home and building wealth and equity that enables people to:

- Send their children to college
- Refinance high-rate consumer debt to reduce their overall payment burden so they can manage their family budget
- Make home improvements to further increase the value of their property
- Start a business

There are many myths and misunderstandings about nonprime loans and borrowers. The following is designed to clarify some of the more common misconceptions and to indicate the positive contributions nonprime mortgage lending makes to our nation.

Fact: Homeownership builds strong communities.

According to a study conducted by the Hudson Institute[2]: “It has long been felt that the benefits of becoming a homeowner are not limited to the new owner, but also spill over to other members of society. Spillovers that are commonly cited include the fruits of greater participation in civic affairs, reductions in crime, and improved scholastic performance of children.”

“These studies of investing in the local community provide rather strong evidence that homeownership generates external benefits for the community. In effect, the act of buying a home causes the homeowner's incentives to become more closely aligned with the community's, encouraging him to engage in activities (e.g., local memberships, local problem-solving) that benefit the community as well as the homeowner.”

Fact: Homeownership is one of the best ways to build personal wealth.

Franklin D. Raines, former chairman and CEO of Fannie Mae stated this well in a 2002 speech titled Harnessing the Mystery of Capital; Closing the Wealth Gap: “Owning a home is the working man and woman's capital engine, the democratization of capital. Owning a home is the only investment – and the only leveraged investment – available to most Americans. It is a powerful way to transmit wealth from generation to generation."

[2] “External Benefits of Homeownership” William Shew and Irwin M. Stelzer of Hudson Institute, February 2004.

According to a study at the University of Southern California[3]: "…[H]omeownership comprises a primary investment vehicle of American households; in that regard, elevated homeownership among minority households undoubtedly would serve to boost their wealth and economic status."

Thanks, in part, to nonprime lending, homeownership is at an all time high – 69 percent according to the National Association of Realtors. And minority homeownership is higher than ever also – 49 percent for African Americans, 47 percent for Hispanics, 58 percent for Asians, Pacific Islanders and Native Americans.

Fact: Nonprime loans offer individuals opportunities for homeownership and wealth building that the prime market does not. By expanding access to credit, you expand opportunities for individuals who do not qualify for traditional loans.

Fact: Many people have less-than-perfect credit records that disqualify them from a prime loan often due to a life event such as a job loss, divorce, disability or death in the family.

Fact: More women and minorities have difficulty qualifying for prime loans due to less wealth, life events described above as well as things like lack of an extensive credit record or limited employment history.

Fact: Many people use their nonprime loan to build a strong credit record and then move on to a prime loan after two or three years. In other words, nonprime mortgage loans can be the bridge for helping borrowers improve their credit worthiness.

Fact: Many nonprime borrowers have excellent credit records but are seeking loan terms that fall outside the guidelines of conforming lenders such as:

- They are self-employed
- They have multiple sources of income
- They have non-traditional sources of income
- They loan they seek has a high loan-to-value

Foreclosure

Misconception: Lenders foreclose on troubled borrowers at the first sign of a problem.

Fact: Lenders take great care to work with borrowers who are challenged to meet their financial obligations. There are many options for borrowers including extended repayment plans, loan modifications and reduced payoffs. Typically, a foreclosure proceeding will

[3] Stuart Gabriel and Gary Painter, Lusk Center for Real Estate, Marshall School of Business and School of Policy, Planning, and Development at the University of Southern California.

not begin until a borrower has no other means of catching up and is at least three payments behind.

Misconception: Lenders have a financial incentive to foreclosure on properties.

Fact: On the whole, lenders lose money on foreclosures. Generally, the losses amount to tens of thousands of dollars per loan (e.g., over 40 percent of the principal balance). Lenders want to keep borrowers in their home. It is in everyone's best interest.

Like many nonprime lenders, Option One has many programs to reach troubled borrowers. In fact, Option One pays for credit counseling for some borrowers and can directly connect the borrower to a third-party professional credit counselor. In some cases, Option One is able to revise loan terms to help a borrower get through a difficult period.

Option One also invests in various outreach programs as noted earlier.

<u>Prepayment Penalties</u>

Misconception: Loans that charge a prepayment penalty if the borrower repays the loan soon after it was made are a disadvantage to borrowers.

Fact: Many borrowers prefer a loan with a prepayment penalty because it reduces their interest rate or their points and fees associated with the loan, resulting in their paying significantly less for their loans overall.

Following are key points about prepayment penalties:

- For Option One borrowers opting for a loan with a prepayment penalty provision, the provision only lasts for the first two or three years of the loan.
- Option One offers loans with and without a prepayment provision so the borrower always has a choice.
- Option One provides a clear disclosure about prepayment penalties in plain-language, consumer-friendly documents.
- Many borrowers use these two-to-three years to build their credit record to qualify for a prime loan at a lower interest rate. In fact, Option One reports to credit agencies monthly to help borrowers build strong credit histories.
- Prepayment penalty provisions make the loan more attractive to investors because it gives more certainty to expectations of a loan staying on the books and ensuring the investor will receive their anticipated return. Investors therefore will pay a higher premium for loans with prepayment provisions and this allows the lender to offer the borrower a lower rate.

- This is very attractive for people who know they are going to stay in their homes for several years.

Nonprime Borrower Demographic Profile

Misconception: Nonprime borrowers are vulnerable populations such as the elderly, immigrants or minorities.

Fact: Nonprime borrowers reflect the general population.

Ethnicity

SMR Research,[4] one of the leading national third-party firms that collects and reviews industry data, found after analyzing year 2002 HMDA data and 2000 Census data that the ethnic breakdown of nonprime lending was the following:

Ethnic Breakdown of Nonprime Lending

Ethnicity	% of total population	% of nonprime borrowers
White	68.2	62.5
Hispanic	13.7	14.6
African American	11.9	13.2
Asian	3.7	3.9
Native American	0.7	0.6

Age

In an analysis of age and nonprime lending, SMR Research states that although, "the oldest homeowners have the lowest incomes of any homeowner group….The subprime share of the market is greatest by far where the elderly concentration is lowest."

"In summary, the subprime lender share of the market is highest in census tracts where elderly borrowers are least concentrated (0 to 1% of borrower). Subprime share is lowest where elderly borrowers are most concentrated (more than 50% of borrowers). Rather than 'targeting' the elderly, these data seem to prove the reverse."

Income

According to SMR Research 2002 data:
Prime borrowers' average annual income: $87,184
Nonprime borrowers' average annual income: $71,509

[4] SMR Research Corporation, "Predatory Lending: A New Study of Unfair Lending Accusations" (2004).

APPENDIX B

FAIR LENDING BEST PRACTICES

When we began our business in 1992, we started by creating a strong foundation. Even before developing a business plan, we established a set of values that we live each day. Our associates and our customers test everything we do against these values:

Do what is ethical, fair and makes good business sense.
Do our best.
Treat others as we want to be treated.

As residential mortgage lenders, we focus on helping our borrowers achieve the dream of homeownership or other important dreams, such as paying down high-interest credit-card debt, sending their children to college or remodeling their homes to increase their value for current enjoyment or future sale. We believe in homeownership as an important step in building wealth and improving the lifestyles of families throughout our nation.

Our commitment is to make our loans available to diverse communities and customers on an equal opportunity basis. We lend without regard to race, color, religion, national origin or ancestry, gender, marital status, handicap status, familial status, age (as long as the applicant is able to enter into a binding contract), receipt of public assistance, or the exercise of rights under the Consumer Credit Protection Act.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive lending practices, which harm not only consumers but also affect the reputations of all mortgage bankers. As responsible lenders, we comply fully with all mortgage-lending laws. These include the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act and the Equal Credit Opportunity Act.

When we created our Best Practices in Origination, we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time for mortgage products and services.

Serving You Right From The Start

At Option One and H&R Block Mortgage, our belief is that making good loans – loans that offer clear benefits -- to informed borrowers is the right thing to do.

Understanding How the Mortgage Process Works

We want you to be comfortable with the home-loan process and knowledgeable about your options so we start by providing educational information on various loan options before you even choose a loan. When you apply for a loan with us – whether through a mortgage broker or one of our loan officers – you receive a brochure that explains the lending process, definitions of key terms and information on contacting HUD-approved credit counseling agencies.

We are committed to financial literacy and support organizations such as:

- BorrowSmart (www.borrowsmart.org), a nonprofit educational foundation that specializes in helping consumers understand what to consider when refinancing a home loan.
- JumpStart (www.jumpstart.org), a nonprofit foundation that focuses on ways to increase the financial knowledge of young people.
- Don't Borrow Trouble (www.dontborrowtrouble.com), a program that is dedicated to increasing consumers' financial literacy, especially in understanding the risks, rights and responsibilities involved in taking out a home equity loan.
- Junior Achievement (www.ja.org), a nonprofit organization dedicated to educating young people about business, economics and free enterprise. Option One associates support Junior Achievement's programs for young people in the classroom.

In addition to our materials, we recommend you consult these sources for information.

Making Sure Loan Requirements Are Met

Based on the information you have provided on your application, we work hard to see that you are able to repay your loan and that the terms of the loan are appropriate for your particular situation.

This includes:

- Offering products that meet diverse credit profiles and incomes.
- Determining that you are able to repay the loan by:

    - Verifying sources of fixed income.
    - Verifying disposable income in cases where debt payment already exceeds 45 percent of the income you have disclosed on your application or you make less than $2,500 a month.
    - Only accepting appraisals performed by a licensed professional and completed in accordance with the Uniform Standards of

Professional Appraisal Practice. We trust the appraisal professional's local market knowledge and ability to place an appropriate value on the home. We never ask an appraiser to submit a report with a home value that we've pre-determined. When submitted, all appraisals are reviewed by Option One's trained underwriters and, at times, by licensed review appraisers.

Providing You With Options

Refinance Options That Benefit You

Refinancing may seem like a good deal, but there are many factors involved in determining if it is right for you. Using the information you have provided, Option One works hard to determine whether a refinance loan will benefit you. Factors considered in determining customer benefit include:

- Interest rates on the current and new loan.
- Amount of cash you would receive on the new loan.
- Points and fees on the new loan.
- Any prepayment charges that might apply on the current loan.
- Loan term comparison of current and new loan.
- Terms of any special loans or second mortgages that exist.
- Whether costs on a new loan could be recouped within 48 months.
- Whether it has been more than 24 months since the last refinance.
- Relieving a financial hardship.

In addition, we have a benefits review committee that looks at a sample of loans after funding. If a loan is brought to the committee's attention that did not clearly benefit the customer, the committee will take corrective action, which may include:

- Refunding points and fees.
- Creating more favorable loan terms at no cost to the borrower.
- Retraining or disciplining associates involved.

Prepayment Charge Options

Borrowers can choose a loan with or without a charge for repaying the loan early. Some borrowers may prefer to benefit from a lower annual percentage rate (APR) in exchange for choosing a loan with a prepayment charge. For example, some borrowers who plan to stay in their home for the length of the prepayment period could find the lower APR very beneficial. For other borrowers, a loan without a prepayment charge might be the best option for their situation. The choice is yours, and we explain this to you in a brochure you receive when you apply for a loan. Most of our loans that have prepayment options expire after two years and none are longer than three years.

Clear Loan Disclosures

Because we want borrowers to understand the terms of their loans, we have a strong disclosure process. After you submit a loan application, you can expect to receive our disclosures within three days even if you've already received disclosures from a mortgage broker. When you apply for a loan, you'll receive a brochure that explains the lending process. When your loan closes, we also provide you with an easy-to-understand summary of the terms of the loan.

Option One also has an early re-disclosure process. As soon as we learn of any change in your loan terms, including points and fees, we will notify you promptly. To eliminate surprises, if key changes are found within 48 hours of closing, we will give you the option to reschedule the closing so you have enough time to review and fully understand the changes.

Protection for You

Protecting You Against Fraud

Because we have zero tolerance for fraud, we also have a process to help customers who may, in rare instances, be defrauded by parties not affiliated with Option One. To identify and address these unfortunate situations we:

- Train certain associates to recognize evidence of possible fraud.
- Maintain a dedicated fraud unit at our headquarters to investigate and respond effectively to activities by unfair or fraudulent parties.

We are also a financial supporter of Stop Mortgage Fraud, www.stopmortgagefraud.com, a Mortgage Bankers Association-sponsored effort to combat fraud in our business.

Your Identity

Option One has an identity-theft hotline for current customers, which is staffed by trained associates who can provide information on how to report identity theft to local law enforcement agencies and credit bureaus. You can reach our hotline at (800) 704-0800, ext. 30080.

Your Personal Information Is Kept Private

We do not sell your personal information. We use it only to conduct the business we have with you and we have strong internal controls to protect your personal information.

High-Cost Loans Are Not a Part of Our Product Line

Option One and H&R Block Mortgage do not offer loans defined as 'high cost' by federal, state or local laws.

Loans That Are a Benefit to You

There are some loans we don't think are usually in our customers' best interests, so we do not offer them. These include:

- Loans based purely on the equity in the property.
- Stated-income loans or loans that do not require income documentation if you are on a fixed income, such as Social Security or a pension.

- Loans with increasing interest rates in the event payments are missed.
- Loans that deduct initial principal and interest payments at closing.

Practices That Benefit You
We keep our customers' best interests in mind.

- We never disburse funds directly to home-improvement contractors. You choose your contractor, and you conduct all business dealings directly with them.
- To make certain there is no personal financial benefit for someone to charge you a higher rate, we:

    - Do not pay overages to our retail loan officers, which means the loan officer does not receive a financial incentive to charge a higher interest rate than our published rate.
    - If we service your loan, we do not solicit you to refinance unless you ask. If you request information on refinance options, we have a team of associates who can help.
    - We do not offer mandatory arbitration.

Behind the Scenes at Option One

Code of Business Ethics and Conduct
All associates annually re-commit themselves to the company's Code of Business Ethics and Conduct. By signing the code, associates promise to conduct business in accordance with the law, protect customers' privacy, and treat customers, other associates and business partners with fairness, respect and dignity.

Training
All associates involved in the lending process get training, including learning about fair lending practices and determining how a loan benefits the borrower.

Quality Control and Audits Are a Regular Part of Running our Business
There are a lot of things you'll never see or experience that are happening behind the scenes at Option One to help us serve you better, including:

- Our Compliance Department regularly reviews business processes and procedures for compliance with state and federal laws and regulations.
- Our Internal Audit Department regularly audits business processes and procedures and reports the results to Option One's management team.
- Our customer service and collections phone services are monitored to see that customer calls are handled professionally and accurately.
- Our due-diligence team audits a random sample of loans to make sure they are problem free.

- If a problem is suspected, another team takes over, checking for evidence of fraud.
- We have quality control measures in place to monitor and promote the best practices we've established to serve you well.

We Welcome Change

Our goal is to get better and better at what we do. We make a practice of evaluating our best practices on an ongoing basis so that we are always doing things better, finding solutions to your needs and working harder to serve you.

Working with our Brokers and Lenders to Serve You

Option One originates loans through a national network of brokers and lenders. To provide the highest quality experience for you, we've established the following practices:

Licensing Audits

A broker who wants to become an approved broker with Option One must apply to the company, providing information about his or her brokerage. We also verify that the mortgage broker has a current state license – and we check that license at renewal time, typically once a year. We also require that brokers comply with all federal, state and local laws.

A Commitment to Continuous Learning

We strive to give our brokers educational materials and experiences that will help them serve you better.

Established in 2002, Option One University provides our brokers and lenders with topical information on a variety of subjects, from responsible non-discriminatory lending practices to the appraisal process. These classes help mortgage professionals serve the borrowing public even better.

We also help keep our brokers current through a variety of other tools, including a quarterly publication specifically designed for them. And we have developed a Web site to keep them informed about legislation that impacts borrowers, including laws that could limit the ability of consumers to get credit when they need it.

We Require Factual Information

To become a broker with Option One, brokers must sign a broker agreement. That agreement specifies that all customer information submitted to us must be accurate and complete to the best of broker's knowledge.

We Hold Brokers Responsible

Option One has zero tolerance for fraud. We move quickly to terminate our relationship with brokers who have committed fraud and report them to the state licensing-agency and/or to federal, state or local law enforcement agencies.

APPENDIX C

BROKER'S COMMITMENT TO RESPONSIBLE LENDING

As a Broker and/or lender approved to submit loans to Option One,
and its employees and associates ("We") agree and acknowledge the following: (Company Name)

1. We affirm that our primary obligation is to act in the best interest of the Borrower. Therefore:
   a. We will always carefully analyze the Borrower's financial situation and true ability and willingness to repay the loan. We will only submit to Option One loans that are appropriate to this true ability.
   b. We will not knowingly submit an application for a non-prime loan for a borrower who is eligible for, and whose needs are best met by, a prime loan.

2. We will always operate in full compliance with all federal and state lending requirements -- including disclosing all fees on the GFE and HUD-1.

3. We will always comply with state and federal fair lending and non-discrimination laws. (We acknowledge and share Option One's commitment to abiding by both the spirit and letter of all fair lending laws and practices.)

4. We are properly licensed in the States where we do business.

5. We will always, to the very best of our ability, ensure that each and every loan submission contains NO false or misleading information. In particular (and without limitation) we will ensure that:
   a. The true source of the down payment is disclosed to Option One.
   b. The appraisal is a truly independent analysis of the value of the collateral.
   c. The borrower's true income is accurately calculated and disclosed.

   (We acknowledge and share Option One's commitment to preventing mortgage fraud. We understand that Option One views fraud as both a criminal and predatory practice. We understand that Option One reports all fraud to licensing and/or criminal authorities and may civilly sue brokers and agents that participate in fraudulent activities.)

6. We will not submit to Option One loans that refinance "Special" mortgages (such as reverse mortgages, mortgages from charitable organizations with discounted interest rates, specially subsidized loans, etc.).

7. We acknowledge that Option One will not fund "High Cost" loans as defined by applicable federal state or local ordinances.

8. We will always comply with the terms of our Broker Agreement with Option One.

9. We acknowledge and agree with Option One's Best Practices.

10. We will ensure that all of our employees and associates involved in submitting loans to Option One have read, understood and agree with this Broker Commitment to Responsible Lending.

Signature of Principal Officer Date

Printed Name of Principal Officer

APPENDIX D

BROKER COMPENSATION (YSP) AND THE FEES IN YOUR TRANSACTION DISCLOSURE

Loan Number: Servicing Number: Date:

In your loan transaction, you will have to pay fees to your broker, lender, and third parties (such as the appraiser, title company, closing agent, etc.). Some of these fees may be paid out of your pocket, others may be paid from the loan proceeds, and yet others may be paid by another party on your behalf (for instance, perhaps the seller of your property agreed to pay some of your costs). You should discuss with your broker the type of fees you will have to pay in your loan transaction, and the best way for you to handle the payment of those fees.

One of the ways that you can pay your broker is through something called a Yield Spread Premium, usually referred to as a YSP. When some or all of the broker's fee is paid by a YSP, it means that the lender is paying the broker on your behalf. The upside is you will be reducing the amount you have to pay out of pocket for the loan fees, or less money will be added on your loan balance to pay these fees. The benefit of a YSP is it leaves more money in your pocket. But in return for this benefit to you, you agree to pay a higher interest rate on the loan, allowing the lender to recoup the money it paid for you on this transaction.

THE YSP CHOICE IS YOURS TO MAKE

In your transaction, you are agreeing to pay a higher interest rate of ____________%. Your broker will directly receive compensation from Option One Mortgage Corporation ("OOMC") in the amount of $ _____________ _______. You understand that this compensation will appear as "broker compensation" or "yield spread premium" on certain disclosures (i.e. Good Faith Estimate of Closing Costs and HUD-1 Settlement Statement).

Borrower's Acknowledgment:

I acknowledge that I have a choice regarding loan terms. I have voluntarily agreed to the inclusion of the Yield Spread Premium in my loan terms.

Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date

APPENDIX E

FRAUD DETECTION & PREVENTION PROGRAM

OVERVIEW:

Option One is committed to building and maintaining a comprehensive, industry-leading fraud detection and prevention program. The Company has made the detection and prevention of fraud one of its highest priorities. This dedication to increasing awareness and halting the spread of fraud extends from Option One's senior management down to every employee at its branches.

Option One has long been committed to responsible lending and servicing practices. In addition, it has concentrated its efforts with respect to fraud detection and prevention program in response to the rise in the incidence of fraud. The enhancements that Option One has undertaken include (1) the reorganization of the corporate reporting structure and the addition of several new positions dedicated to the detection and prevention of fraud; (2) the revision of fraud-related policies and the creation of new policies aimed to prevent fraud and other misconduct; (3) the development of targeted reviews intended to identify instances of fraud and the responsible parties; (4) specialized training to increase fraud awareness; (5) the institution of regularized reports by the Chief Risk Officer to the Audit Committee of the parent company's Board of Directors; (6) the creation of an anonymous hotline for Option One employees to submit inquiries and concerns regarding potential misconduct; and (7) oversight of the hotline activity by the Chief Risk Officer. These and other measures that Option One has developed and implemented are described more fully below.

KEY ASPECTS OF THE PROGRAM:

- **Corporate Commitment.** Option One's commitment to fraud prevention extends from the top down throughout the Company, and Option One continually demonstrates to all of its employees that fraud cannot and will not be tolerated. For example, in January 2004, a memo from Option One's CEO expressed the need for heightened sensitivity to the growing problem of fraud. Continued training and fraud awareness presentations further emphasize the importance that Option One has placed on the detection and prevention of fraud.

- **Fraud Steering Committee.** Option One has a Fraud Steering Committee, which serves as the senior body for guiding corporate-wide anti-fraud policies. The Committee has the authority to order investigations, terminate employees or suspend brokers, and recommend policy revisions. Membership on the Committee comprises senior-level officers, including the Chief Risk Officer, General Counsel, Chief Appraiser, Chief Financial Officer, Senior Vice President for Credit Oversight and Senior Vice President for Wholesale Operations.

- **Fraud Committee.** Option One also has an inter-departmental Fraud Committee, which acts as a forum for the exchange of ideas, methods and recommendations for fraud detection and prevention. This Committee is chaired by the Company's Director of Portfolio Risk, and includes representatives from the Servicing, Wholesale, Appraisal, Training, Risk Management, Risk Mitigation, Asset Review, Broker Approval and Review, Closing Operations, Compliance, Underwriting, Human Resources and Secondary Marketing departments.

- **Independent Reporting Structure.** While all of Option One's departments prioritize the detection and prevention of fraud, primary responsibility rests with the Chief Risk Officer. Option One has reorganized its reporting structure to create a direct line from the Chief Risk Officer to the Company's Chief Executive Officer, independent from the Chief Operating Officer and the operational divisions of the Company. Personnel in departments including Portfolio Risk, Broker Approval and Review, Compliance and Risk Mitigation in turn report up to the Chief Risk Officer.

- **Risk Mitigation Department.** Option One has a dedicated Risk Mitigation Department, which investigates and takes action regarding fraud and improper conduct by employees and third parties. The department's responsibilities include assisting branch associates in responding to concerns regarding loan documentation and conducting independent reviews of loan files, brokers and other third parties who are involved in the application process.

- **Pre-Funding Reviews.** The Risk Mitigation Department conducts reviews of specific loan file documents, prior to loan funding, at the request of branch associates. These reviews may include calling to re-verify employment, confirming loan file information or taking other steps to ensure the accuracy and legitimacy of loan documents prior to funding.

- **Post-Funding Reviews.** The Risk Mitigation Department also conducts post-funding reviews, which typically involve the in-depth examination of multiple loans submitted by the same broker or Account Executive. These reviews may be triggered by delinquency reports, requests from the branches or the Appraisal, Servicing, Asset Management or Compliance departments. In addition, referrals for review are obtained from the Company's Consumer Complaints Task Force, Servicing High Risk Group and Legal Department. These reviews are supplemented by those performed by the Quality Control Department, some of whose analyses are directed toward the detection of mortgage fraud.

- **Corporate Appraisal Department.** The corporate Appraisal Department reviews appraisals on a sample basis. These reviews aid in the detection of property "flips," inflated appraisals and other forms of mortgage loan fraud. This department also tracks the performance of appraisers and maintains lists of "advised" (on-watch) and suspended appraisers.

- **Closing Department.** Option One's corporate Closing Department monitors closing agents, maintains a list of on-watch and suspended closing agents, and provides anti-fraud training to branch closers. In addition, Option One requires additional documentation for loans submitted by brokers who are affiliated with a closing agent.

- **Broker Approval.** Option One requires brokers to submit a detailed application, which is evaluated at both the branch and corporate levels prior to approval. This approval process includes verification of licenses, background searches and scrutiny of brokers' affiliations with other third parties, such as closing agents, involved in the mortgage lending business.

- **Broker Watch Lists.** All new brokers are automatically placed on a watch list for at least their first five loan submissions, ensuring that their loans will be underwritten by a senior underwriter and specially scrutinized. In addition, established brokers who are suspected of fraud or whose loans are not performing as expected (e.g., high rate of default) are placed on a watch list and their loan applications are likewise scrutinized.

- **Prompt and Decisive Action in the Event of Fraud.** Option One immediately takes action against those brokers found to have committed fraud and suspends them, where appropriate. Option One also may make referrals to appropriate law enforcement agencies and authorities. In addition, Option One maintains a Barred Individuals List of individuals whose conduct has warranted suspension or termination. This list includes brokers, loan officers, closing agents, appraisers, and others who have committed fraud against Option One. Option One will not originate a loan in which any individual on the Barred Individuals List is known to be involved in any capacity.

- **Specialized Training.** Option One conducts specialized "Red Flags" training at the start of the tenure of each employee involved in the loan origination process. This training includes a review of a specially developed Red Flags Guide that features examples and explanations of fraudulent schemes. Employees must certify that they have completed this training and must be re-certified annually to ensure that they remain aware and educated as to current industry trends. The Red Flags Guide is continually updated as new schemes are uncovered and information is learned by the Company.

- **Training of Third Parties.** In addition to training its own employees, Option One conducts training for its business partners that addresses the importance of detecting and preventing fraud. This education currently includes courses offered through Option One University and Campus MBA for brokers and other third parties, newsletters that address current issues in the industry, and speeches and classes conducted by Option One senior management at industry conferences.

- **Source and Seasoning Policy.** In order to combat down payment fraud, Option One instituted a source and seasoning of funds policy in April 2004 for all full documentation and stated income loans. This policy requires that the source of funds paid toward a borrower's down payment must be verified or must have been in the borrower's bank account for at least thirty days prior to the loan closing.

- **Anti-Flipping Policy.** The Company deters property "flipping" by placing significant restrictions on loans secured by properties that have been sold within the prior 12 months.

With respect to such applications, the Company requires a number of additional safeguards, such as additional documentation for home improvements and a technical review of the appraisal where the home value has increased by more than 10%.

- **Targeted Broker and Account Executive Reviews.** The Company has initiated comprehensive reviews of selected account executives and brokers. The account executives and brokers are targeted for review based on risk factors such as higher than expected delinquency rates, early payment default or loss severity, and unusual product mix. The results of these reviews are provided to the Fraud Steering Committee and may trigger an in-depth review of loan files for fraud.

- **Branch Investigations.** When Option One suspects instances of fraud at one of its branches or questions the possible involvement of branch employees in fraudulent activity, senior management directs in-depth branch investigations, which may lead to termination of employees and referrals for prosecution of third parties.

APPENDIX F

SERVICING BEST PRACTICES

When we began our business in 1992, we started by creating a strong foundation. Even before developing a business plan, we established a set of values that we live each day. Our associates test everything we do against these values:

Do what is ethical, fair and makes good business sense.
Do our best.
Treat others as we want to be treated.

As a residential mortgage servicer, we know that homeownership is the cornerstone of the American dream and we recognize its importance in building wealth and improving the lifestyles of families throughout our nation.

Option One plays a significant role in the housing market and we understand our obligation to make our services as easy to understand as possible for the consumer. Further, as an equal opportunity lender and servicer, we know how much our customers rely on us for honesty, fairness and a dedication to serving their best interests. We have made a commitment to serve our customers well.

We support strong consumer protections to prevent misconduct in mortgage lending and have taken a leadership stand against abusive servicing practices, which harm not only consumers but also affect the reputations of all servicers. As responsible mortgage bankers, we comply fully with all mortgage-lending laws. These include the Fair Debt Practices Collection Act, the Real Estate Settlement Procedures Act, the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act and the Equal Credit Opportunity Act.

When we created our Best Practices in Servicing, we were guided by these laws, but in the end, relied most heavily on the principles set forth in our well-established company values. They serve as our touchstone in providing high ongoing levels of service to our customers as we meet their changing needs over time and work to advance their understanding of the mortgage lending process.

Serving You Right from the Start

We Contact You
"Welcome to Option One!" These are the first words you'll hear from us as a new customer because you'll get a personal phone call from one of our customer service professionals. We call to thank you for your business, to make sure you understand key features of your loan and to answer any questions you might have. If your loan was transferred to Option One from another lender, we will send you a welcome letter with information about our services and how to get in touch with us if you have questions.

You Can Call Us, Too
We know when you're in the middle of a busy workday, you may not be thinking about your mortgage. That's why we have extended phone hours when you can speak to a customer service representative in English or Spanish, day or night. Additionally, our larger call centers maintain lists of Option One associates who speak other languages. If they are available when you call, we will be happy to transfer your call to these associates.

Our representatives are available:

Monday through Friday from 8 a.m. to midnight EST (5 a.m. to 9 p.m. PST)

Saturday from 9:30 a.m. to 6 p.m. EST (6:30 a.m. to 3 p.m. PST)
Before our customer service representatives start working with you, they receive more than 100 hours of training so that they can respond to your questions accurately and knowledgeably – and if they don't know the answer when you call, they'll find out and call you back. Our customer service phone number is (800) 648-9605.

Do It Yourself
We realize many homeowners prefer to do it themselves. Option One provides free 24-hour service through our automated phone system and our secure Web site at www.optiononemortgage.com, both of which provide information such as:

- Loan activity
- Online duplicates of billing statements
- Escrow
- How to obtain a loan payoff
- Verification of mortgage

Write to Us
Sometimes you just want to get things down on paper. That's why we have a Customer Resolution Department, a special unit dedicated exclusively to answering your letters promptly, completely and accurately. Typically, we respond faster than government-mandated guidelines.

Our mailing address is printed on the back of our monthly billing statements. In addition, this mailing address is listed under the "contact us" tab within our Servicing Web site at www.optiononeonline.com.

You can write us at:
Option One Mortgage Corporation
Attention: Servicing Unit
P.O. Box 57054
Irvine, CA 92619-7054

How Are We Doing?
Option One recently contracted with a national, independent polling organization to

complete a phone survey of several hundred servicing customers. In the spirit of ongoing improvement, we wanted to know what we are doing well, but more importantly, how we can improve. Our customers gave us many valuable suggestions and we plan to review and respond to them all.

We Treat You the Way We Want to Be Treated

From time to time, you may work with one of our vendors. We expect high standards of ethical professionalism from our vendors and ask that they comply with all record keeping, privacy and fairness laws and regulations.

We Welcome Change

Our goal is to get better and better at what we do. We have dedicated teams that regularly review our servicing practices to identify and implement the changes at Option One that keep us focused on finding solutions to your needs and working harder to serve you.

When It's Time to Make Your Payment

It's about Options

Option One has many convenient payment options that work for you.

- Automatic withdrawals from checking accounts with varied payment dates.
- An option to pay online – either via our Web site, or through your own bank's online bill payment service.
- East and West coast mail-in facilities, so your payment gets to us fast.
- We also provide phone payment and wiring options. Our fees for these types of payments made over the phone through our automated 800 number or directly with one of our representatives are among the lowest in the industry.

Sometimes you may have a question about your bill. If you do, please call us right away at (800) 648-9605, and we'll be happy to help.

Prompt and accurate payment posting is important to Option One. In order to process payments in a timely and accurate way, we do the following:

- Make every effort to process all payments on the business day they are received.
- If we are unable to credit your payment to your loan, a letter will be sent to you right away explaining why and providing you with a phone number to call in order for us to assist you.
- Write and call you if your bank returns your payment unpaid.
- Write and call you if your payment is late.
- Send an updated billing statement and letter if your payment is not received by the late charge date.
- Take a picture of your check upon processing in order to answer any payment questions you may have about your loan.

Sometimes, mortgage loans are sold or transferred from one company to another. We recognize that this can be confusing even though the company transferring your loan and the company receiving your loan both send letters with information on whom to call and where to send your payments. For that reason, when loans are transferred to Option One, we automatically block all late-charge assessments for a full 60 days so that you are not penalized in any way after the transfer. We also block all reporting to the credit bureaus for 60 days to make sure that you are fully protected during this time.

If You're Interested in Refinancing

As soon as you tell us you're ready to pay off your loan, we give you several options.

Refinancing with Us

If you originally got your loan through us and you tell us you are interested in refinancing, we have a unit that specializes in discussing refinance options available to you. This unit has access to the entire spectrum of mortgage programs, including prime, non-prime and government loans.

Paying Us Off

If you want to speed up the payoff of your loan, we:

- Promptly provide payoff statements, typically within 48 hours.
- Promptly return any funds escrowed for taxes or insurance, typically within 30 days.

Protecting You and Your Home

Hazard Insurance

Like all lenders, Option One requires you to have hazard insurance on your home, but we know it is sometimes difficult to keep it in place. Seven days prior to the expiration of your insurance, we make a call to your insurance agent and/or carrier. If your insurance lapses, we also notify you directly, in writing. These notices alert you that if you do not provide proof of insurance coverage as requested, the insurance we buy to cover your home may be more expensive and provide you with less coverage. Our written notices to you are as follows:

- First notice: After 14 days, we remind you to get new insurance.
- Second notice: This is sent 30 days after the first letter to remind you again.
- Third notice: 74 days after the day your insurance expires, we buy insurance for you and have our carrier mail you the policy document.
- Final notice: Approximately 90 days after we purchase the new insurance policy, we send you an additional letter advising you of the advance made to purchase the policy.
- **And:** Your billing statement will also reflect this transaction.

If we do have to buy insurance for you, we do not receive any commissions. Instead, we ask the insurance companies to reduce your premium by the amount of the commission they would have paid us. Once you have purchased a new insurance policy, we'll promptly cancel the policy we purchased and reimburse any amounts due you.

We have a master policy that covers the following, so we don't require you provide us with proof of insurance in these cases:

- Loan balances of less than $2,500.
- Second mortgages.
- Condominiums or town homes with master hazard policies.

Escrow Accounts
Putting aside money each month to pay real-estate tax and homeowner's insurance helps customers avoid large periodic lump-sum payments when bills are due. We provide these timesaving and convenient escrow accounts free of charge, and you can establish an escrow account with us before or anytime after your loan closes. There are no set-up or removal fees for an escrow account and because we take care of the required payments, you don't have to worry.

Option One encourages our customers to apply for escrow accounts. We include an escrow authorization form with your closing documents. You have the opportunity to complete the form, which authorizes us to set up an escrow account for your real-estate taxes and homeowners insurance.

Our Web site, www.optiononeonline.com, contains a link that describes escrow accounts. Start in the general information section and open the borrower knowledge tab. You may also call our customer service department at any time to ask for additional information and to apply for an escrow account. That phone number is (800) 648-9605.

Your Credit
We report to the three major national credit reporting agencies so that customers working to improve their credit standing have that information reported completely each month. A positive payment history can help you obtain a prime loan in the future.

Against Fraud
Option One has zero tolerance for fraud. We have developed a process to help customers who may, in rare instances, be defrauded by parties not affiliated with Option One. To identify and address these unfortunate situations, we:

- Train all associates involved in the lending process on ways to recognize red flags.
- Train certain loan counselors to recognize evidence of possible fraud based on customer comments and feedback.
- Maintain a dedicated fraud unit at our headquarters to investigate and respond effectively to activities of unfair or fraudulent actions by others.

We are also a financial supporter of Stop Mortgage Fraud (www.stopmortgagefraud.com), a Mortgage Bankers Association-sponsored effort to combat fraud in our business.

Your Identity
Option One has an identity theft hotline staffed by trained associates who can provide information on how to report identity theft to local law enforcement agencies and credit bureaus. You can reach our hotline at (800) 704-0800, ext. 30080.

Your Personal Information Is Kept Private
We do not sell your personal information. We use it only to conduct the business we have with you, and we have strong internal controls to protect you.

Information Available at No Cost to You
Many services are free at Option One:

- Free phone services, automated or live
- Free automatic payment withdrawals from your checking account
- Free online services
- Free escrow accounts for taxes and insurance
- Free copies of payment histories
- Free copies of loan documents
- Free payoff statements
- Free verifications of mortgages
- Free change of title/owner
- Free outbound faxing

We Want You to Keep Your Home
We know things can happen in life that lead to financial difficulties, but we do many things to help keep you in your home. In other words, if you have a problem, we do our best to find a solution.

Professionals on Staff
We believe in serving our customers only with qualified, committed and well-trained professionals, so we do not use temporary employees to make or receive calls from customers. When you call us, you'll always get us!

Comprehensive Reviews
We believe that it is in your and our best interests that you keep your home. Therefore, if your loan becomes delinquent, we will explore options with you, which may include developing an extended repayment plan, borrowing from other sources to resolve your short-term financial hardship, or refinancing or selling your home. We begin the foreclosure process only after we've completed a comprehensive review and determined that such action is reasonable and legitimate.

Extended Payment Plans
After we gather income and other financial information to determine that repaying past-due amounts over time will truly solve your financial difficulties, we offer plans that help you continue making house payments. There is never any charge for this service and we do not raise rates on past-due loans. Our goal is to help you stay in your house.

No Incentive Compensation
Our representatives do not get incentives based on the payments they collect. This helps ensure that our associates are not motivated by their own financial benefit.

Behind the Scenes at Option One
There are a lot of things you'll never see or experience that are happening behind the scenes at Option One to serve you better, including:

Quality Assurance Phone Monitoring
We monitor phone calls to make sure that customer calls are handled professionally and accurately. We strictly enforce compliance with the Fair Debt Collection Practices Act, a federal law designed to protect you from abusive and deceptive debt collectors. A single violation of the act may result in termination of that associate.

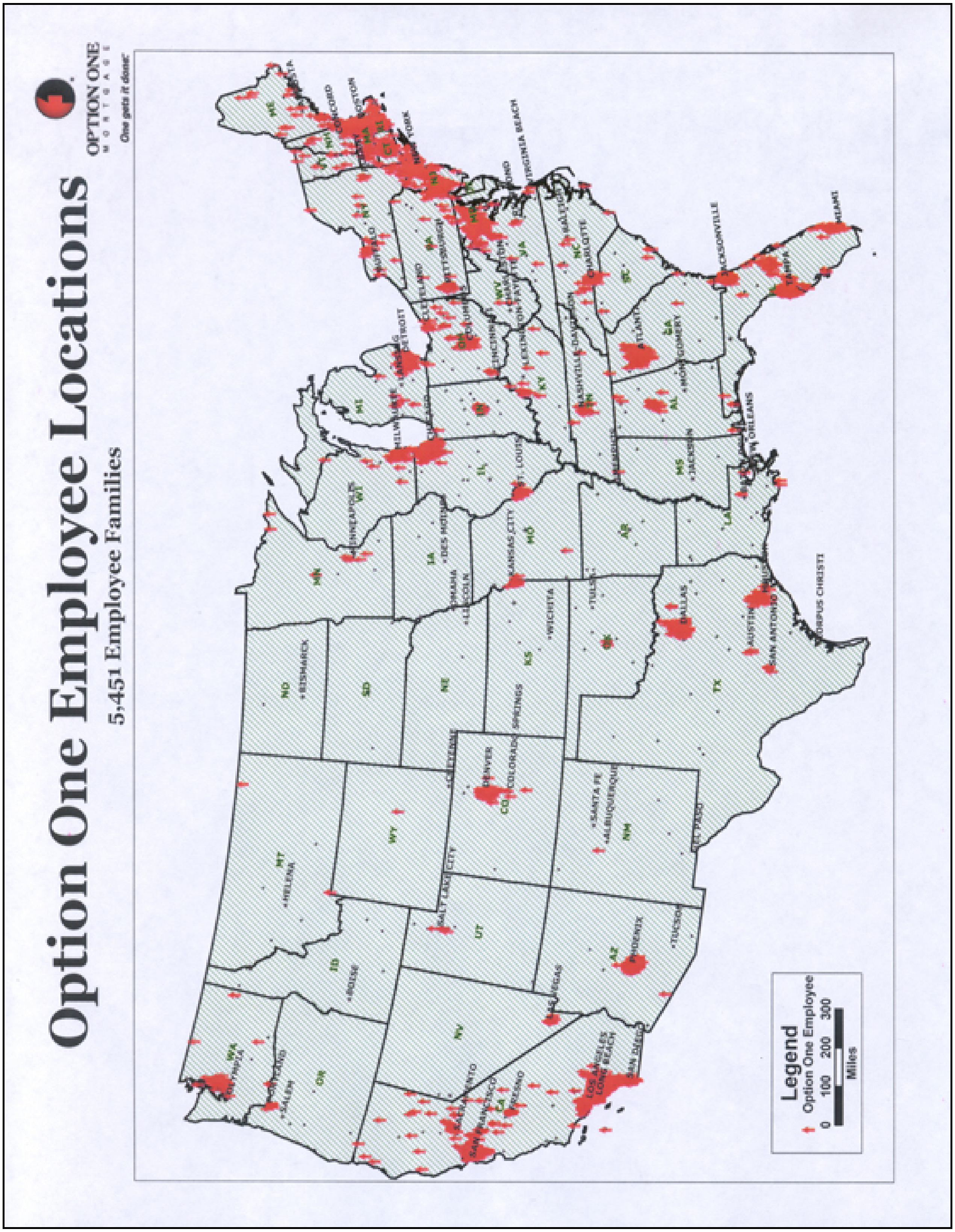
Process and Procedure Reviews

- Our Compliance Department regularly reviews business processes and procedures for compliance with state and federal laws and regulations.
- Our Internal Audit Department regularly audits business processes and procedures and reports the results to Option One's management team.

Our objective is to continue raising the bar in our servicing operations.

APPENDIX G

MAP OF OPTION ONE EMPLOYEES BY GEOGRAPHY



APPENDIX H

MAP OF OPTION ONE BRANCH OFFICE LOCATIONS

APPENDIX “C”

BROKER COMPENSATION (YSP) AND THE FEES IN YOUR TRANSACTION DISCLOSURE

Loan Number: Servicing Number: Date:

In your loan transaction, you will have to pay fees to your broker, lender, and third parties (such as the appraiser, title company, closing agent, etc.). Some of these fees may be paid out of your pocket, others may be paid from the loan proceeds, and yet others may be paid by another party on your behalf (for instance, perhaps the seller of your property agreed to pay some of your costs). You should discuss with your broker the type of fees you will have to pay in your loan transaction, and the best way for you to handle the payment of those fees.

One of the ways that you can pay your broker is through something called a Yield Spread Premium, usually referred to as a YSP. When some or all of the broker's fee is paid by a YSP, it means that the lender is paying the broker on your behalf. The upside is you will be reducing the amount you have to pay out of pocket for the loan fees, or less money will be added on your loan balance to pay these fees. The benefit of a YSP is it leaves more money in your pocket. But in return for this benefit to you, you agree to pay a higher interest rate on the loan, allowing the lender to recoup the money it paid for you on this transaction.

THE YSP CHOICE IS YOURS TO MAKE

In your transaction, you are agreeing to pay a higher interest rate of ____________%. Your broker will directly receive compensation from Option One Mortgage Corporation ("OOMC") in the amount of $ _______ _______________. You understand that this compensation will appear as "broker compensation" or "yield spread premium" on certain disclosures (i.e. Good Faith Estimate of Closing Costs and HUD-1 Settlement Statement).

Borrower's Acknowledgment:

I acknowledge that I have a choice regarding loan terms. I have voluntarily agreed to the inclusion of the Yield Spread Premium in my loan terms.

Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date
Borrower	Date	Borrower	Date

APPENDIX “D”

Analysis of
The Impact of Prepayment Penalties on
Residential Sub-prime Lending Coupons

May 12, 2004

Executive Summary:

For over 10 years, loan prepay penalties have been an instrumental cash flow in motivating fixed income bond investors to purchase bonds collateralized by sub-prime residential loans. If loan prepayment penalties were to be reduced in term, amount or eliminated completely, demand and/or pricing of the bonds backed by sub-prime loans could be adversely affected. We feel that in the absence of prepayment penalties:

1. Investors would want to be compensated for the heighten cash flow risk. They would either drop their bid in price or loan coupons would be forced higher to compensate for the added volatility. Higher coupons could also cause lending volumes to decline and lender profitability to erode as fixed expenses rose proportionally.

2. Additionally, securitization structures would likely be modified to reflect the rating agency's focus on the heightened cash flow volatility of the less-protected collateral pool. This adjustment would reduce sale proceeds for the lender.

Together, lower volume driven by higher coupons and higher costs (on a percentage basis) could have a significant negative impact on lenders margins. There are large lenders who, in this highly favorable interest rate and credit market, have lower overhead and benefit from scale. For some of the smaller lenders, the loss of prepayment penalties could mean the difference between small profits and losses. Borrowers seeking new loans would pay the consequences through higher coupons.

It is unreasonable to assume that the very favorable current interest rate environment and benign credit markets will remain unchanged in the future. If the markets were to revert back to more normalized environments (higher interest rates and defaults), even the large lenders could find their profitability impacted.

In this paper we seek to illustrate the impact that prepayment penalties have on the investor, the borrower and the lender. We provide this analysis based on the current market conditions which we consider to be very accommodating.

We have undertaken a quantitative analysis (outlined in the following sections) to estimate the rise in coupons necessary to compensate for the complete loss of prepay penalties. This projected increase, in the current environment given our assumptions, is 120 bps (i.e. - if current coupons were assumed to be 6.49%, this would project an increase to 7.69%). It should be noted that this increase is very sensitive to both the interest rate environment and underlying assumptions highlighted herein, and could be larger or smaller based on changes to these assumptions (i.e. - in faster prepay environments, the coupon increase would likely be greater and vice versa).

We have also used the scenarios in the above exercise to illustrate the impact to the sale proceeds of the originator. By removing the prepayment penalty income, increasing prepayment speeds assumptions and holding lending coupons constant, the impact would be a decrease of 1.98% in net sale proceeds (expressed in terms of par, see assumptions and illustration in Appendix B). This was enough to change a profitable issuance to a loss in today's environment. Similar to the coupon analysis discussed previously, this illustration is highly sensitive to the assumptions used to create it. This exercise is not intended to represent the actual margins realized by issuers; rather it attempts to quantify how margins could be affected given a change to a certain set of assumptions.

We have generated our opinions about this issue based on our direct and indirect research. Additionally, we have interviewed leading capital markets participants including but not limited to: loan and bond investors, research firms, loan originators, loan servicers, rating agencies and Wall Street dealers.

The Economics of Sub-Prime Lending:

A major shift has occurred since the sub-prime market started in the late 80's. The fixed income bond community has become the dominant provider of capital to the sub-prime borrower community. Previously, banks were the dominant capital provider. They had extensive loan origination networks and combined them with low cost deposits as their source of funding to generate attractive spread income. Currently, it is loan intermediaries such as loan brokers and conduit operators who originate, aggregate and sell the loans in bulk to the bond investment community. They use loan securitization to facilitate this process.

In the early days of the evolution from banks to bonds, the capital markets were unwilling to purchase the first loss and prepayment penalty cash flows at the offered prices. Intermediaries such as conduit managers retained a relatively large amount of credit and prepayment risk and retained the excess cash flow from prepayment penalties for taking the risk. These roles have largely changed. Now, the bond markets are more mature and the originators commit less capital in the risk because bond investors are willing to pay more. Their experience in understanding the product has improved, and capital markets have developed instruments (such as prepayment penalties) to give investors an added degree of comfort when committing capital to this volatile asset sector. The usefulness of these instruments, coupled with a benign credit environment and attractive interest rate environment, has dramatically improved the bid for sub-prime loans and the securities backed by them over the past several years.

<u>The favorable market conditions have been a material component of the sub-prime markets success.</u> For instance: house prices have risen materially, loan coupons have stayed low, investors have bought bonds and levered their purchase with low cost financing. Meaningful improvements have also been made to loan servicing practices. This has caused fewer loans to reach foreclosure. <u>The result is that in more recent history, bonds investors have had a good experience and view the sector favorably.</u>

Longer term, we feel the capital markets will continue to be the lead liquidity provider for the lenders, but <u>the favorable current market environment should not be relied upon to support the sub-prime market to the same degree in the future.</u> In other words, the market demand for bonds backed by sub-prime collateral may not be as robust in the future if a less desirable interest rate and/or credit environment were to occur. If prepayment penalties were to be eliminated in a period when the markets were more volatile lender liquidity could be reduced even more dramatically. Loan coupons could rise above the theoretical values calculated using today's market environment due to the combined effect.

Why are the capital markets a better bid than the banks and the loan originators?

1. A vast majority of the loans originated to date have exceeded initial credit projections.
2. The ratings for much of the previously issued debt have performed well.
3. Bond investors are generally comfortable with house prices and labor markets.
4. Investors, along with rating agencies, accept the inevitable variances associated with the "pool style" of lending. This approach involves looking at sub-prime risk in aggregate at the pool level (as opposed to the loan level), and using loan features such as prepayment penalties to stabilized cash flows even though the underlying loans are volatile.

Prepayment penalties are an important part of the proposition to invest in bonds collateralized by sub-prime loans:

Some market participants have argued that lenders could survive if prepayment penalties were eliminated in their entirety. We feel the elimination of prepay penalties could cause liquidity concerns to the sector as a whole. <u>Eliminating prepayment penalties would impair the ability to securitize the risk by removing an important cash flow that provides diversification as well as cash flow stability</u>. This would decrease lender's profitability which would, in turn, reduce capital available to the sector as a segment of these lenders exited the business.

Why prepayment penalties exist:

<u>Many investors lost a lot of money in the early days of sub-prime bond investing</u>. Most of them have said that it was a function of higher than expected losses and unpredictable prepays. <u>Prepay penalties evolved as a partial solution to attract investors back to the sector.</u>

Today, many loan and bond investors find sub-prime prepayment penalties particularly important. In addition to the prepay sensitivity created by interest rate volatility, the additional risk of prepayment due to credit curing is higher on sub-prime collateral. Credit curing occurs when borrowers make timely payments, improve their credit and qualify for a lower rate. Because of this additional uncertainty not found in prime loans, investors want to be paid more to take that <u>un-hedgeable</u> risk.

The capital markets generally prefer collateral and transaction structure consistency. History has shown that the markets can react to *small* changes in collateral and deal structures if necessary. Small is the operative word. Large changes in loan terms and securitization structure typically create unwanted market disruptions. These disruptions have historically affected liquidity and pricing in a negative fashion.

For instance - if a pool of mortgages contained 80% prepay penalties, and this percentage of loans was reduced to 70%, this change would be manageable and securitization pricing would not suffer materially. Loan coupons would likely remain unchanged. In a more dramatic example, if the number of penalty loans within a pool were dropped from 80% to 5%, investor demand would be impacted. As the percentage of loans in a pool with prepayment penalties declines, the impact to prepayment assumptions becomes more and more significant. A larger percentage decrease would force bidding assumptions and potentially securitization structure to change, causing a re-pricing of assets as well as a re-structuring of securitizations. We believe the market could adjust to less punitive penalties or shorter duration penalties, but their existence as an instrument remains fundamentally important to liquidity in the sub-prime sector.

From a lender's perspective, sub-prime loans have higher costs to originate. This makes this type of lending less profitable if a loan prepays after a short period. Investors are not willing to pay premium prices for loans that are likely to credit cure without some sort of protection to their return on the investment. <u>The credit curing option that the borrower enjoys is un-hedgeable.</u>

This relationship is best understood as a function of investor demand and loan supply:

The demand side: Bond Investors:

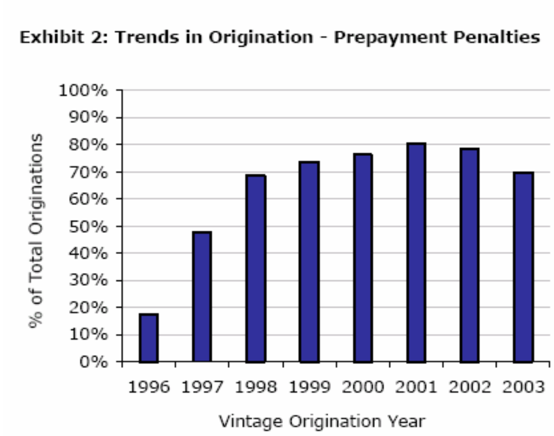
- Find that prepay penalties stabilize the cash flow pattern of the sub-prime collateral.
- Find that there is not a large derivative market in the sub prime sector (unlike the prime loan markets). As such, there are few, if any, hedging products that can offset rate speculation and credit curing exposure.

The supply side: Lenders:

- Have realized that without the bid from the capital markets, the liquidity of their loans would be significantly impaired. They also realize that these loans cannot be profitably produced given their cost to originate unless there are alternative sources of cash if the loans prepay.
- Use prepayment penalties to assist them during the period when they are aggregating new loans for sale in large bond deals. During that period,

they are exposed to prepayment risk which can be costly due to their high basis in the loans. Penalties mitigate this risk (by slowing speeds). It is important to note that a lender's all in cost for a sub prime loan is frequently higher than the penalty amount. As such, the penalty income may not be sufficient to cover the loss.

Homeowners have been a beneficiary of the bond markets strong bid for the loans. Many of the most distressed borrowers have been given loans because the markets will accept them in fractional percentages of a securitization. Others (less distressed but still sub-prime) simply enjoy a lower rate of interest than they would be offered without the same penalties.



Source: Banc One

The exhibit above shows the trend in the use of prepayment penalties. The percentage of loans originated with prepayment penalties has remained relatively stable since 1999, accounting for 70% to 80% of total annual originations.[1]

Definition and types of penalties:

Loan prepayment penalties are contractual features included in a mortgage that require a homeowner to pay a fee if they repay their mortgage in the early years of the loan's contracted life. The amount of the fee and the period the homeowner is required to pay this fee is disclosed in the original loan documentation.

A prepayment penalty is frequently found on different types of sub-prime mortgages (fixed rate, adjustable rate and hybrids). Usually, the penalty amount declines (to zero) with the passage of time and will not apply to repayment resulting from a home's sale.

Bond investors frequently have differing opinions about the value of prepay penalties on the three different loan types:

[1] Banc One, "ABS Yearbook 2004", pg.51

1. Prepayment penalties on fixed rate loans are heavily scrutinized by bond investors. As interest rates decline, investors want the bond cash flow to remain outstanding for the longest period. The put option of the borrower (prepayment) becomes more and more attractive to the borrower as rates continue to rally, making investors' focus on the prepayment penalty increasingly important on fixed rate loans.

2. For hybrid arms, most penalties expire no later than the first loan coupon reset date. Depending how far in the future the first reset date is, the impact can be very similar to the fixed loan example above or the ARM example below.

3. Prepayment penalties on ARMs are scrutinized the least because investors do not usually expect to have the price of their bonds deviate much from par. As such, a prepayment at par is not as costly.

There are two predominant types of prepay penalties. The first defines itself as a function of the loan coupon and the second defines itself as a function of the loan balance at the time of the repayment. Typical penalty types are are:

1. Six months interest (often on 80% of the loan balance)*
2. Flat percent of loan balance (5%, 3%, etc.)*

**Both types often have varied terms (2 yr, 3yr, 5 yr)*

Prepayment penalties effect on prepayment speeds:

Although historical loan prepayment data is available for sub-prime loans with prepayment penalties in general, prepayment data on loans sorted by prepayment penalty type is not available in a useful data set. It is our experience that most loan servicers do not keep accurate historical records in this regard. Although the data does exist with some servicers, the data that is available could be questioned as not being completely representative of all loans with these various types of penalties.

Loans with prepayment penalties are usually associated with lower rates, creating a two fold effect on projected and historical prepayment speeds. They prepay more slowly because:

1. There is an economic disincentive (penalty) in doing so, and;
2. The lower rate (than the no-penalty loan) decreases the refinancing incentive.

Figure 9a. **Prepayments on 2/28 Loans by Penalty Amount**

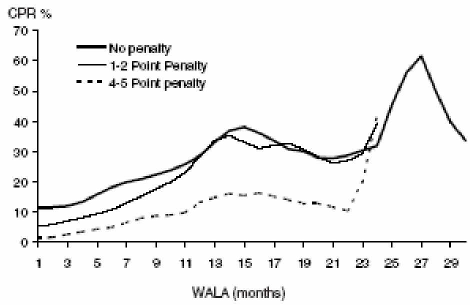
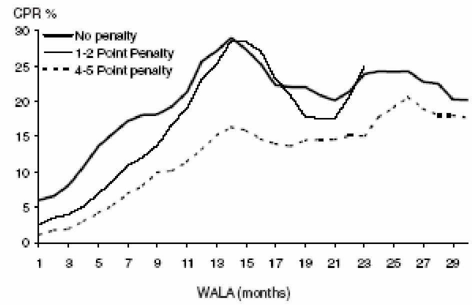


Figure 9b. **Prepayments on Fixed Rate Loans by Penalty Amount**



Source: Lehman Brothers

The rating agencies project the expected speed difference when they rate bond deals. Historically this decrease in prepayment speeds has been estimated to be approximately 10%[2] relative to loans without prepay penalties. In today's market, many investors estimate a decrease in prepay speeds due to the use of prepay penalties as high as 40-50%.

Concentration of prepayment penalties in sub-prime loans:

There is unquestionably a large disparity between the amounts of prime borrowers taking out loans with prepayment penalties versus the amount of sub-prime borrowers using penalties. Freddie Mac estimates that 80% of sub-prime loans carry prepayment penalties versus 2% in prime[3].

As stated earlier, prepay penalties on sub-prime loans became very popular in the mid 1990's to motivate investors to enter or return to the sub prime bond markets. Investors had inconsistent results and lenders used penalties to motivate them to buy bonds. Given the significant growth of sub-prime bond issuance since that time, it appears that this strategy was helpful. There are generally two perspectives of why there is a higher percentage of penalties on sub-prime versus prime:

1. **Opponents** to prepayment penalties would argue that many of these sub-prime borrowers are less sophisticated than prime borrowers, and often have these penalties included in their loan without fully understanding them or without understanding them at all.

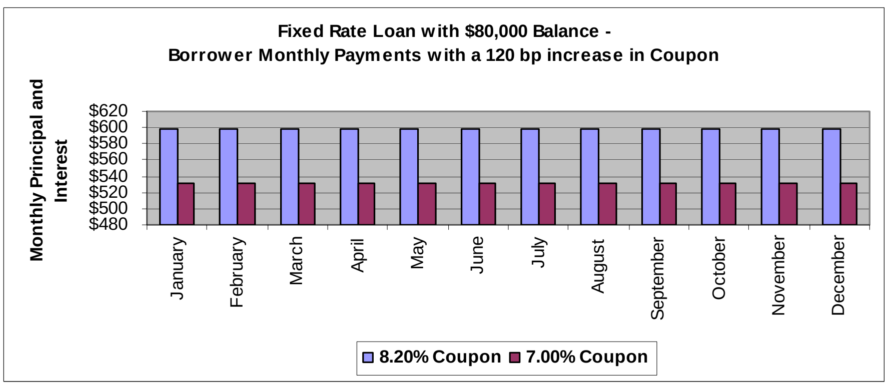
2. **Proponents** of penalties would argue that without these penalties, lenders would be forced to charge these borrowers significantly higher rates of interest, precluding many of them for qualifying for the requested loan amount. They take the perspective that borrowers freely enter this relationship because they have decided to accept the lower coupon and higher proceeds in exchange for temporary limitations.

[2] Standard & Poors, "NIM analysis: Valuing Prepayment Penalty Fee Income" January 3, 2001.
[3] Taken from "Frequently Asked Questions on Prepayment Penalties", www.freddiemac.com/singlefamily

Many borrowers are advantaged (via lower loan coupon) by the presence of prepayment penalties. Take, for instance, a prime borrower that is confident that he will be in his home for the next several years and does not wish to speculate on future lending coupons. By accepting a loan with a prepayment penalty, the borrower can enjoy a lower rate of interest (faster equity creation) over the term of the mortgage. The sub-prime borrower could be advantaged by a similar situation and/or be able to qualify for a mortgage that may have not been available without the presence of penalties due to the lower coupon.

The Borrowers Perspective – How will affordability be affected?

To illustrate the dollar impact of a lending coupon change to the sub-prime borrower, we look at a 7% fixed coupon loan with a balance of $80,000. A 120 bp increase in coupon would increase the annual payments on the loan from $6,386 to $7,178 for a difference of $792 (a significant sum for borrowers in this economic bracket, effectively putting this loan out of reach for a segment of them).



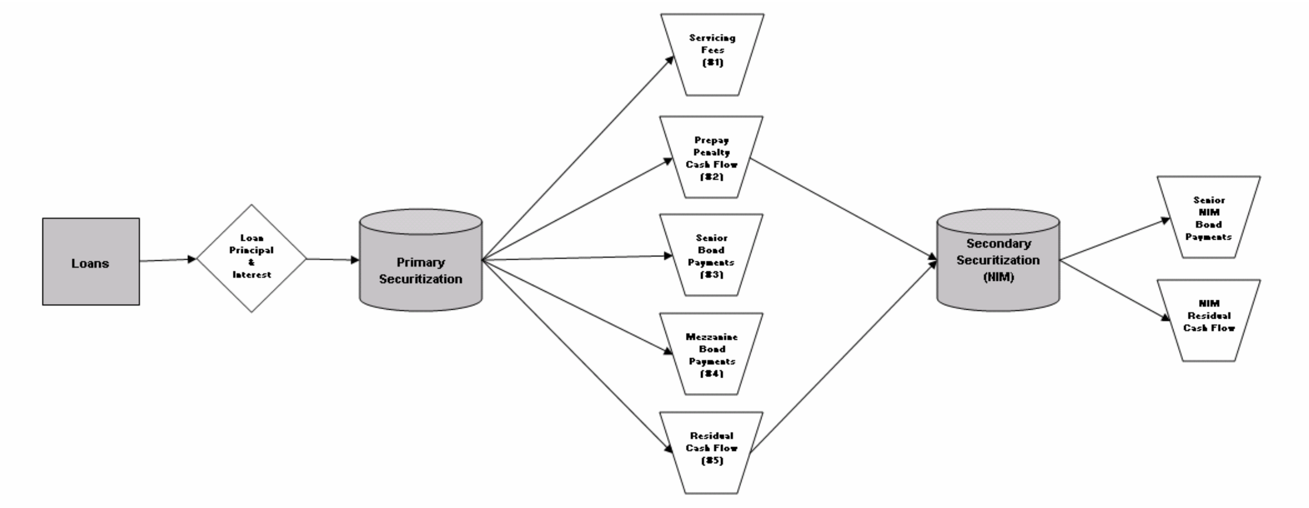
Source: Pentalpha

To look at it from another perspective, if the same borrower wanted to keep his monthly payment constant given a 120 bp rise in coupon, his loan size would have to be reduced from $80,000 to $71,250 (an over 10% decrease in the amount of money available to purchase the home).

The Investors Perspective – How will liquidity be affected?

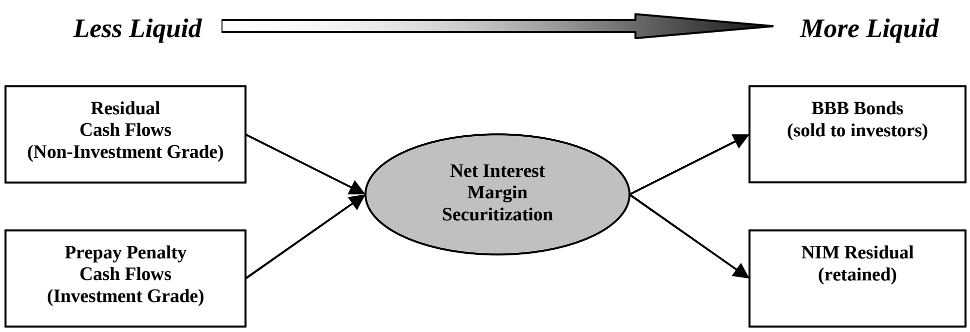
Although there are many bond transaction structures that are used in the market today, the over-collateralization structure is the most commonly used. As part of that structure, the following cash flows are created (all of the loans monthly cash flows are distributed into one of these five instruments):

1. Loan servicing cash flow
2. Prepayment penalty cash flow
3. Senior bond cash flow
4. Mezzanine bond cash flow
5. Residual cash flow



The cash flows found in #3 and #4 are commonly sold to investors in the form of bonds. The lender usually keeps cash flow #1 and applies an accounting value to that asset. An example of how the cash flows to #2 and #5 are monetized can be seen in a transaction structure called a net interest margin security ("NIM").

In a NIM securitization, an originator combines the junior residual cash flows (#5) with the senior prepayment penalty cash flows (#2) to create a new bond they can then sell to the investor community. The ability to sell these instruments to the capital markets on a combined basis creates liquidity for the lender.



It is estimated that prepayment penalties currently represent approximately 5%-15% of the projected gross cash flows in NIM transactions (depending on assumptions for prepayment rate and percent of penalties collected). The prepayment penalty cash flow is frequently considered a natural "hedge" for these transactions. If prepayment speeds were to increase (reducing cash flow to the residual), penalty income increases. Conversely, as prepayment speeds slow (increasing cash flow to the residual), penalty income decreases.

If prepayment penalties were reduced or eliminated completely, the rating agencies would likely reduce the amount of credit support and size of the senior bonds backed by NIM cash flows because of the loss of their diversification properties. Additionally, investors would also increase the yields demanded on these securities (decreasing proceeds) as the collateral would have lost this self-hedging characteristic and become inherently more risky.

The Originators Perspective - How is profitability affected?

In order to keep profitability unchanged, we estimated that the lender would need to raise loan coupons by 120 bps (our analysis is illustrated in a following section). The magnitude of this shift has been estimated by others at 100 bps[4]. It is important to note that our analysis illustrates the ***aggregate*** estimate of the move in loan coupon for an entire securitization. Individual loan coupons might have to be adjusted anywhere from 75 bps to 125 bps given the different types of penalties and credit risk that would have to be compensated for.

In order to understand the logic behind this estimated change in loan coupon, we outline here the basics of securitization economics and the steps originators take to lend profitably.

An originator will most often sell the loans it originates into the capital markets in the form of a securitization. In a securitization, the lender usually makes its money through:

1. Origination and underwriting fees associated with each loan.
2. The fee it charges to service the loans over time.
3. The collection and/or securitization of cash flow from the residual interest.
4. The collection and/or securitization of cash flow from the prepayment penalties.

[4] Chu & Kwan, Lehman Brothers "MBS&ABS Strategies" July 17, 2000.

By removing prepayment penalties as a source of cash flow, all four sources of profitability for the lender will be affected in the following ways:

Impact to issuance proceeds: Given faster prepayment speeds, securitization structures on the NIM transactions may have to be reduced in size to account for the change in cash flow characteristics. This will negatively affect the originators sale proceeds. The yield on the NIM transaction would also have to be increased as well to account for the increase in risk without the stabilizing effect of penalties. An example of the effect of faster prepayment speeds on securitization economics is illustrated in Appendix B.

Impact to residual cash flow income: Residual cash flows are often thought of as excess interest securities. Some describe residuals as paying the difference between the weighted average coupons of the collateral less the debt service on the securitization. As such, when you increase prepayment speeds (which would occur in the absence of prepayment penalties) there is less collateral to generate the excess interest and future cash flow will be reduced.

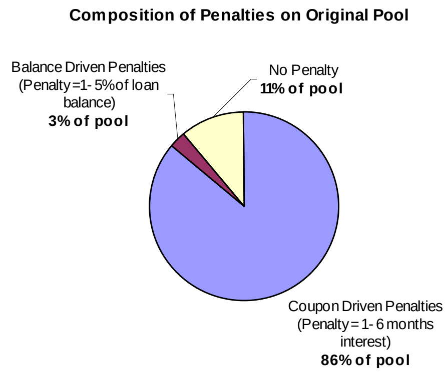
Impact to loan origination fee income: Given that many of the sub-prime borrowers will not be able to qualify/afford the higher rates necessitated by lack of penalties, there will be a smaller volume of borrowers to lend to. This results in a smaller volume of loans produced. Most lenders' profitability will likely decline as fixed expenses rise on a percentage basis.

Impact to servicing fee income: Since the servicing fee is earned on the outstanding balance of the loan, and there is empirical evidence that non-prepayment penalty loans prepay faster, the cash flow to the servicing strip will be reduced as loans exit the pool at a faster rate and fee income is decreased over time. This is problematic due to the high fixed cost of sub-prime servicing.

Impact to prepayment penalty income: The direct impact of the elimination of penalties on this source of income for the originator is obvious (it will no longer exist). The indirect impact would be seen in net interest margin re-securitizations (a source of liquidity for originators).

Originator profitability impact – an example:

In order to better understand the impact of prepayment penalties on the lender's profitability, we analyzed the economics of a recent fixed rate sub-prime transaction. The intention of this analysis was to estimate how much loan coupons would have to be increased to compensate for the absence of prepayment penalties. In this recent transaction, the size of the sub-prime fixed rate collateral was $960MM with a bond WAC[5] of 6.49%. Approximately 89% of these loans had prepayment penalties varying in term from 1 to 5 years:



In order to replicate the effect of removing prepayment penalties, two variables were stressed:

1. Prepayment projections (CPR[6]) on the collateral and;
2. The associated coupons on that collateral.

The logic being that collateral originated without penalties would be originated with a higher coupon and prepay at a faster rate.

The bonds were offered on the transaction assuming a prepayment speed of 20 HEP[7]. For purposes of this analysis, we have estimated the loss of prepayment penalty protection would increase the projected prepayment speed assumption to 30 HEP. With this faster prepayment assumption and the penalty cash flow eliminated, the coupon on the collateral was increased until the aggregate pre-loss cash flow to the servicing strip and residual was equivalent to the original scenario.

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[5] WAC = Weighted Average Coupon

[6] CPR, (Constant Prepayment Rate) as defined by Bloomberg: CPR attempts to predict the percentage of principal that will prepay over the next 12 months based on historical principal paydowns.

[7] HEP, or (Home Equity Prepayment) Curve was developed by Prudential Securities and remains an actively used analytical tool. As Defined by Bloomberg: a prepayment measure scale with a 10 month seasoning ramp, as compared to the 30 month ramp for the PSA curve. The HEP scale ranges from 0% to 100%. A HEP value corresponds to the terminal 10th month CPR speed – having evenly stepped the preceding 9 months. For example, 20% HEP corresponds to 2% the 1st month, 4% the 2nd month, and 20% in the 10th month and thereafter. *A graphical example of 20 HEP and 30 HEP is provided as Appendix A.*

Outline of analysis:

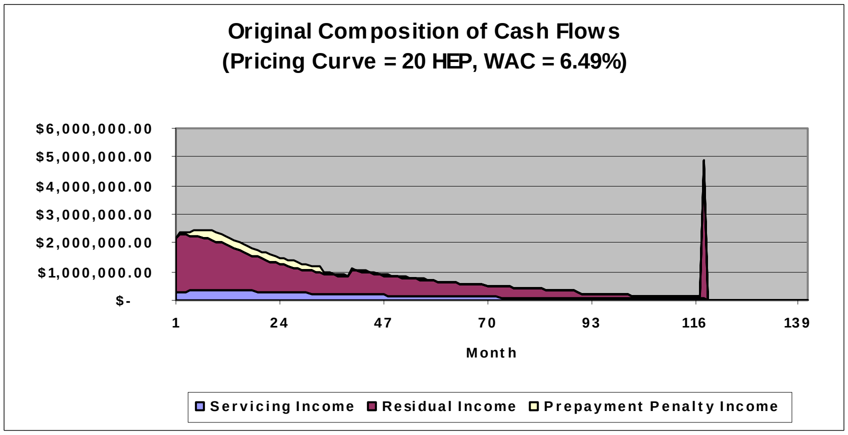
1. **Control Scenario -** The transaction was run at the securitization pricing assumptions of 20 HEP. This generated cash flows to the servicing strip, residual, and prepayment penalty class. The cash flows of the prepayment penalty and servicing classes were discounted at 8%, the residual cash flow was discounted at 18%. The net present value of the components was as follows: $15,180,397 of servicing income, $50,178,350 of residual income and $7,610,416 of prepayment penalty income. The cumulative Net Present Value (NPV) of the three cash flows was $72,969,164.

2. **Increased Prepayment Speed Scenario to Simulate Behavior of Non-Penalty Loans -** The prepayment penalty cash was removed, and the prepayment speed assumption on the associated collateral was increased to 30 HEP (from 20 HEP). The NPV of the cash flows (omitting the prepayment penalty class) in this scenario were as follows: $11,074,184 to the servicing class and $42,029,146 to the residual class. This aggregate NPV of $53,103,330 represents a loss of $72,969,164 - $53,103,330 = ($19,865,834)

3. **Increased Prepayment Speed with Lending Coupon Adjustment Scenario –** In the 30 HEP scenario, the coupon on the collateral was increased until the aggregate NPV cash flow in the adjusted scenario (#2) was equivalent to the control scenario (#1). The intention was to compensate for the loss of the penalty income (-$7,610,416), as well as the impairment to the cash flow to the residual (-$8,149,204) and servicing strip (-$4,106,214). To increase the NPV by this ($19,865,834) total, the loan coupon adjustment necessary was 115 bps. We believe there would have to be an additional 5 bps of coupon increase (estimate by Pentalpha) to compensate for the lower proceeds associated with the AAA bonds due to the likely change in assumptions used in the bidding process. This brings the total coupon increase to 120 bps.

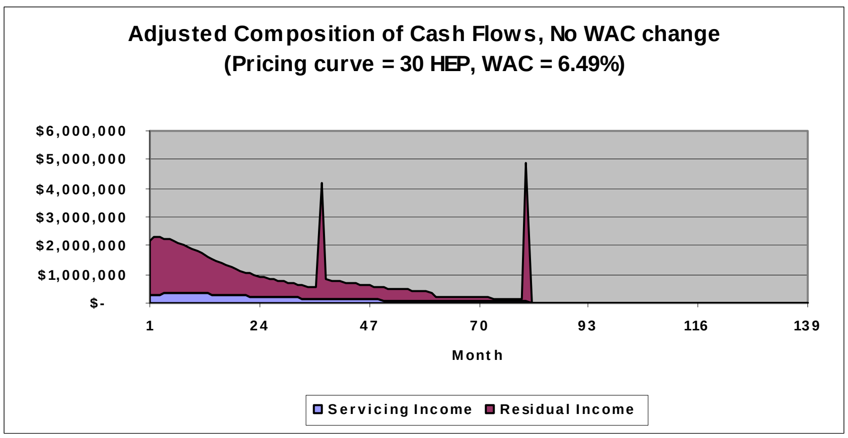
Summary Cash Flows:

Scenario #1: NPV of Cash Flows = $72,969,164



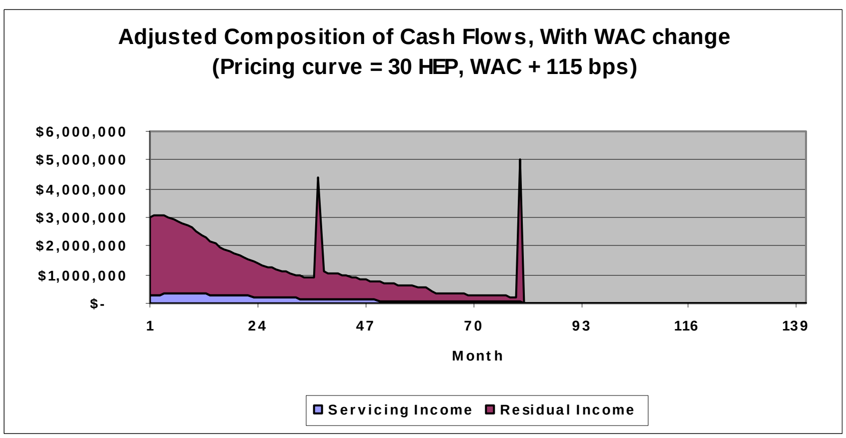
Source: Pentalpha, Wall Street Analytics

Scenario #2: NPV of Cash Flows = $53,103,330



Source: Pentalpha, Wall Street Analytics

Scenario #3: NPV of Cash Flows = $72,969,164



Source: Pentalpha, Wall Street Analytics

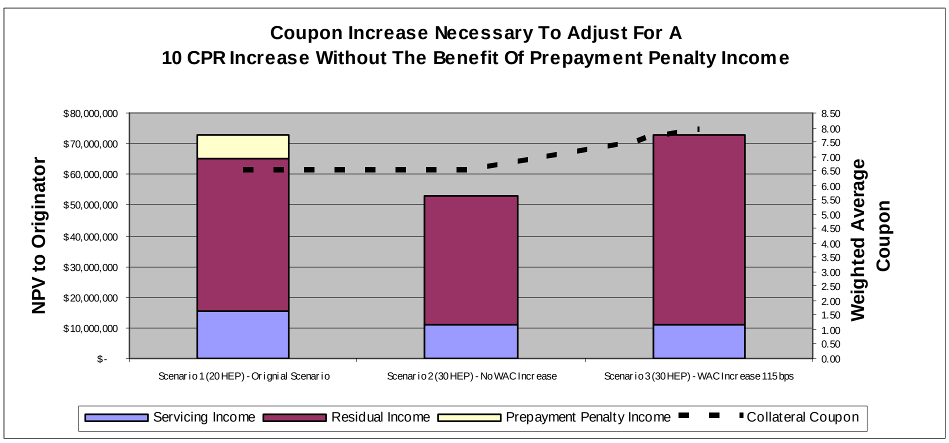
Results:

The components of the 120 bp estimated increase in loan coupon to compensate for the elimination of penalty income (given an increase in the pricing curve to 30 HEP) were as follows:

Impact of prepayment penalty income on loan coupon:

Original WAC on Mortgage Pool	6.49%		
Increase necessary to compensate for the impairment to residual class due to faster prepay speeds	0.47%		
Increase necessary to compensate for the removal of prepayment penalty cash flows	0.44%	+115 bps	+120 bps
Increase necessary to compensate for impairment to servicing strip due to faster prepay speeds	0.24%		
Approximated Increase due to loss of proceeds from wider execution on investment grade bonds	0.05%	+5 bps	
Estimated WAC on Mortgage Pool after adjustment	7.69%		

Source: Pentalpha



Source: Pentalpha

The graph shows that as the prepayment speed is increased from 20 HEP in scenario 1 (penalty income) to 30 HEP in scenario 2 (without prepayment penalty income), the net present value to the residual is decreased by ($8,149,203). The net present value of the servicing strip is also reduced by ($4,106,214) in scenario 2. The net present value of the prepayment penalties ($7,610,416) is eliminated. This ($19,865,834) total ($8,149,203+$4,106,214+$7,610,416) is then recouped in scenario 3 by increasing the loan coupon by 115 bps. In scenario 3, the net present value of the cash flow in scenario 1 is equal to that in scenario 3.

Looking at the "original composition of cash flows" on page # 15, there is a large distribution in residual cash flow at month 117. This is the release of the over-collateralization in the deal to the owner of the residual class assuming no losses or delinquencies. The over-collateralization (residual) can be thought of as the first loss piece. In our scenario # 2 - "adjusted composition of cash flows" on page # 15 we can see that the increase in coupon and faster prepayment speed has triggered the release of cash to the residual in months 35 and 79 based on step-down provisions in the deal structure. This illustrates the impact that faster prepayment speeds can have on some of the trigger mechanisms imbedded in these securitizations. The "adjusted composition of cash flows" shows a shorter, more volatile cash flow stream in both the loan coupon change and no loan coupon change scenarios.

Notes to Coupon Adjustment Exercise:

1. The analysis is highly sensitive to the assumptions tied to prepayment rates, as well as the discount rates used for the servicing income, prepayment penalty income, and residual income. The assumptions used are for illustration purposes only.

2. The increase in loan coupon due to the wider bond yields expected on the AAA classes (5 bps) is an estimate by Pentalpha.

3. This is a coupon sensitivity analysis. The interest rate environment will have a significant impact on this type of analysis. In a rising rate environment the speed differential between penalty and non-penalty loans will tighten significantly.

4. The collateral used in this analysis was originated with a fixed coupon, the impact to lending coupons could be significantly different with floating rate collateral.

5. This is a pre-loss analysis. The impact of losses could alter the results.

How will the margins of the originator be effected?

From the issuers perspective - Appendix B, shows the sources and uses of cash usually found in a whole loan execution as well as a typical securitization execution. It estimates the economic impact of removing prepayment penalties assuming faster prepayment speeds without a coupon adjustment. Dollar figures for the residual class, loan servicing strip, and prepayment penalty class are taken from our previous example. The figures are expressed as a percent of par (i.e.- in a $1 billion dollar transaction $50 million is 5% of par).

The impact in this example of moving the pricing curve from 20 HEP to 30 HEP and removing penalties (without increasing coupons) is significant. The profitability on the securitization decreases by 1.98% in sale proceeds (expressed as a percent of par). This amount exceeds lender margins and creates a loss in this example.

Notes to the securitization example (Exhibit B):

1. The estimates used for whole loan prices, underwriting fees, broker fees, costs to produce the loan, prepayment speed and discount rates are all assumptions used for illustration purposes only.

2. <u>This analysis is not intended to be an illustration of the current realized net profit margins of the issuer, actual margins in the marketplace may differ</u>. We are attempting here to illustrate the potential economic impact of changes to these cash flows.

3. This analysis utilizes pre loss cash flows. Residual class, loan servicing and prepayment penalty classes are highly sensitive to losses and could affect the economics of the analysis.

Conclusion:

Some market participants suggest that if prepayment penalties were eliminated in their entirety, the originators would simply make less money and continue to operate less profitably. We suggest here that the loss of prepay penalties without an increase in loan coupons could upset the originators liquidity as well as the economics of the securitization process.

In practice, we would expect borrowers to be highly sensitive to the theoretical change in coupon rates presented here. It is unlikely that originators could simply raise loan coupons to adjust for this loss to their profitability without significantly effecting lending volumes. While some of the larger originators might find it possible to continue to operate at reduced margins if prepayment penalties were to be eliminated (without being able to increase coupons as dramatically as presented here), we feel many of the smaller lenders would not. Should the capital environment change for the worse (higher defaults, faster prepayment speeds, flatter yield curve) without the benefit of prepayment penalties, even the larger firms could potentially find this type of lending unprofitable.

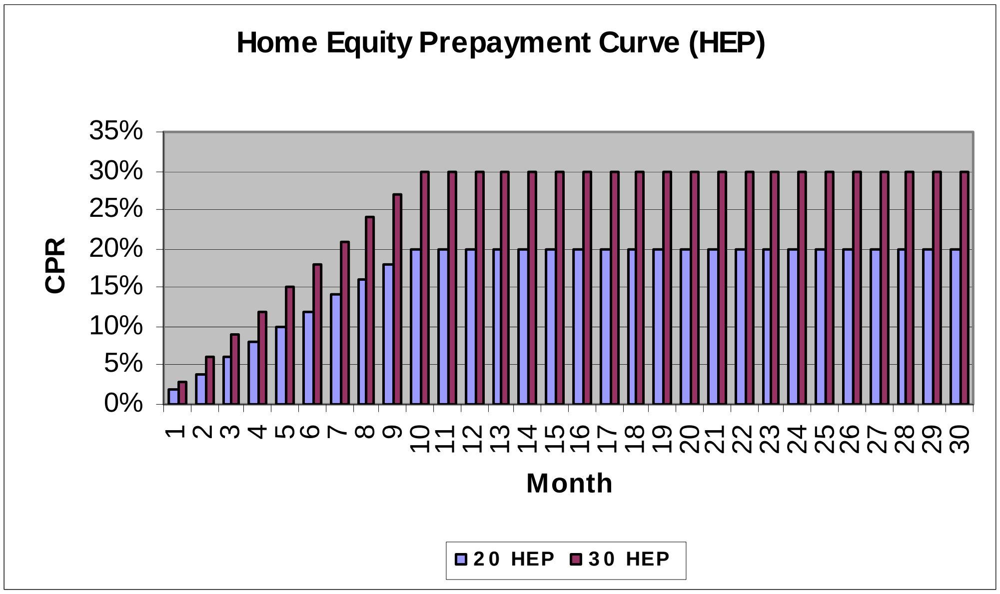
We attempt to illustrate here that there are many redeeming aspects of the prepay penalty feature that are beneficial to the borrower, originator and investor. These benefits are most commonly enjoyed as lower coupons and access to capital at the borrower level, greater liquidity at the investor level, and profitability at the originator level. Eliminating the use of prepay penalties would cause more repercussions than merely raising coupons while impairing lender liquidity and profitability. Without prepayment penalties some "challenged" borrowers could be priced out of the market and homeownership would be made unnecessarily more expensive for others. Many of the smaller lenders would experience significant financial stress given the reduced margins in the remaining volume. The decreased profitability to the sector would ultimately be paid for at the consumer level with fewer opportunities for the most distressed borrowers.

About Pentalpha Capital Group:

Pentalpha is an independent investment advisory and consulting firm founded in 1994. The firm specializes in complex loan and bond structures and is a consultant to leading investors, originators, servicers, and insurers of structured finance products. A more detailed description of Pentalpha can be found at www.pentalphaglobal.com.

Wall Street Analytics – an independent software development company specializing in the structured finance sector of the fixed income industry, was responsible for building the cash flow engine used in this report.

Appendix A



Home Equity Prepayment Curve (HEP)
35%
30%
25%
20%
15%
10%
5%
0%
CPR
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30
Month
20 HEP
30 HEP

Appendix B

Proceeds Analysis: Wholesale vs Securitization
Effect of Prepayment Speed and Prepayment Penalty Income on Securitization Economics

With Prepayment Penalties, Collateral Run at 20 HEP

Assumptions:	
WAC on Collateral:	6.49%
Collateral Type:	Fixed
Pricing Speed:	20 HEP

Discount Rates:	
Servicing:	8.00%
Prepayment Penalties:	8.00%
Residual:	18.00%

	Origination Costs	Proceeds from Loan Sale	Net Proceeds to Originator
Loan Originated	($100.00)		
Fees to Brokers	($1.00)		
Costs to Produce	($2.00)	$104.25	
	($103.00)	$104.25	**$1.25**

	Origination Costs		Direct Proceeds from Securitization	Indirect (retained) Proceeds from Securitization	Gross Proceeds from Securitization	Underwriting Costs on the Securitization	Net Proceeds to Originator
		Bond Proceeds	$98.00				
Loan originated at 6.5%	($100.00)	Residual	→	$5.01			
Fees to Brokers	($1.00)	Prepayment Class	→	$0.76			
Costs to Produce	($2.00)	Servicing Strip	→	$1.51		($1.00)	
	($103.00)		$98.00	$7.28	$105.28	($1.00)	**$1.28**

Without Prepayment Penalties, Collateral Run at 30 HEP

Assumptions:	
WAC on Collateral:	6.49%
Collateral Type:	Fixed
Pricing Speed:	30 HEP

Discount Rates:	
Servicing:	8.00%
Prepayment Penalties:	8.00%
Residual:	18.00%

	Origination Costs	Proceeds from Loan Sale	Net Proceeds to Originator
Loan Originated	($100.00)		
Fees to Brokers	($1.00)		
Costs to Produce	($2.00)	$102.30	
	($103.00)	$102.30	**($0.70)**

	Origination Costs		Direct Proceeds from Securitization	Indirect (retained) Proceeds from Securitization	Gross Proceeds from Securitization	Underwriting Costs on the Securitization	Net Proceeds to Originator
		Bond Proceeds	$98.00				
Loan originated at 6.5%	($100.00)	Residual	→	$4.20			
Fees to Brokers	($1.00)	Prepayment Class	→	$0.00			
Costs to Produce	($2.00)	Servicing Strip	→	$1.10		($1.00)	
	($103.00)		$98.00	$5.30	$103.30	($1.00)	**($0.70)**

**This example is for illustration purposes only and is not intended to accurately represent the margins actually realized by issuers.*

**Cash flows were generated assuming no losses.*

**If the retained classes were to be pledged to a Net Interest Margin securitization, additional costs (interest rate caps, securitization fees) would be borne that are not represented here*

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