FEDERAL RESERVE BANK *of* CLEVELAND

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VIA E-MAIL

Mr. William R. Breetz, Jr.
Chairman, Uniform Law Commission Drafting Committee
for Home Foreclosure Procedures Act
University of Connecticut School of Law
Knight Hall Room 202
35 Elizabeth Street
Hartford, CT 06105

Re: Draft of the Home Foreclosure Procedures Act dated June 5, 2014 ("Act")

Dear Mr. Breetz:

In anticipation of consideration of the Act by the National Conference of Commissioners on Uniform State Law at its annual meeting later this month, I provide these comments on section 606 of the Act related to the effect of the holder in due course rule on home mortgage loans.[1] I plan to attend the Commission's annual meeting as an observer. I look forward to listening to the discussion of these matters at the annual meeting.

As a preliminary matter, I appreciate the perseverance of the Chair, Reporters, and Drafting Committee in working to formulate a middle-ground proposal limiting the holder in due course rule as requested by the Commissioners during their annual meeting in 2013. The three alternatives and accompanying notes set forth in the Act reflect many hours of intense discussion among members of the drafting committee and observers. In these discussions, I have argued that there is a need to limit the application of the holder in due course rule to home mortgage loans to better align incentives of market participants by bringing greater accountability to the home mortgage market. The allocation of liability to home loan purchasers gives them incentive to police the practices of originators through due diligence on originators and transactions. My detailed policy arguments are set forth in my previous letters to you dated February 5, 2013 and March 28, 2013. Initially, I favored full abrogation of the holder in due course rule for home mortgage loans. However, my views evolved as I listened to the discussion at meetings of the Drafting Committee. I now support narrowly tailoring the limitation to minimize the impact on the cost and availability of credit. My comments below aim at that objective.

[1] The views expressed herein are my personal views, and not those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

I affirm the common characteristics of all three of the alternatives: (1) limiting the potential liability of a holder in due course to the outstanding loan balance, (2) only applying the new rule prospectively to obligations incurred after the effective date of the Act, and (3) only preserving claims and defenses based on fraud, material misrepresentation, or fundamental breach of promise in connection with the original loan transaction. These things all promote market certainty as to the maximum possible liability, loans subject to preservation of claims and defenses, and types of claims and defenses that may be asserted.

The preservation of fraud claims would make an important change in the law. Currently, the holder in due course rule preserves so-called real defenses, which include "fraud in the factum" (obligor signed the instrument without knowledge of its character or essential terms), but bars so-called personal defenses, which include fraud in the inducement (obligor was aware of the character or essential terms of the instrument, but signed based on false information or deception). Many of the claims that arose during the recent mortgage foreclosure crisis involved fraud in the inducement. For example, many homeowners were told that they were signing a fixed rate obligation when in fact they signed a variable rate obligation. Many other homeowners were misled by statements that they would be able to refinance an obligation within a number of years, when a balloon payment became due, or when an interest rate adjustment occurred.

I recommend adoption of Alternative A as set forth in the Act because it (1) includes a time limit on when a homeowner may raise claims or defenses, (2) only allows for reformation of the obligation or recoupment for economic loss, and (3) gives the homeowner the right to bring a declaratory judgment action. The time limitation of three years from the date of the original transaction, or one year after an adjustment of the interest rate or prepayment fee,[2] promotes market certainty about the longevity of potential liability, allowing the purchasers of obligations to assess and price the risk. Limiting reformation or recoupment to economic loss promotes market certainty about the amount of potential liability. Giving homeowners the ability to seek reformation or recoupment more strongly affirms the homeowner's anticipated bargain than mere protection from a deficiency judgment. The right to bring a declaratory judgment avoids the need for homeowner default in order to assert claims and defenses against a holder in due course. Encouraging performance is a better policy choice for homeowners, creditors, and the housing market than encouraging default. In my opinion, Alternative A satisfactorily balances the policy considerations.

I suggest that a definition of "adjustment of the interest rate on the obligation" should be added to the Act. I am concerned that small adjustments might be used to cut off the one-year period during which claims and defenses are preserved. For instance, an adjustment of one-tenth of a percent on the day after the expiration of three years would seem to trigger the start of the one-year period. Such a change would hardly be noticeable. But a cumulative change of one percent over five years after the date of origination of the obligation could make a difference in a homeowner's ability to repay the obligation. Therefore, I suggest that an "adjustment" should be defined as an aggregate increase of one percent in the interest rate on the obligation. A homeowner should notice a difference of this magnitude, and the period should allow enough time for the homeowner to recognize the change and the consequences.

I also suggest the addition of a springing mechanism for section 606 of the Act – it would become effective in a state only after a minimum number of states adopted it (e.g., ten states). This would provide some protection for a state mortgage market against the withdrawal of purchasers of home mortgage loans from the state. Prospective purchasers might withdraw from a state mortgage market because of the

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[2] The one-year period could start after an adjustment that occurred more than three years after the date of the original transaction (e.g., five years after the date of the original transaction).

expansion in potential liability to deter other states from enacting similar legislation, but it is unlikely that purchasers would withdraw from the market if the limitation on the holder in due course rule applied to a significant segment of the market.

Thank you for this opportunity to comment.

Sincerely,

Mark B Greenlee

Mark B. Greenlee
Vice President and Counsel

cc: Ms. Lucy Grelle