BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE:	July 17, 2009
TO:	Board of Governors
FROM:	Governor Duke Committee on Consumer and Community Affairs
SUBJECT:	Proposed Amendments to Regulation Z (Truth in Lending)

The attached item has been reviewed by members of the Consumer and Community Affairs Committee and is now ready for Board consideration.

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TO: Board of Governors

FROM: Division of Consumer and Community Affairs[*]

SUBJECT: Proposed Amendments to Regulation Z (Truth in Lending)

ACTION REQUESTED: Approval to publish proposed amendments to Regulation Z (Truth in Lending) for public comment. For closed-end mortgage transactions, the amendments would revise the disclosure requirements and address other issues such as loan originators' compensation. For open-end mortgage transactions, the amendments would revise the disclosure requirements and address other issues such as account terminations, suspensions and credit limit reductions, and reinstatement of accounts.

Summary

The goal of the proposed amendments to Regulation Z is to improve the effectiveness of disclosures that creditors provide to consumers at application and throughout the life of a mortgage. The proposed changes are the result of staff's review of the provisions that apply to closed-end credit transactions secured by real property or a dwelling and open-end credit transactions secured by a consumer's dwelling (also known as home-equity lines of credit, or HELOCs). Staff recommends changes to the timing, format, and content of disclosure requirements for both closed-end mortgages and HELOCs.

Closed-End Mortgages

For closed-end mortgages, staff recommends changes to the four main types of credit disclosures governed by Regulation Z: (1) disclosures at application; (2) disclosures within three days after application; (3) disclosures three days before consummation; and (4) disclosures after

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consummation. In addition, staff recommends additional protections related to limits on loan originator compensation.

Disclosures at Application. The proposal contains new requirements and changes to the format and content of disclosures given at application, to make them more meaningful and easier for consumers to use. The proposed changes (which are discussed in detail on pages 18 to 21) include:

- Providing a new one-page Board publication, entitled "Key Questions to Ask about Your Mortgage," which would explain the potentially risky features of a loan.
- Providing a new one-page Board publication, entitled "Fixed vs. Adjustable Rate Mortgages," which would explain the basic differences between such loans and would replace the lengthy Consumer Handbook on Adjustable-Rate Mortgages (CHARM booklet) currently required.
- Revising the format and content of the current adjustable-rate mortgage (ARM) loan program disclosure, including: a requirement that the disclosure be in a tabular question and answer format, a streamlined plain-language disclosure of interest rate and payment information, and a new disclosure of potentially risky features, such as prepayment penalties.

Disclosures within Three Days after Application. The proposal also contains revisions to the TILA disclosures provided within three days after application to make the information clearer and more conspicuous. The proposed changes (which are discussed in detail on pages 21 to 25) include:

- Revising the calculation of the finance charge and annual percentage rate (APR) so that they better capture most fees and costs paid by consumers in connection with the credit transaction.
- Providing a graph that would show consumers how their APR compares to the APRs for borrowers with excellent credit and for borrowers with impaired credit.
- Requiring disclosure of potential changes to the interest rate and monthly payment.
- Disclosing total settlement charges, as is currently required for the Good Faith Estimate (GFE) under the Real Estate Settlement Procedures Act (RESPA) and Regulation X.

- Summarizing key loan features, including the loan term, amount, and type.

- Adopting new format requirements, including rules regarding: type size and use of boldface for certain terms, placement of information, and highlighting certain information in a tabular format.

Disclosures Three Days before Consummation. The proposal would now require creditors to provide a "final" TILA disclosure that the consumer must receive at least three business days before consummation. In addition, two proposed alternatives (which are discussed in detail on pages 25 to 28) include:

- Alternative 1: If any terms change after the "final" TILA disclosures are provided, then another final TILA disclosure would need to be provided that the consumer must receive at least three business days before consummation.

- Alternative 2: If the APR exceeds a certain tolerance or an adjustable-rate feature is added after the "final" TILA disclosures are provided, then another final TILA disclosure would be provided that the consumer must receive at least three business days before consummation. All other changes could be disclosed at consummation.

Disclosures after Consummation. The proposal would change the timing, content and types of notices provided after consummation. The proposed changes (which are discussed in detail on pages 28 to 30) include:

- For ARMs, increasing advance notice of a payment change from 25 to 60 days, and revising the format and content of the ARM interest rate adjustment notice.

- For loans with negative amortization, requiring a monthly statement to provide information about payment options that include the costs and effects of negatively-amortizing payments.

- For creditor-placed property insurance, requiring notice of the cost and coverage of such insurance at least 45 days before imposing a charge for the insurance.

Loan Originator Compensation. The proposal contains new limits on originator compensation. The proposed changes (which are discussed in detail on pages 30 to 33) include:

- Prohibiting certain payments to a mortgage broker or a loan officer that are based on the loan's terms and conditions.

- Prohibiting a mortgage broker or loan officer from "steering" consumers to transactions that are not in their interest in order to increase the mortgage broker's or loan officer's compensation.

Home-Equity Lines of Credit

For HELOCs, staff recommends amendments related to the five main types of HELOC disclosures that would be governed by Regulation Z: (1) disclosures at application; (2) disclosures within three days after application; (3) disclosures at account opening; (4) periodic statements; and (5) change-in-terms notices. Also, the proposal provides additional guidance and protections, including certain changes to disclosure requirements, related to account terminations, suspensions and credit limit reductions, and reinstatement of accounts.

Disclosures at Application. The proposal contains several changes to the disclosures currently required at the time that a consumer applies for a HELOC. The proposed changes (which are discussed in detail on pages 34 to 35) include:

- Eliminating the requirement to provide a dense, multiple-page disclosure of generic rates and terms of the creditor's HELOC products, as well as the requirement to provide a Board-published, lengthy brochure explaining HELOC products and risks.
- Requiring the creditor to provide at application a new one-page Board publication summarizing basic information and risks regarding HELOCs, entitled "Key Questions to Ask about Home Equity Lines of Credit."

Disclosure within Three Days after Application. The proposal also replaces the disclosure of generic rates and terms with a new transaction-specific disclosure that must be given within three days after application. The proposed changes (which are discussed in detail on pages 35 to 37) include:

- Providing information about rates and fees, payments, and risks in a tabular format.
- Highlighting whether the consumer will be responsible for a balloon payment.
- Presenting payment examples based on both the current rate available and the maximum possible rate for the HELOC.

Disclosures at Account Opening. The proposal would retain the existing requirement to provide consumers with transaction-specific information about rates, terms, payments, and risks at the time of account opening. To facilitate comparison, the proposal would prescribe formatting for this information similar to that of the proposed disclosure provided within three business days after application. The proposed changes are discussed in detail on pages 38 to 40.

Periodic Statements. The proposal contains changes to the format and content of the periodic statement for HELOCs, largely conforming to the periodic statement provisions finalized in the December 2008 final rule for credit cards (December 2008 Open-End Final Rule). The proposed changes (which are discussed in detail on pages 40 to 43) include:

- Eliminating the disclosure of the effective annual percentage rate.
- Grouping interest charges and fees separately and requiring disclosure of separate totals of interest and fees for both the period and the year to date.

Change-in-Terms Notices. The proposal contains changes to the format and content of the change-in-terms notice, largely conforming to the change-in-terms provisions finalized in the December 2008 Open-End Final Rule. In addition, the proposal would increase advance notice of a change in a HELOC term from 15 to 45 days in advance of the effective date of the change. The proposed changes are discussed in detail on pages 44 to 46.

Account Terminations. The proposal would prohibit creditors from terminating an account for payment-related reasons until the consumer has failed to make a required minimum periodic payment for more than 30 days after the due date for that payment. Staff is recommending that the Board request comment on whether a delinquency threshold of more than 30 days or some other time period is appropriate. The proposed changes are discussed in detail on page 47.

Suspensions and Credit Limit Reductions. The proposal contains a number of additional protections related to temporary suspensions of advances and credit limit reductions. The proposed changes (which are discussed in detail on pages 47 to 50) include:

- Establishing a new safe harbor for suspending or reducing a line of credit based on a "significant" decline in property value. For HELOCs with a combined loan-to-value ratio at origination of 90 percent or higher, a five percent decline in the property value would be "significant."

- Providing additional guidance regarding the information on which a creditor may rely to take action based on a material change in the consumer's financial circumstances, such as the type of credit report information that would be appropriate to consider.

Reinstatement of Accounts. The proposal contains additional requirements regarding reinstating accounts that have been temporarily suspended or reduced. The proposed changes (which are discussed in detail on page 50) include:

- Requiring additional information in notices of suspension or reduction about consumers' ongoing right to request reinstatement and creditors' obligation to investigate this request.

- Requiring creditors to complete an investigation of a request within 30 days of receiving a request for reinstatement and to give a notice of the investigation results to consumers whose lines will not be reinstated.

Background

The Truth in Lending Act

Congress enacted the Truth in Lending Act (TILA) based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. One of the purposes of TILA is to provide a meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit.

TILA's disclosures differ depending on whether consumer credit is an open-end (revolving) plan or a closed-end (installment) loan. TILA is implemented by the Board's Regulation Z. An Official Staff Commentary interprets the requirements of Regulation Z. By statute, creditors that follow in good faith Board or official staff interpretations are insulated from civil liability, criminal penalties, or administrative sanctions.

<u>The Board's Rulemaking Authority</u>

TILA mandates that the Board prescribe regulations to carry out the purposes of the act. TILA specifically authorizes the Board, among other things, to do the following:

- Issue regulations that contain such classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with the act, or prevent circumvention or evasion.

- Exempt from all or part of TILA any class of transactions if the Board determines that TILA coverage does not provide a meaningful benefit to consumers in the form of useful information or protection. The Board must consider factors identified in the act and publish its rationale at the time it proposes an exemption for comment.

- Require additional disclosures for HELOC plans.

In addition, TILA authorizes the Board to prohibit acts or practices in connection with:

- Mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of the Home Ownership and Equity Protection Act (HOEPA) of 1994; and

- Refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.

<u>The Board's Review of Regulation Z</u>

The Board has amended Regulation Z numerous times since TILA simplification in 1980. In 1987, the Board revised Regulation Z to require special disclosures for closed-end adjustable-rate mortgages secured by the borrower's principal dwelling. In 1989, the Board revised Regulation Z to implement the Home Equity Loan Consumer Protection Act of 1988. The 1989 revisions required creditors to disclose extensive information about HELOCs to consumers, and imposed substantive limitations on HELOC creditors – principally, by prohibiting changes in terms except under very limited circumstances. In 1995, the Board revised Regulation Z to implement HOEPA's changes to TILA. HOEPA requires special disclosures and substantive protections for home-equity loans and refinancing with APRs or points and fees above certain statutory thresholds. Numerous other amendments have been made over the years to address new mortgage products and other matters, such as abusive lending practices in the mortgage and home equity markets.

The Board's current review of Regulation Z was initiated in December 2004 with an advance notice of proposed rulemaking.[1] At that time, the Board announced its intent to conduct its review of Regulation Z in stages, focusing first on the rules for open-end (revolving) credit accounts that are not home-secured, chiefly general-purpose credit cards and retailer credit card plans. In December 2008, the Board approved final rules for open-end credit that is not home-secured.

Beginning in 2007, the Board proposed revisions to the rules for closed-end credit in several phases.

- HOEPA. In 2007, the Board proposed rules under HOEPA for high-cost mortgage loans (2007 HOEPA Proposed Rule). The final rules, approved in July 2008 (2008 HOEPA Final Rule), prohibited certain unfair or deceptive lending and servicing practices in connection with closed-end mortgages. The Board also approved revisions to advertising rules for both closed-end and open-end home-secured loans to ensure that advertisements contain accurate and balanced information and do not contain misleading or deceptive representations. The final rules also required creditors to provide consumers with transaction-specific disclosures early enough to use while shopping for a mortgage.

[1] The review was initiated pursuant to requirements of section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, section 610(c) of the Regulatory Flexibility Act of 1980, and section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. An advance notice of proposed rulemaking is published to obtain preliminary information prior to issuing a proposed rule or, in some cases, deciding whether to issue a proposed rule.

- Timing of Disclosures for Closed-End Mortgages. On May 7, 2009, the Board approved final rules implementing the Mortgage Disclosure Improvement Act of 2008 (the MDIA). The MDIA adds to the requirements of the 2008 HOEPA Final Rule regarding transaction-specific disclosures. Among other things, the MDIA and the final rules require early, transaction-specific disclosures for mortgage loans secured by dwellings even when the dwelling is not the consumer's principal dwelling, and require waiting periods between the time when disclosures are given and consummation of the transaction.

This proposal would revise the rules for disclosures for closed-end credit secured by real property or a consumer's dwelling and open-end credit secured by a consumer's dwelling. Staff anticipates reviewing the rules for rescission and reverse mortgages in a subsequent phase of the Regulation Z review.

Coordination with Disclosures Required under the Real Estate Settlement Procedures Act

Staff recommends that the Board work with the Department of Housing and Urban Development (HUD) to ensure that TILA and the Real Estate Settlement Procedures Act of 1974 (RESPA) disclosures are compatible and complementary, including potentially developing a single disclosure form that creditors could use to combine the initial disclosures required under TILA and RESPA. The two statutes have different purposes but have considerable overlap. Harmonizing the two disclosure schemes would ensure that consumers receive consistent information under both laws. It may also help reduce information overload by eliminating some duplicative disclosures. Consumer testing would be used to ensure that consumers could understand and use the combined disclosures. In the meantime, however, staff recommends that the Board include a revised model TILA form in its proposal, so that commenters can see how the Board's proposed revisions to Regulation Z might be applied in practice.

RESPA, which is implemented by HUD's Regulation X, seeks to ensure that consumers are provided with timely information about the nature and costs of the settlement process and are protected from unnecessarily high real estate settlement charges. To this end, RESPA mandates that consumers receive information about the costs associated with a mortgage loan transaction, and prohibits certain business practices. Under RESPA, creditors must provide a good faith estimate (GFE) of settlement costs within three business days after a consumer submits a written application for a mortgage loan, which is the same time creditors must provide the early TILA disclosure. RESPA also requires a statement of the actual costs imposed at loan settlement (HUD-1 settlement statement). In November 2008, HUD published revised RESPA rules, including new GFE and HUD-1 settlement statement forms, which lenders, mortgage brokers, and settlement agents must use beginning on January 1, 2010. In addition to revised disclosures of settlement costs, the revised GFE now includes loan terms, some of which would also appear on a TILA disclosure, such as whether there is a prepayment penalty and the borrower's interest rate and monthly payment. The revised GFE form was developed through HUD's consumer testing.

TILA, which is implemented by the Board's Regulation Z, governs the disclosure of the APR and certain loan terms. This proposal contains a revised model TILA form that was developed through consumer testing. In addition to a revised disclosure of the APR and loan terms, the revised TILA disclosure would include the total settlement charges that appear on the GFE required under RESPA. Total settlement charges would be added to the TILA form because consumer testing conducted by the Board found consumers wanted to have settlement charges disclosed on the TILA form.

Staff believes the proposed revised TILA form and HUD's revised GFE represent significant improvements, but overlap between the two forms could be eliminated to reduce information overload and consistency issues. There have been previous efforts to develop a combined TILA and RESPA disclosure form, which were fueled by the amount, complexity, and overlap of information in the disclosures. Under a 1996 congressional directive, the Board and HUD studied ways to simplify and improve the disclosures. In July 1998, the Board and HUD submitted a joint report to Congress that sketched a broad outline intended to be a starting point for consideration of legislative reform of the mortgage disclosure requirements (1998 Joint Report).[2] The 1998 Joint Report included a recommendation for combining and simplifying the RESPA and TILA disclosure forms to satisfy the requirements of both laws. In addition, the 1998 Joint Report recommended that the timing of the TILA and RESPA disclosures be coordinated. Recent regulatory changes addressed the timing issues so that the initial disclosures required under TILA and RESPA would be delivered at the same time.

Consumer Testing

A principal goal for the Regulation Z review is to produce revised and improved mortgage disclosures that consumers will be more likely to understand and use in their decisions, while at the same time not creating undue burdens for creditors. For closed-end mortgages, Regulation Z currently requires creditors to provide at application a generic ARM loan program disclosure and the CHARM booklet. A transaction-specific TILA disclosure is required within three business days of application and at least seven business days before consummation. For HELOCs, creditors must provide generic disclosures regarding various terms and features of the creditor's HELOC plans at application, along with a lengthy, Board-published brochure explaining HELOC products. The creditor does not have to provide a transaction-specific disclosure for HELOCs (i.e., including terms such as the consumer's APR and credit line limit) until the consumer opens the account.

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[2] Bd. of Governors of the Fed. Reserve Sys. and U.S. Dep't of Hous. and Urban Dev., *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act* (1998), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

In 2007, the Board retained a research and consulting firm (ICF Macro) that specializes in designing and testing documents to conduct consumer testing to help the Board's review of Regulation Z. Working closely with staff, ICF Macro conducted several tests in different cities throughout the United States. The closed-end testing consisted of four focus groups and twelve rounds of one-on-one cognitive interviews. The HELOC testing consisted of five rounds of one-on-one cognitive interviews. The goals of these focus groups and interviews were to learn more about how consumers shop for mortgages and HELOCs, what information consumers read when they receive mortgage and HELOC disclosures, and assess their understanding of such disclosures.

The consumer testing groups contained participants with a range of ethnicities, ages, educational levels, and mortgage behaviors, including first-time closed-end mortgage and HELOC shoppers, prime and subprime borrowers, and consumers who had obtained one or more closed-end mortgages or HELOCs. For each round of testing, ICF Macro developed a set of model disclosure forms to be tested. Interview participants were asked to review model forms and provide their reactions, and were then asked a series of questions designed to test their understanding of the content. Data were collected on which elements and features of each form were most successful in providing information clearly and effectively. The findings from each round of interviews were incorporated in revisions to the model forms for the following round of testing.

<u>Development and testing of Regulation Z disclosures</u>. Staff worked with ICF Macro to develop and test several types of disclosures, including:

<u>For closed-end mortgages</u>:

- Two Board publications to be provided at application, entitled "Key Questions to Ask about Your Mortgage" and "Fixed vs. Adjustable Rate Mortgages";

- An ARM loan program disclosure to be provided at application;
- A transaction-specific TILA disclosure that must be provided within three business days of application and at least seven business days before consummation, and that the consumer must receive again within three business days of consummation;
- An ARM interest rate adjustment notice to be provided after consummation; and
- A payment option monthly statement to be provided after consummation.

For HELOCs:

- A Board publication to be provided at application, entitled "Key Questions to Ask about Home Equity Lines of Credit";
- A transaction-specific TILA disclosure to be provided within three business days of application, but no later than at account-opening; and
- A transaction-specific TILA disclosure to be provided at the time the consumer opens the account.

Staff revised two additional HELOC disclosures to be provided after account opening: a periodic statement and a change-in-terms notice that must be provided as applicable. Staff intends to test these two disclosures during the comment period. In addition, staff developed model clauses for proposed notices required in connection with terminating, suspending or reducing accounts, and reinstating accounts, and may test these clauses during the comment period.

Some of the key findings of the consumer testing are summarized below, and in the *Federal Register* notices containing the proposals for closed-end mortgages and HELOCs. ICF Macro will also issue two reports summarizing the results of the testing for closed-end mortgages and HELOCs, respectively, and these reports will be available on the Board's public Web site along with the Regulation Z proposal.

Results of closed-end testing. Consumer testing showed that consumers seldom contact more than one loan originator when looking for a mortgage loan. For consumers who do shop for a mortgage, most end their shopping process at the time of application. Therefore, the proposal requires creditors to provide key information about evaluating loan terms at the time an application form is provided.

Consumer testing also indicated that consumers were most likely to select a loan based on interest rate, monthly payment, loan type (such as fixed-rate or adjustable-rate), and settlement costs. Thus, under the proposal, the revised TILA disclosure would prominently display these features in a tabular format. In addition, the APR would be disclosed in large font and explained in the context of the APR for prime and higher-priced loans. Setting apart the most important terms in this way will better ensure that consumers are apprised of these terms.

Many consumers indicated that they learned at loan closing that their loan terms had changed or their settlement charges had increased. Thus, the proposal would require creditors to provide a final TILA disclosure that the consumer must receive at least three business days before consummation.

Consumer comprehension of the costs and effects of potential rate and payment increases and negatively-amortizing payment options significantly increased when consumers reviewed model forms developed by the Board and ICF Macro. Thus, the proposal would require creditors to provide a revised ARM interest rate adjustment notice, and a payment option monthly statement in a format substantially similar to the model forms.

Results of HELOC testing. Consumer testing showed that consumers seldom contact more than one loan originator when looking for a HELOC and generally go to their current mortgage provider, a prior lender, or a bank with which they have an existing banking relationship. Currently, Regulation Z requires that consumers receive generic HELOC program disclosures and a HELOC brochure at application, but does not require that consumers receive any other disclosures until account opening. Consumer testing indicated that consumers had difficulty understanding and using the information in these dense, lengthy disclosures.

The proposal therefore would require creditors to provide at application a Board publication entitled, "Key Questions to Ask about Home Equity Lines of Credit," which would replace the HELOC brochure with a concise summary of HELOC product characteristics and risks. The proposal also would change the current timing, content, and format of generic HELOC plan disclosures currently required at application. Specifically, the proposal would require creditors to provide a transaction-specific TILA disclosure within three business days of application, but no later than at account opening. To facilitate comparison, a similarly-formatted disclosure would be required to be provided at account opening.

Consumer testing also indicated that most consumers do not fully comprehend how HELOCs work, especially the draw and repayment periods. Thus, under the proposal, the revised TILA disclosure would explain more complicated terms in plain language and present them in a tabular format.

Consumer comprehension of the costs and effects of various terms significantly increased when consumers reviewed model forms developed by the Board and ICF Macro. Thus, the proposal would require creditors to provide a revised periodic statement and change-in-terms notice incorporating formatting – such as the presentation of key information in a table – found effective with other HELOC model disclosures tested, as well as periodic statements and change-in-terms notices tested for the December 2008 Open-End Final Rule.

<u>Additional testing during and after the comment period</u>. During the comment period, staff will work with ICF Macro to conduct additional testing of model disclosures. After receiving comments from the public on the proposal and the proposed disclosure forms, staff will work with ICF Macro to further revise model disclosures based on comments received, and to conduct additional rounds of cognitive interviews to test the revised disclosures. After the cognitive interviews, quantitative testing will be conducted. The goal of the quantitative testing is to measure consumers' comprehension of the newly-developed disclosures relative to existing disclosures with a larger and more statistically representative group of consumers.

<u>Other Outreach and Research Efforts</u>

Staff also solicited input from members of the Board's Consumer Advisory Council on various issues presented by the review of Regulation Z. During 2009, for example, the Council discussed ways to improve disclosures for home-secured credit. In addition, staff met or conducted conference calls with various industry and consumer group representatives throughout the review process leading to this proposal. Staff also reviewed disclosures currently provided by creditors, the Federal Trade Commission's report on consumer testing of mortgage disclosures,[3] HUD's report on consumer testing of the GFE,[4] and other information. In addition, staff reviewed research on home equity lending, and surveys on HELOC usage and trends.[5]

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[3] James M. Lacko and Janis K. Pappalardo, Fed. Trade Comm'n, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Protoype Disclosure Forms* (2007), *available at* http://www.ftc.gov/os/2007/06P025505Mortgage Disclosure Report.pdf.
[4] U.S. Dep't of Hous. and Urban Dev., *Summary Report: Consumer Testing of the Good Faith Estimate Form (GFE)* (2008), *available at* http://www.huduser.org/publications/pdf/Summary_Report_GFE.pdf.
[5] Surveys reviewed include: Brian Bucks et al., *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, FEDERAL RESERVE BULLETIN (Feb. 2009); Alan Greenspan and James Kennedy, *Sources and Uses of Equity Extracted from Homes* (March 2007); Consumer Bankers Ass'n, *Home Equity Loan Study* (2005, 2007); Am. Bankers Ass'n, *ABA Home Equity Lending Survey Report* (2005); Glenn Canner et al., *Recent Developments in Home Equity Lending*, FEDERAL RESERVE BULLETIN (April 1998).

Discussion

The goal of the proposed revisions is to improve the effectiveness of the Regulation Z disclosures that must be provided to consumers for closed-end credit transactions secured by real property or a dwelling and open-end credit transactions secured by a consumer's dwelling. To shop for and understand the cost of credit, consumers must be able to identify and understand the key terms of the mortgage. But the terms and conditions for mortgage transactions can be very complex. The proposed revisions to Regulation Z are intended to provide the most essential information to consumers when the information would be most useful to them, with content and formats that are clear and conspicuous. The proposed revisions are expected to improve consumers' ability to make informed credit decisions and enhance competition among mortgage loan originators. Many of the changes are based on the consumer testing that was conducted in connection with the review of Regulation Z.

In considering the proposed revisions, staff sought to ensure that the proposal would not reduce access to credit, and sought to balance the potential benefits for consumers with the compliance burdens imposed on creditors. For example, the proposed revisions seek to provide greater certainty to creditors in identifying what costs must be disclosed for mortgages, and how those costs must be disclosed. More effective disclosures may also reduce confusion and misunderstanding, which may also ease creditors' costs relating to consumer complaints and inquiries.

I. Closed-End Credit Secured by Real Property or a Dwelling

A. <u>Disclosures at Application</u>

Currently, Regulation Z requires pre-application disclosures only for adjustable-rate transactions. For these transactions, creditors are required to provide the CHARM booklet and a disclosure of twelve items of information at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

Summary of Proposed Revisions

The proposal contains a number of revisions to the format and content of disclosures provided at application, to make the disclosures more meaningful and easier to understand. To address concerns about other risky features in addition to adjustable rates, creditors would be required to provide a new one-page Board publication, entitled "Key Questions to Ask about Your Mortgage." In addition, creditors would be required to provide a one-page Board publication, entitled "Fixed vs. Adjustable Rate Mortgages," to explain the basic differences between fixed-rate and adjustable-rate mortgages. These publications would be provided regardless of whether the consumer is seeking a fixed-rate or adjustable-rate mortgage. Finally, for consumers who express interest in an ARM, creditors would be required to provide a revised ARM loan program disclosure that focuses on interest rate and payment features and key questions about risks.

"Key Questions to Ask about Your Mortgage" publication. Currently, Regulation Z requires pre-application disclosures only for adjustable-rate transactions. Over time, consumers have been provided with more loan choices in addition to adjustable-rate features, but also more potential risks. The proposal would require creditors to provide to consumers a one-page Board publication, entitled "Key Questions to Ask about Your Mortgage." Creditors would be required to provide this publication for all closed-end mortgages, not just adjustable-rate mortgages, before the consumer applies for a loan or pays a nonrefundable fee, whichever is earlier. The publication would inform consumers about the following risky features: interest rate increases, monthly payment increases, interest-only features, negative amortization features, prepayment penalties, balloon payments, and no-documentation or low-documentation loans. To enable consumers to track the presence or absence of potentially risky features throughout the mortgage process, these key questions and answers would also be included in the ARM loan program disclosure and in the transaction-specific TILA disclosure.

"Fixed vs. Adjustable Rate Mortgages" publication. Currently, creditors must provide the CHARM booklet at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier. Consumer testing indicated, however, that consumers find the CHARM booklet too lengthy to be useful. Thus, instead of the CHARM booklet, the proposal would require creditors to provide a one-page Board publication, entitled "Fixed vs. Adjustable Rate Mortgages." The publication would contain a plain-language explanation of the basic differences between fixed-rate and adjustable-rate mortgages.

ARM loan program disclosure. Currently, for each adjustable-rate loan program in which a consumer expresses an interest, creditors must provide a disclosure of twelve items of information, including the index and margin to be used to calculate interest rates and payments, and either a 15-year historical example of rates and payments for a $10,000 loan, or the maximum interest rate and payment for a $10,000 loan originated at the interest rate in effect for the disclosure's identified month and year. Consumer testing indicated that consumers overwhelmingly find the current ARM loan program disclosure unclear and not useful. Consumer testing also showed that consumers do not understand the historical example; they would prefer more information specific to their potential loan. Thus, the proposal would simplify the ARM loan program disclosure to focus on the interest rate and payment and the key questions about risk for the particular loan program. The disclosure would be provided in a tabular question and answer format to enable consumers to easily locate the most important information.

B. <u>Disclosures within Three Days after Application</u>

TILA and Regulation Z currently require creditors to provide an early TILA disclosure within three business days after application and at least seven business days before consummation, and before the consumer has paid a fee other than a fee for obtaining a credit history.[6] If subsequent events make the early TILA disclosure inaccurate, the creditor must provide corrected disclosures before consummation. However, if subsequent events cause the APR to exceed certain tolerances, the creditor must provide a corrected disclosure that the consumer must receive at least three business days before consummation.

The early TILA disclosure and any corrected disclosure (collectively, the "TILA disclosure") must include certain loan information, including the amount financed, the finance charge, the APR, the total of payments, and the amount and timing of payments. The finance charge is the sum of all credit-related charges, but excludes a variety of fees and charges. TILA requires that the finance charge and the APR be disclosed more conspicuously than other information. The APR is calculated based on the finance charge and is meant to be a single, unified number to help consumers understand the total cost of credit.

<u>Summary of Proposed Revisions</u>

The proposal contains a number of revisions to the format and content of TILA disclosures to make them clearer and more conspicuous. Special formatting requirements, consistent terminology, and a minimum 10-point font would ensure that consumers are able to identify and review key loan terms. To better represent the cost of credit, the proposal would

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[6] To ease discussion, the description of the closed-end mortgage disclosure scheme includes the MDIA's recent amendments to TILA and the requirements of the 2008 HOEPA Final Rule that will be effective July 30, 2009.

eliminate exclusions from the finance charge and require a simpler, more inclusive approach. The finance charge would no longer be disclosed more conspicuously than other credit terms, but the disclosure of the APR would be enhanced to improve consumers' comprehension of the cost of credit. To further assist consumers in determining whether the proposed loan is affordable for them, creditors would be required to disclose the interest rate together with the corresponding monthly payment, the loan amount, settlement costs, and the key questions about risk.

Calculation of the finance charge. The proposal contains a number of revisions to the calculation of the finance charge and the disclosure of the finance charge and the APR to improve consumers' understanding of the cost of credit. Under TILA, the "finance charge" is the sum of all charges payable by the consumer that are imposed by the creditor in connection with the credit transaction, but does not include any charges that would be payable in a comparable cash transaction. The finance charge is meant to represent the cost of credit expressed as a dollar amount, and is also used to calculate the APR, which is meant to represent the cost of credit expressed as a yearly percentage rate. Currently, TILA and Regulation Z permit creditors to exclude several fees or charges from the finance charge, including certain fees or charges imposed by third party closing agents; certain premiums for credit or property insurance or fees for debt cancellation or debt suspension coverage, if the creditor meets certain conditions; security interest charges; and real-estate related fees, such as title examination or document preparation fees.

Consumer groups, creditors, and government agencies have long been dissatisfied with the "some fees in, some fees out" approach to the finance charge. Consumer groups and others believe that the current approach obscures the true cost of credit. They contend that this approach creates incentives for creditors to shift the cost of credit from the interest rate to ancillary fees excluded from the finance charge. They further contend that this approach undermines the purpose of the APR, which is to express in a single figure the total cost of credit. Creditors maintain that consumers are confused by the APR, and, thus, believe that the current approach creates significant regulatory burdens. They contend that determining which fees are or are not included in the finance charge is overly complex and creates litigation risk.

For these reasons, staff recommends the Board use its exception and exemption authority to override exclusions to the finance charge for closed-end mortgages, including HOEPA loans.[7] The proposal would maintain TILA's definition of a finance charge as a fee or charge that is payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to the extension of credit. However, the proposal would now require the finance charge to include charges by third parties if the creditor requires the use of a third party as a condition of or incident to the extension of credit (even if the consumer chooses the third party), or if the creditor retains a portion of the third-party charge (to the extent of the portion retained). Charges that would be incurred in a comparable cash transaction, such as transfer taxes, would continue to be excluded from the finance charge. Under this approach, consumers would benefit from having a finance charge and APR disclosure that better represent the cost of credit, undiluted by myriad exclusions for various fees and charges. This approach would cause more loans to be subject to the special protections of the Board's 2008 HOEPA Final Rule, special disclosures and restrictions for HOEPA loans, and certain state anti-predatory lending laws. However, the proposal would also reduce compliance burdens, regulatory uncertainty, and litigation risks for creditors.

[7] HOEPA loans are closed-end, non-purchase money mortgages secured by the consumer's principal dwelling, that have APRs or points and fees that exceed certain statutory triggers.

Disclosure of the finance charge and the APR. Currently, creditors are required to disclose the loan's "finance charge" and "annual percentage rate," using those terms, more conspicuously than the other required disclosures. Consumer testing indicated that consumers do not understand the term "finance charge." Most consumers believe the term refers to the total of all interest they would pay if they keep the loan to maturity, but do not realize that it includes the fees and costs associated with the loan. For these reasons, the proposal replaces the term "finance charge" with "interest and settlement charges" to make clear it is more than interest, and the disclosure would no longer be more conspicuous than the other required disclosures.

In addition, the disclosure of the APR would be enhanced to improve consumer comprehension of the cost of credit. Under the proposal, creditors would be required to disclose the APR in 16-point font in close proximity to a graph that compares the consumer's APR to the HOEPA average prime offer rate for borrowers with excellent credit and the HOEPA threshold for higher-priced loans.[8] This disclosure would put the APR in context and help consumers understand whether they are being offered a loan that comports with their creditworthiness.

Interest rate and payment summary. Currently, creditors are required to disclose the number, amount, and timing of payments scheduled to repay the loan. Under the MDIA's amendments to TILA, creditors will be required to provide examples of adjustments to the regular required payment based on the change in interest rates specified in the contract. Consumer testing consistently indicated that consumers shop for and evaluate a mortgage based on the contract interest rate and the monthly payment, but consumers have difficulty understanding such terms using the current TILA disclosure. Under the proposal, creditors would be required to disclose in a tabular format the contract interest rate together with the

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[8] The "average prime offer rate" is a survey-based estimate of rates currently offered on low-risk prime mortgages. A "higher-priced loan" is a first-lien mortgage with an APR that is 1.5 percentage points or more above the average prime offer rate, or a subordinate-lien loan that is 3.5 percentage points or more above the average prime offer rate.

corresponding monthly payment, including escrows for taxes and property and/or mortgage insurance. Special disclosure requirements would be imposed for adjustable-rate or step-rate loans to show the interest rate and payment at consummation, the maximum interest rate and payment at first adjustment, and the highest possible maximum interest rate and payment. Additional special disclosures would be required for loans with negatively-amortizing payment options, introductory interest rates, interest-only payments, and balloon payments.

Disclosure of other terms. In addition to the interest rate and monthly payment, consumer testing indicated that consumers benefit from the disclosure of other key terms in a clear format. Thus, the proposal would require creditors to provide in a tabular format information about the loan amount, the loan term, the loan type (such as fixed-rate), the total settlement charges, and the maximum amount of any prepayment penalty. In addition, creditors would be required to disclose in a tabular question and answer format the "Key Questions about Risk," which would include a disclosure of information about interest rate increases, payment increases, and prepayment penalties, and, as applicable, interest-only payments, negative amortization, balloon payments, demand features, no-documentation or low-documentation loans, or shared-equity or shared-appreciation features.

C. Disclosures Three Days before Consummation

Under the MDIA's amendments to TILA, the creditor will be required to provide the TILA disclosure to the consumer within three days after receiving the consumer's written application and at least seven business days before consummation, and before the consumer has paid a fee other than a fee for obtaining a credit history (early TILA disclosure). If the APR on the early TILA disclosure exceeds a certain tolerance before consummation, the creditor must provide a corrected disclosure that the consumer must receive at least three days before consummation. If any term other than the APR becomes inaccurate, the creditor must give the corrected disclosure no later than at consummation.

Summary of Proposed Revisions

The proposal offers for comment two alternative approaches to address concerns about consumers facing settlement costs or loan terms at closing that differ from those that were disclosed in the early TILA disclosure. Both proposals would require the creditor to provide a final TILA disclosure that the consumer must receive at least three business days before consummation, even if subsequent events do not make the early TILA disclosure inaccurate. Under the first approach, if any terms change during this three-business-day waiting period, the creditor would be required to provide another final TILA disclosure and three-business-day waiting period. Under the second approach, the creditor would be required to provide another final TILA disclosure and three-business-day waiting period only if the APR exceeds a certain tolerance or the creditor adds an adjustable-rate feature.

Timing of disclosure. Currently, creditors are required to provide the early TILA disclosure within three days of receiving the consumer's written application or before consummation, whichever is earlier. If any term of the TILA disclosure becomes inaccurate, the creditor must provide a corrected disclosure before consummation, which is, in effect, at closing. Under the MDIA's amendments to TILA, effective July 30, 2009, the creditor will be required to provide the early TILA disclosure to the consumer within three days after receiving the consumer's written application and at least seven business days before consummation, and before the consumer has paid a fee other than a fee for obtaining a credit history. If the APR on the early TILA disclosure exceeds a certain tolerance before consummation, the creditor must provide a corrected disclosure that the consumer must receive at least three days before consummation. If any term other than the APR becomes inaccurate, the creditor must give the corrected disclosure no later than at consummation. The consumer may waive the seven- and three-day waiting periods for a bona fide personal financial emergency.

There are, however, long-standing concerns about consumers facing different loan terms or increased settlement costs at closing. Members of the Board's Consumer Advisory Council, participants in public hearings, and commenters on prior Board rulemakings have expressed concern about consumers not learning of changes to credit terms or settlement charges until consummation. In addition, consumer testing indicated that consumers are often surprised at closing by changes in important loan terms, such as the addition of an adjustable-rate feature. Despite these changes, consumers report that they have proceeded with closing because they lacked alternatives (especially in the case of a home purchase loan), or were told that they could easily refinance with better terms in the near future.

For these reasons, the proposal would require the creditor to provide a "final" TILA disclosure that the consumer must receive at least three business days before consummation, even if nothing has changed since the early TILA disclosure was provided. In addition, staff recommends two alternative approaches to address changes to loan terms and settlement charges during the three-business-day waiting period. Under the first approach, if any terms change during the three-business-day waiting period, the creditor would be required to provide another final TILA disclosure and wait an additional three-business-days before consummation could occur. This proposal would enable consumers to know their loan terms and total settlement charges with certainty three days before consummation and have a meaningful opportunity to make an informed credit decision. If the terms or costs did not match the previous TILA disclosures, the consumer could contact the creditor and seek clarification or take other action.

This proposal would delay closing, which would inconvenience some consumers for potentially minor changes. It appears, however, that the cost would be outweighed by the benefit to consumers of knowing the final cost of credit in advance of consummation.

Staff also recommends seeking comments on an alternative proposal. Under the second approach, creditors would be required to provide another final TILA disclosure, but would have to wait an additional three-business-days before consummation only if the APR exceeds tolerance or the creditor adds an adjustable-rate feature. Otherwise, the creditor would be permitted to provide another final TILA disclosure at consummation. This proposal would avoid inconveniencing consumers and increasing costs unless changes were made to key terms of the loan.

D. Disclosures after Consummation

Regulation Z requires certain notices to be provided after consummation. Currently, for adjustable-rate transactions, creditors are required to provide a notice of an interest rate adjustment at least 25, but no more than 120, calendar days before a payment at a new level is due. There are no disclosure requirements for other post-consummation events.

Summary of Proposed Revisions

The proposal seeks to address concerns that consumers may not have enough time to evaluate the effects and costs of post-consummation events that impact their payments. Thus, under the proposal, creditors would be required to provide the ARM interest rate adjustment notice in a revised format at least 60 days before payment at a new level is due. To address concerns about the impact of negatively-amortizing payments, creditors would be required to provide a statement not later than 15 days before a periodic payment is due for a negatively-amortizing payment option loan. Finally, to address concerns about the cost of creditor-placed property insurance, creditors would be required to provide notice of the cost and coverage of such insurance at least 45 days before a charge is imposed for the insurance.

ARM interest rate adjustment notice. Currently, for adjustable-rate transactions, creditors are required to provide a notice of interest rate adjustment at least 25, but no more than 120, calendar days before a payment at a new level is due. In addition, creditors must provide an adjustment notice at least once each year during which an interest rate adjustment is implemented without an accompanying payment change. These disclosures must include certain information, including the current and prior interest rates and the index values upon which the current and prior interest rates are based.

Staff recommends that creditors be required to provide the ARM interest rate adjustment notice at least 60 days before payment at a new level is due. This proposal seeks to address concerns that consumers need more than 25 days to seek out a refinancing in the event of a payment adjustment. This notice is particularly critical for subprime borrowers who may be more vulnerable to payment shock and may have a more difficult time refinancing a loan. To improve consumer comprehension, the proposal would require creditors to use a revised notice that would contain a table with a comparison of current and new interest rate and payment information, along with the due date for the new payment.

Payment option statement. Currently, creditors are not required to provide disclosures after consummation for negatively-amortizing loans, such as payment option loans. To ensure consumers receive information about the risks associated with payment option loans, (e.g., payment shock), the proposal would require creditors to disclose a periodic statement for negatively-amortizing loans. The disclosure would contain a table with a comparison of the amount and impact on the loan balance and property equity of a fully-amortizing payment, an interest-only payment, and a minimum negatively-amortizing payment. This disclosure would be provided not later than 15 days before a periodic payment is due.

Creditor-placed property insurance notice. Creditors are not currently required under Regulation Z to provide notice before charging for creditor-placed property insurance. Industry reports indicate that the volume of creditor-placed property insurance has increased significantly. Consumers struggling financially may fail to pay required property insurance premiums unaware that creditors have the right to obtain such insurance on their behalf and add the premiums to their outstanding loan balance. Such premiums are often considerably more expensive than premiums for insurance obtained by the consumer. Thus, under the proposal, creditors would be required to provide notice to consumers of the cost and coverage of creditor-placed property insurance at least 45 days before a charge is imposed for such insurance. In addition, creditors would be required to provide consumers with evidence of such insurance within 15 days of imposing a charge for the insurance.

E. Prohibitions on Payments to Loan Originators and Steering

Currently, creditors pay commissions to loan originators in the form of "yield spread premiums." A yield spread premium is the present dollar value of the difference between the lowest interest rate a wholesale lender would have accepted on a particular transaction and the interest rate a mortgage broker actually obtained for the lender. Some or all of this dollar value is usually paid to the mortgage broker by the creditor as a form of compensation, though it may also be applied to other closing costs.

Yield spread premiums can create financial incentives to steer consumers to riskier loans for which the loan originators will receive greater compensation. Consumers generally are not aware of the loan originators' conflict of interest and cannot reasonably protect themselves against it. Yield spread premiums may provide some benefit to consumers because consumers do not have to pay loan originators' compensation in cash or through financing. However, this benefit may be outweighed by costs to consumers, such as when consumers pay a higher interest rate or obtain a loan with terms the consumer may not have chosen otherwise, such as a prepayment penalty or an adjustable rate.

In response to these concerns, the 2007 HOEPA Proposed Rule attempted to address the potential unfairness through disclosure. The proposal would have prohibited a creditor from paying a mortgage broker more than the consumer had previously agreed in writing that the mortgage broker would receive. A mortgage broker would have had to enter into the written agreement with the consumer before accepting the consumer's loan application and before the consumer paid any fee in connection with the transaction (other than a fee for obtaining a credit report). The broker also would have disclosed (1) that the consumer ultimately would bear the cost of the entire compensation even if the creditor paid part of it directly; and (2) that a creditor's payment to a broker could influence the broker to offer the consumer loan terms or products that would not be in the consumer's interest or the most favorable the consumer could obtain.

Based on analysis of comments received on the 2007 HOEPA Proposed Rule, the results of consumer testing, and other information, the Board withdrew the proposed provisions relating to broker compensation in the 2008 HOEPA Final Rule. In particular, the Board's consumer testing raised concerns that the proposed agreement and disclosures would confuse consumers and undermine their decision-making rather than improve it. Consumers often concluded, erroneously, that brokers are more expensive than creditors. Many also believed that brokers would serve their best interests notwithstanding the conflict resulting from the relationship between interest rates and brokers' compensation.[9] The proposed disclosures presented a significant risk of misleading consumers regarding both the relative costs of brokers and lenders and the role of brokers in their transactions. In withdrawing the broker compensation provisions of the 2007 HOEPA Proposed Rule, the Board stated it would continue to explore available options to address potential unfairness associated with loan originator compensation arrangements.

To address the concerns related to loan originator compensation, staff recommends the Board prohibit payments to mortgage brokers and to creditors' employees who originate loans (collectively, "loan originators") that are based on the loan's terms and conditions. Staff also recommends the Board prohibit loan originators from "steering" consumers to transactions that are not in consumers' interest in order to increase the loan originators' compensation. These rules would be proposed under the Board's HOEPA authority to prohibit unfair or deceptive acts or practices in connection with mortgage loans.

To address the potential unfairness that can arise with loan originator compensation, the proposal would prohibit loan originators from receiving compensation based on the credit transaction's terms or conditions. This prohibition would not apply to payments that consumers make directly to loan originators. Staff recommends the Board solicit comment on an alternative that would allow loan originators to receive payments that are based on the principal loan amount, which is a common practice today. If a consumer directly pays the loan originator, the proposal would prohibit the loan originator from also receiving compensation from any other party in connection with that transaction.

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[9] *See* Macro International, Inc., *Consumer Testing of Mortgage Broker Disclosures* (July 10, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf.

Under the proposal, a "loan originator" would include both mortgage brokers and employees of creditors who perform loan origination functions. The 2007 HOEPA Proposed Rule covered only mortgage brokers. However, a creditor's loan officers frequently have the same discretion as mortgage brokers over loan pricing that enables them to modify the loan's terms to increase their compensation, and there is evidence that creditors' loan officers engage in such practices. For this reason, staff recommends the Board apply the prohibition to both mortgage brokers and loan officers.

The proposal would also prohibit loan originators from directing or "steering" consumers to a particular creditor's loan products based on the fact that the loan originator will receive additional compensation even when that loan may not be in the consumer's best interest. Staff recommends the Board solicit comment on whether the proposed rule would be effective in achieving the stated purpose. In addition, staff recommends the Board solicit comment on the feasibility and practicality of such a rule, its enforceability, and any unintended adverse effects the rule might have.

F. <u>Additional Protections</u>

<u>Credit insurance or debt cancellation or debt suspension coverage eligibility for all loan transactions</u>. Currently, creditors may exclude from the finance charge a premium or charge for credit insurance or debt cancellation or debt suspension coverage if the creditor discloses the voluntary nature and cost of the product, and the consumer signs or initials an affirmative request for the product. Concerns have been raised about creditors who sometimes offer products that contain eligibility restrictions, specifically age or employment restrictions, but do not evaluate whether applicants for the products actually meet the eligibility restrictions at the time of enrollment. Subsequently, consumers' claims for benefits may be denied because they did not

meet the eligibility restrictions at the time of enrollment. Consumers are presumably unaware that they are paying for a product for which they will derive no benefit. Under the proposal, creditors would be required to determine whether the consumer meets the age and/or employment eligibility criteria at the time of enrollment in the product and provide a disclosure that such a determination has been made. The proposal is not limited to mortgage transactions and would apply to all closed-end and open-end transactions.

II. Home-Equity Lines of Credit

A. Disclosures at Application

TILA and Regulation Z require creditors to provide to the consumer two types of disclosures at the time of application: a set of disclosures describing various features of a creditor's HELOC plans (the "application disclosures") and a home-equity brochure published by the Board (the "HELOC brochure"), which provides information about how HELOCs work. Neither contains transaction-specific information about the terms of the HELOC, such as the consumer's credit limit or APR.

Summary of Proposed Revisions

Staff recommends that the Board use its adjustment and exception authority to make the changes described below. Specifically, staff recommends replacing the application disclosures with transaction-specific HELOC disclosures ("early HELOC disclosures") that must be given within three business days after application (but no later than account opening). In addition, staff recommends eliminating the requirement for creditors to provide to consumers the HELOC brochure. Instead, the proposal would require a creditor to provide to consumers at application a new one-page document published by the Board entitled, "Key Questions to Ask about Home Equity Lines of Credit" (the "Key Questions" document).

<u>"Key Questions to Ask about Home Equity Lines of Credit" publication</u>. Currently, a creditor is required to provide to a consumer the HELOC brochure or a suitable substitute at the time an application for a HELOC is provided to the consumer. The HELOC brochure is 20 pages long and provides general information about HELOCs and how they work, as well as a glossary of relevant terms and a description of various features that can apply to HELOCs.

The proposal would eliminate the requirement for creditors to provide to consumers the HELOC brochure with applications. The Board's consumer testing on HELOC disclosures has shown that consumers are unlikely to read the HELOC brochure because of its length. Instead, the proposal would require a creditor to provide the new "Key Questions" document that would be published by the Board. This one-page document is intended to be a simple, straightforward and concise disclosure informing consumers about HELOC terms and risks that are important to consider when selecting a home-equity product, including potentially risky features such as adjustable rates and balloon payments. The "Key Questions" document was designed based on consumers' preference for a question-and-answer tabular format, and refined in several rounds of consumer testing.

B. <u>Disclosures within Three Days after Application</u>

Regulation Z currently requires the disclosures that must be provided on or with an application to contain information about the creditor's HELOC plans, including the length of the draw and repayment periods, how the minimum required payment is calculated, whether a balloon payment will be owed if a consumer only makes minimum required payments, payment examples, and what fees are charged by the creditor to open, use, or maintain the plan. These disclosures do not include information dependent on a specific borrower's creditworthiness or the value of the dwelling, such as a credit limit or the APRs offered to the consumer, because the application disclosures are provided before underwriting takes place.

Summary of Proposed Revisions

The Board's consumer testing on HELOC disclosures has shown that, because the current application disclosures do not contain transaction-specific information applicable to the consumer, these disclosures may not provide meaningful information to consumers to enable them to compare different HELOC products and to make informed decisions about whether to open an HELOC plan. Thus, the proposal would replace the application disclosures with transaction-specific "early HELOC disclosures" that must be given within three business days after application (but no later than account opening), and revise the format and content of the disclosures to make them more clear and conspicuous.

Content of proposed early HELOC disclosures. The proposal would require creditors to include several additional disclosures in the early HELOC disclosures not currently required to be disclosed as part of the application disclosures, such as (1) the APRs and credit limit being offered; (2) a statement that the consumer has no obligation to accept the terms disclosed in the early HELOC disclosures; and (3) if the creditor has a provision for the consumer's signature, a statement that a signature by the consumer only confirms receipt of the disclosure statement. Based on consumer testing conducted by the Board on HELOC disclosures, the Board believes that these new disclosures would provide meaningful information to consumers in deciding whether to open a HELOC plan.

The proposal would not require creditors to provide certain disclosures currently required to be disclosed as part of the application disclosures. For example, currently TILA and Regulation Z require the creditor to disclose a 15-year historical payment example table, a statement that the APR does not include costs other than interest, and a statement of the earliest time the maximum rate could be reached. Based on consumer testing, the Board believes that these disclosures do not provide meaningful information to consumers in deciding whether to open a HELOC plan. However, other information that consumer testing demonstrated would be helpful to consumer would be required to be disclosed.

Moreover, the proposal would revise certain information that TILA and Regulation Z currently require be disclosed in the application disclosures and included in the proposed early HELOC disclosures. For example, the application disclosures currently must include several payment examples based on a $10,000 outstanding balance. Staff recommends that the Board require payment examples in the early HELOC disclosures based on the full credit line. Based on consumer testing, staff believes that this revision to the payment examples, and other revisions to the existing application disclosures, would effectively provide meaningful information to consumers in deciding whether to open a HELOC plan.

<u>Format requirements for the proposed early HELOC disclosures</u>. The proposal would impose stricter format requirements for the proposed early HELOC disclosures than currently are required for the application disclosures. The application disclosures may be provided in a narrative form; under the proposal, the early HELOC disclosures must be provided in the form of a table with headings, content, and format developed through multiple rounds of consumer testing. In consumer testing, participants found information in a tabular format easier to understand and had more success answering comprehension questions than when these participants reviewed application disclosures in a narrative form.

C. Disclosures at Account Opening

TILA and Regulation Z require creditors to disclose costs and terms at the time that a HELOC plan is opened. The disclosures must specify the circumstances under which a "finance charge" may be imposed and how it will be determined, including charges such as interest, transaction charges, minimum charges, each periodic rate of interest that may be applied to an outstanding balance (e.g., for purchases or cash advances) as well as the corresponding APR. In addition, creditors must disclose the amount of any charge other than a finance charge, such as a late-payment charge. Currently, few format requirements apply to account-opening disclosures; typically they are interspersed among other contractual terms in the creditor's account agreement.

Summary of Proposed Revisions

Staff recommends that the Board use its authority to require additional disclosures for HELOC plans and to make exceptions and adjustments to revise the account-opening disclosure requirements in two significant ways. First, the proposal would require a tabular summary of key terms. Second, the proposal would reform how and when cost disclosures must be made.

Account-opening summary table. The proposal seeks to make the cost disclosures provided at account opening more conspicuous and easier to read. Accordingly, the proposal identifies specific costs and terms that creditors would be required to summarize in a table. This account opening table would be substantially similar to the early HELOC disclosure table that would be provided within three business days after application, with two major exceptions. First, the account-opening table would show only the payment plan chosen by the consumer, rather than a maximum of two plans required in the early HELOC disclosures. Second, the account-opening table would contain transaction fees and penalty fees not required to be disclosed in the early HELOC disclosure table. Despite these differences between the two tables, the Board believes that consumers could use the new table provided at account opening to compare the terms of their accounts to the early HELOC disclosure table. Consumers would no longer be required to search for the information in the credit agreement.

How charges are disclosed. Under the current rules, a creditor must disclose any “finance charge” or “other charge” in the written account-opening disclosures. In addition, the regulation identifies fees that are not considered to be either “finance charges” or “other charges” and, therefore, need not be included in the account-opening disclosures. The distinctions among finance charges, other charges, and charges that do not fall into either category are not always clear. Examples of included or excluded charges are in the regulation and commentary, but these examples cannot provide definitive guidance in all cases. This uncertainty can pose legal risks for creditors that act in good faith to comply with the law. Creditors are subject to civil liability and administrative enforcement for under-disclosing the finance charge or otherwise making erroneous disclosures, so the consequences of an error can be significant. Furthermore, over-disclosure of rates and finance charges is not permitted by Regulation Z for open-end credit.

The fee disclosure rules also have been criticized as being outdated and impractical. These rules require creditors to provide fee disclosures at account opening, which may be months, and possibly years, before a particular disclosure is relevant to the consumer, such as when the consumer calls the creditor to request a service for which a fee is imposed. In addition, an account-related transaction may occur by telephone, when a written disclosure is not feasible.

The proposed rule is intended to respond to these criticisms while still giving full effect to TILA’s requirement to disclose credit charges before they are imposed. Accordingly, under the proposal, the revised rules would (1) specify precisely the charges that creditors must disclose in writing at account opening (e.g., interest, account-opening fees, transaction fees, annual fees, and penalty fees such as for paying late), which would be listed in the summary table, and; (2) permit creditors to disclose certain optional charges orally or in writing before the consumer agrees to or becomes obligated to pay the charge. These proposals reflect amendments finalized in the December 2008 Open-End Final Rule for open-end (not home-secured) credit; however, they would not change current substantive restrictions on permissible changes in HELOC terms.

D. Periodic Statements

Currently, TILA and Regulation Z require creditors to provide periodic statements reflecting the account activity for the billing cycle (typically, one month). In addition to identifying each transaction on the account, TILA and Regulation Z require creditors to identify "finance charges" assessed against the account during the statement period. Regulation Z requires "finance charges" to be identified as such, as well as disclosure of each "other charge" assessed against the account during the statement period. TILA and Regulation Z require creditors to disclose the periodic rate that applies to an outstanding balance and its corresponding APR, as well as an "effective" or "historical" APR for the billing cycle, which includes not just interest but also finance charges imposed in the form of fees.

Summary of Proposed Revisions

The proposal contains a number of significant revisions to periodic statement disclosures. First, staff recommends that the Board use its adjustment and exception authority to eliminate the requirement to disclose the effective APR for HELOCs. Second, creditors would no longer be required to characterize particular costs on the periodic statement as "finance charges." Instead, costs would be described either as "interest" or as a "fee." Third, interest charges and fees imposed as part of the plan must be grouped together and totals disclosed for the statement period and year to date. To facilitate compliance, the proposal would include sample forms illustrating the revisions.

The effective APR. Under TILA, the "effective" APR disclosed on periodic statements reflects the cost of interest and certain other finance charges imposed during the statement period. For example, for a cash advance, the effective APR reflects both interest and any flat or proportional fee assessed for the advance. For the reasons discussed below, staff recommends eliminating the requirement to disclose the effective APR.

Creditors believe that the effective APR should be eliminated. They believe that consumers do not understand the effective APR, including how it differs from the corresponding (interest rate) APR, why it is often "high," and which fees the effective APR reflects. Creditors say they find it difficult, if not impossible, to explain the effective APR to consumers who call them with questions or concerns. They note that callers sometimes believe, erroneously, that the effective APR signals a prospective increase in their interest rate, and they may make uninformed decisions as a result. And, creditors say, even if the consumer does understand the effective APR, the disclosure does not provide any more information than a disclosure of the total dollar costs for the billing cycle. Moreover, creditors say that the effective APR is arbitrary and inherently inaccurate, principally because it amortizes the cost for credit over only one month (billing cycle) even though the consumer may take several months (or longer) to repay the debt.

Consumer groups acknowledge that the effective APR is not well understood by consumers, but argue that it nonetheless serves a useful purpose by showing the higher cost of some credit transactions. They contend the effective APR helps consumers decide each month whether to continue using the account, to shop for another credit product, or to use an alternative means of payment such as a debit card. Consumer groups also contend that reflecting costs, such as cash advance fees and balance transfer fees, in the effective APR creates a "sticker shock" and alerts consumers that the overall cost of a transaction for the cycle is high and exceeds the advertised corresponding APR. This shock, they say, may persuade some consumers not to use certain features on the account, such as cash advances, in the future. In their view, the utility of the effective APR would be maximized if it reflected all costs imposed during the cycle (rather than only some costs as is currently the case).

As part of consumer testing conducted by the Board on credit cards in relation to the December 2008 Open-End Final Rule, consumer awareness and understanding of the effective APR was evaluated, as well as whether changes to the presentation of the disclosure could increase awareness and understanding. The overall results of this testing demonstrated that most consumers do not understand the effective APR.

Based on this consumer testing and other factors, staff recommends that the Board propose to eliminate the requirement to disclose the effective APR. Under this proposal, creditors offering HELOCs would be required to disclose interest and fees in a manner that is more readily understandable and comparable across institutions. The Board eliminated the effective APR disclosure for open-end (not home-secured) credit in the December 2008 Open-End Final Rule. Staff believes that this approach can more effectively further the goals of consumer protection and the informed use of credit for HELOCs as well.

<u>Fees and interest costs</u>. Currently, creditors must identify on periodic statements any "finance charges" that have been added to the account during the billing cycle; creditors typically

list these charges with other transactions, such as purchases or cash advances, chronologically on the statement. The finance charges must be itemized by type. Thus, interest charges might be described as "finance charges due to periodic rates." Charges such as late-payment fees, which are not "finance charges," are typically disclosed individually and interspersed among other transactions.

Staff drew on consumer testing for open-end (not home-secured) credit, the results of which staff believes apply equally to HELOCs, to recommend a number of changes to the required HELOC disclosures related to finance charges. Under the proposal, creditors would be required to group all charges together and describe them in a manner consistent with consumers' general understanding of costs ("interest charge" or "fee"), without regard to whether the charges would be considered "finance charges," "other charges," or neither. If different periodic rates apply to different types of transactions, creditors would be required to itemize interest charges for the statement period by type of transaction (for example, interest on cash advances) or group of transactions subject to different periodic rates.

In addition, the proposal would require creditors to disclose the total fees and total interest imposed for the cycle, as well as year-to-date totals for interest charges and fees, an amendment finalized for open-end (not home-secured) credit in the December 2008 Open-End Final Rule. The year-to-date figures are intended to help consumers understand annualized costs and the overall cost of their HELOC better than does the effective APR. Staff intends to conduct consumer testing of periodic statement notices for HELOCs during the comment period for this proposal.

E. <u>Change-in-Terms Notices</u>

Currently, Regulation Z requires creditors to send, in most cases, notices 15 days before the effective date of certain changes in the account terms. Advance notice is not required in all cases; for example, if an interest rate increases due to a consumer's default or delinquency, notice has been required, but not in advance of the rate increase. In addition, no notice (either advance or contemporaneous) has been required if the specific change is set forth in the account agreement.

<u>Summary of Proposed Revisions</u>

Staff recommends that the Board propose to revise the change-in-terms rules for HELOCs to parallel in most respects the revisions adopted for open-end (not home-secured) credit in the December 2008 Open-End Final Rule, including the content, timing, and format of such notices. The recommended revisions to change-in-terms notice requirements for HELOCs are intended to improve consumers' awareness about changes to their account terms or increased rates due to delinquency, default, or other reason disclosed in the agreement, and to enhance consumers' ability to make alternative financial choices if necessary.

There are three major components of the proposal regarding change-in-terms notices. First, the proposal would expand the circumstances in which consumers receive advance notice of changed terms, including increased rates. Second, the proposal would provide consumers with earlier notice – 45 days in advance of the effective date of the change rather than 15 days. Third, the proposal would introduce format requirements to make the disclosures about changes in terms, including increased rates, more effective.

<u>Rate increases</u>. Currently, a change-in-terms notice is not required if the agreement between the consumer and the creditor specifically sets forth the change and the specific

triggering event. In the December 2008 Open-End Final Rule, the Board expressed concern that the imposition of penalty rates might come as a costly surprise to consumers who are not aware of, or do not understand, what behavior constitutes a default under the credit agreement. The Board also stated that it believed that consumers would be the most likely to notice and be motivated to act to avoid the imposition of the penalty rate if they receive a specific notice alerting them of an imminent rate increase, rather than a general disclosure stating the circumstances when a rate might increase.

Staff believes that the same reasoning applies in the case of HELOCs, although the circumstances under which a penalty rate may be imposed on a HELOC are more restricted than for credit cards. The HELOC proposal would also require advance notice of any increased rates due to a triggering event specified in the agreement, such as loss of an employee preferred rate because the consumer leaves the creditor's employ.

Timing. Staff recommends that the requirement for notice 15 days in advance of the effective date of a change be changed to require notice 45 days in advance, for the same reasons the Board adopted this requirement for open-end (not home-secured) credit. As discussed in the December 2008 Open-End Final Rule, shorter notice periods, such as 30 days or one billing cycle, may not provide consumers with sufficient time to shop for and possibly obtain alternative financing, or to make other financial adjustments. The 45-day advance notice requirement refers to when the change-in-terms notice must be sent, but it may take several days for the consumer to receive the notice. As a result, staff believes that the 45-day advance notice requirement would give consumers, in most cases, at least one calendar month after receiving a change-in-terms notice to seek alternative financing or otherwise to mitigate the impact of an unexpected change in terms.

Staff also recommends that the Board solicit comment on whether it may be more difficult to seek alternative financing or otherwise mitigate the impact of a change in terms for HELOCs than for credit cards. Staff further recommends the Board solicit comment on whether, because changes in terms are more narrowly restricted for HELOCs than for credit card accounts, the impact on consumers of term changes for HELOCs is likely to be less severe than for credit cards and thus whether the proposed time period is likely adequate.

Format. Few format requirements apply to change-in-terms disclosures. As with account-opening disclosures, creditors commonly intersperse change-in-terms notices with other amendments to the account agreement, and both are provided in pamphlets in small print and dense prose. Consumer testing conducted for the December 2008 Open-End Final Rule suggests that consumers tend to set aside change-in-terms notices when they are presented as a separate pamphlet inserted in the periodic statement. Testing also revealed that consumers are more likely to identify the changes to their account correctly if the changes in terms are summarized in a tabular format.

Staff therefore recommends that the Board propose that if a changed term is one that must be provided in the account-opening summary table, creditors must also provide that change in a summary table to enhance the effectiveness of the change-in-terms notice. Further, if a notice enclosed with a periodic statement discusses a change to a term that must be disclosed in the account-opening summary table, or announces that a default rate will be imposed on the account, a table summarizing the impending change would have to appear on the periodic statement, directly above the transaction list. Staff intends to conduct consumer testing of HELOC change-in-terms notices with a tabular format during the comment period on this proposal.

F. <u>Additional Protections</u>

<u>Account Terminations</u>. TILA and Regulation Z currently permit a creditor to terminate a HELOC for several reasons, including when the consumer has "fail[ed] to meet the repayment terms of the agreement for any outstanding balance." The proposal would interpret this provision to mean that a creditor may not terminate a HELOC plan for payment-related reasons unless the consumer has failed to make a required minimum periodic payment for more than 30 days after the due date for that payment. Staff recommends requesting comment on whether a delinquency threshold of more than 30 days is appropriate or whether some other time period would better achieve the purposes of TILA.

The proposal is principally intended to protect consumers from so-called "hair-trigger" terminations based on minor payment infractions. Overall, the proposal is intended to strike a more equitable balance between creditors' authority to protect themselves against risk (and, for depositories, to ensure their safety and soundness) and effective protection of HELOC consumers from constraints on their credit privileges that do not correspond with reasonable expectations.

<u>Suspensions and credit limit reductions based on a significant decline in the property value</u>. TILA and Regulation Z permit a creditor temporarily to suspend advances or reduce a credit line on a HELOC when "the value of the dwelling that secures the plan declines significantly below the dwelling's appraised value for purposes of the plan." The commentary provides a "safe harbor" standard for determining whether a decline is significant: specifically, a decline in value is significant if it results in the

initial difference between the credit limit and the available equity (the "equity cushion") diminishing by 50 percent.

Concerns have been expressed to staff that the existing safe harbor may not be a viable standard for the higher combined loan-to-value (CLTV) HELOCs made in recent years. For loans nearing or exceeding 100 percent CLTV when originated, for example, a decline in value of a few dollars could result in more than a 50 percent decline in the creditor's equity cushion, because the equity cushion was zero or close to zero at origination. For these higher CLTV loans in particular, creditors have indicated uncertainty about how to determine whether a decline in value is "significant." For their part, consumer advocates have expressed concerns that the lack of guidance on the proper application of the safe harbor allows creditors to take action based on nominal declines in value.

To address these concerns, staff recommends that the Board propose to revise the staff commentary to delineate two "safe harbors" on which creditors could rely to determine whether a decline in property value is "significant":

- First, for plans with a CLTV at origination of 90 percent or higher, a five (5) percent reduction in the property value on which the HELOC terms were based would constitute a significant decline in value.
- Second, for plans with a CLTV at origination of under 90 percent, the existing safe harbor would apply, under which a decline in the value of the property securing the plan is significant if, as a result of the decline, the creditor's equity cushion is reduced by 50 percent.

<u>Suspensions and credit limit reductions based on a material change in the consumer's financial circumstances</u>. TILA and Regulation Z permit a creditor to suspend advances or reduce the credit limit of a HELOC when "the creditor reasonably believes that the consumer will be unable to fulfill the repayment obligations of the plan because

of a material change in the consumer's financial circumstances." Some creditors appear uncertain about when action is permissible under this provision, and many have requested more detailed guidance. Consumer advocates have expressed dissatisfaction with the guidance on this provision as well, voicing concerns that the lack of clear guidance may enable some creditors to take action when consumers are fully capable of meeting their repayment obligations.

The proposal is intended to protect consumers by ensuring that creditors exercise prudent judgment in relying on this provision. Revised commentary would clarify that evidence of a material change in financial circumstances may include credit report information showing late payments or nonpayments on the part of the consumer, such as delinquencies, defaults, or derogatory collections or public records related to the consumer's failure to pay other obligations. The proposed commentary would clarify that any payment failures relied on to show a material change in the consumer's financial circumstances would need to have occurred within a reasonable time from the date of the creditor's review of the consumer's credit performance. A six-month safe harbor for this "reasonable time" would be proposed.

The proposed commentary would retain the existing commentary's guidance stating that evidence supporting a creditor's reasonable belief that a consumer is "unable" to meet the repayment terms may include the consumer's nonpayment of debts other than the HELOC. Under the proposal, these payment failures would have to have occurred within a reasonable time from the date of the creditor's review of the consumer's credit performance, with a proposed six-month safe harbor. Staff recommends requesting comment on whether late payments of 30 days or fewer would be adequate evidence of a failure to pay a debt for purposes of this provision, and whether and under what circumstances credit score declines alone might satisfy the requirements of this provision.

Reinstatement of accounts. Regulation Z requires creditors to reinstate credit privileges once no circumstances permitting a freeze or credit limit reduction under the statute or regulation exist. Recently, due to declining property values and for other reasons, consumers' HELOCs have been suspended and their credit limits reduced more often than in the past. Consumer groups and other federal agencies have raised concerns about whether consumers are properly informed about the creditor's obligation to reinstate credit lines and consumers' rights to request reinstatement, and staff independently researched the reinstatement practices of several HELOC creditors. As a result, staff believes that additional guidance is appropriate. The proposed changes are intended to ensure that consumers have a meaningful opportunity to request reinstatement and to have this request investigated. Major proposed revisions include the following:

- Requiring additional information in notices of suspension or reduction about consumers' ongoing right to request reinstatement and creditors' obligation to investigate this request.
- Requiring creditors to complete an investigation of a request within 30 days of receiving the request and to provide notice of the results to consumers whose credit privileges will not be restored.
- Requiring creditors to cover the costs associated with investigating the first reinstatement request made by the consumer after the line is suspended or reduced.

Conclusion

Staff recommends that the Board publish for public comment the draft proposed amendments to Regulation Z's rules for closed-end credit transactions secured by real property or a dwelling and open-end credit transactions secured by a consumer's dwelling. Staff requests the authority to make minor technical corrections to the *Federal Register* notice as necessary prior to publication to comply with the Paperwork Reduction Act, the Regulatory Flexibility Act, or the Congressional Review Act, or to conform to the requirements of the Office of the Federal Register.